A brief history of regulation

Representing and assisting the buyside at a trade association

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Outline

- The role of financial services trade associations – analysis, assistance, research, promotion and lobbying
- Working for the buyside – who are they?
- The changing emphasis of regulation with particular focus on post-crisis changes and challenges
- Q and As

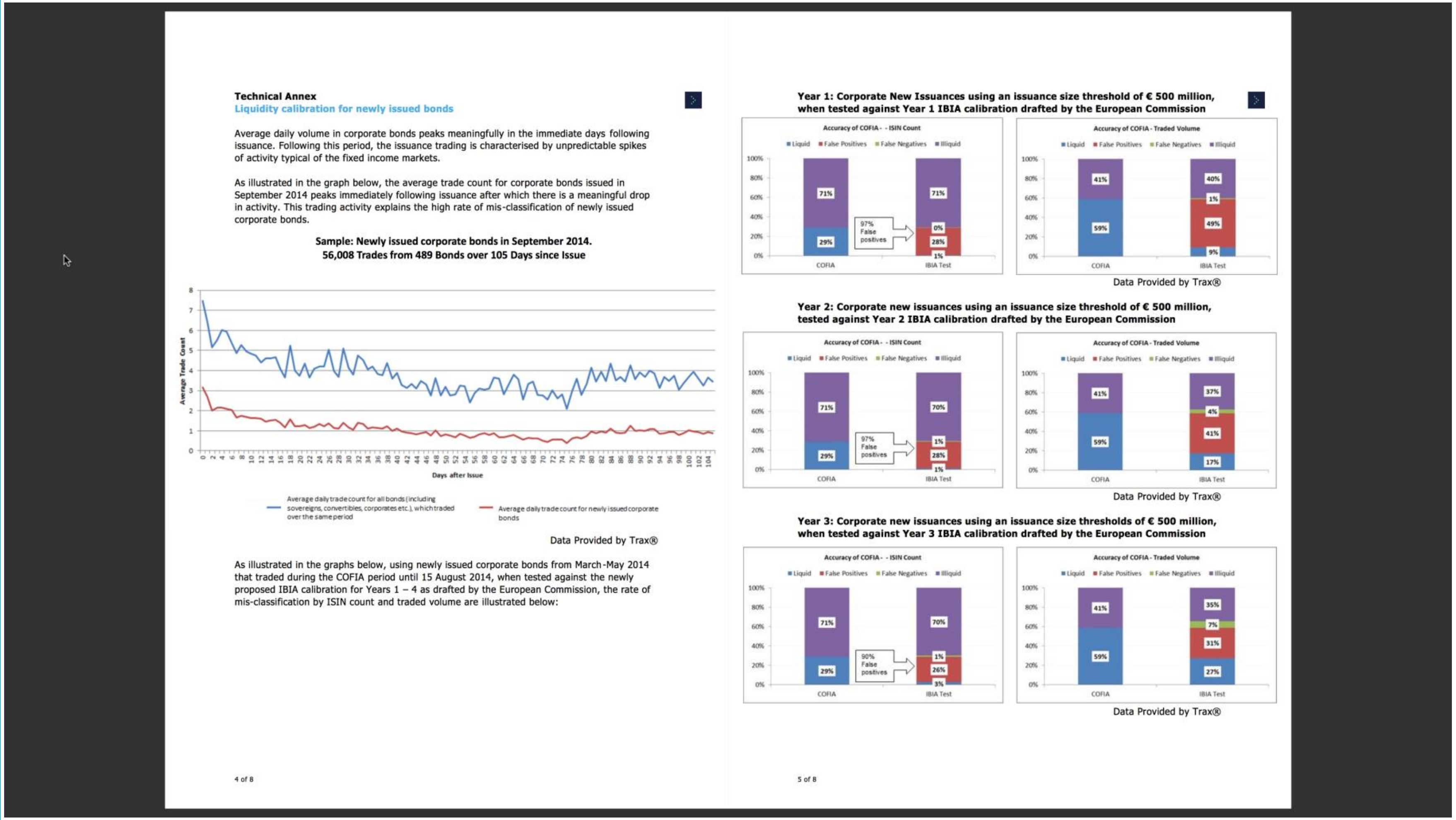
The role of trade associations

- Not-for-profit representatives – of a sector or a product
- Dozens in the City of London but four major sectors:
  - British Bankers Association - banks
  - Association of British Insurers - insurers
  - Association of Financial Markets in Europe – investment banks
  - The Investment Association – asset management
- Owned and governed by members with a permanent staff
- Given the City, all are UK and EU focused
- But also EU-wide groups of TAs – such as European Banking Federation; Insurance Europe; and, the European Funds and Asset Management Association

activities

- Core objectives on themes of promotion and support
- Spokesperson for industry – press and Parliaments
- Publishing industry statistics – monthly fund sales
- Lobbying and public affairs
- Engaging with regulatory and tax consultations
- Providing advice and guidance on rules and practice
- Commissioning research and reports – bond liquidity
- Education and training
- Supporting social initiatives – diversity, apprenticeships, financial exclusion
- @IA – 60 people, £10m pa budget

evidence-based lobbying



Technical Annex

Liquidity calibration for newly issued bonds

Average daily volume in corporate bonds peaks meaningfully in the immediate days following issuance. Following this period, the issuance trading is characterised by unpredictable spikes of activity typical of the fixed income markets.

As illustrated in the graph below, the average trade count for corporate bonds issued in September 2014 peaks immediately following issuance after which there is a meaningful drop in activity. This trading activity explains the high rate of mis-classification of newly issued corporate bonds.

Sample: Newly issued corporate bonds in September 2014.
56,008 Trades from 489 Bonds over 105 Days since Issue

Data Provided by Trax®

As illustrated in the graphs below, using newly issued corporate bonds from March-May 2014 that traded during the COFIA period until 15 August 2014, when tested against the newly proposed IBIA calibration for Years 1 – 4 as drafted by the European Commission, the rate of mis-classification by ISIN count and traded volume are illustrated below:

Year 1: Corporate New Issuances using an issuance size threshold of € 500 million, when tested against Year 1 IBIA calibration drafted by the European Commission

Data Provided by Trax®

Year 2: Corporate new issuances using an issuance size threshold of € 500 million, tested against Year 2 IBIA calibration drafted by the European Commission

Data Provided by Trax®

Year 3: Corporate new issuances using an issuance size thresholds of € 500 million, when tested against Year 3 IBIA calibration drafted by the European Commission

Data Provided by Trax®

guidance and discussion

Investment Management Association

consider with its members whether to provide examples of appropriate oversight models.

Reconciliation

Reconciliation is essential, particularly where CSAs are used

As part of the control function, it is essential to have reconciliation of a) the amounts actually held, for later allocation, with b) records of what should be held. Whether bundled at one provider or operated through one or more CSAs, the balances held need to be reconciled with the trades which generated them on a periodic basis. Investment managers will want to ensure that when payments are made, and these are commonly in batches from CSAs, there is a proper reconciliation with escalation, as might occur for bank balances held by the investment manager.

Of course, the amount and time of a trade is already checked through the need to match trades for settlement purposes.

Documentation

IMA recommends fully documenting any CSAs

Consideration should be given to provisions relating to:

- Who is authorised at the investment manager to direct payments;
- Reporting obligations and standards, including breach and error notifications;
- Dispute resolution clauses;
- Key embedded risks such as foreign exchange rates and responsibilities;
- Clarity as to the existence of credit risk (on which we expand below);
- The timeliness of payments; and,
- Clarity about unused balances.

As mentioned in Section 2, the IMA will consider whether it would be appropriate and beneficial to develop model CSA clauses or a model framework agreement.

Credit risk

Balances at research providers introduce a form of counterparty risk. Formulations such as stating that a broker holds money as client money need to be underpinned by robust legal analysis. CSA balances are not automatically client money and, in order for them to qualify for treatment as such, one requires careful analysis in the context of the FCA's client money rules (with accompanying regulatory guidance) before adoption of such an approach.

Good practice would naturally include checking the creditworthiness of the brokers concerned at appropriate intervals.

The IMA recognises the impact that applying the current FCA rules on client money would have, in terms of cost, administration and risk, and this is an area in which the IMA will carry out further work. The FCA may have the power to impose some form of statutory trust on CSA pools, albeit with a more tailored, simpler regime than for traditional client money. If the IMA's further work supports this, the IMA would then ask the FCA to examine the benefits, costs and proportionality of this.

Timely usage

Expenditure, reporting and escalation procedures at the investment manager can ensure that balances are not allowed to build up beyond approved parameters

An investment manager might determine that it is prudent to direct expenditure frequently. (This will, of course, go a long way towards mitigating the credit risk discussed above.) Procedures should address any residual balances, particularly when those balances are left in place to the next period. CSAs should address this possibility and also whose responsibility it is to identify unused balances.

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Appendix 1: IMA Recommendations to improve current practice

Research vote process

As part of the good practice mentioned in the 'Dear CEO' letter, one firm gave careful consideration as to which services represented valuable inputs to its investment process and challenged brokers about why it should pay for other services.

Certain principles, which reflect the fiduciary nature of discretionary portfolio management, are relevant to the research-vote process. In addition to the duty of investment managers to justify the use of client money as rigorously as the use of their own, one can identify the following:

The method of determining how research providers are rewarded should be aligned with the interests of the investment manager's clients

Monetary budgets should be set at an appropriately granular level, depending upon the nature of the investment process and internal arrangements of the investment manager. For some, a firm-level approach will be adequate; for others, matching budgets and their usage to teams of individual portfolio managers will be more suitable. But there should also be independent review and internal consistency checks, commensurate with the size and nature of the investment manager and its business. The ultimate goal here, of course, remains accountability to customers.

Robust governance models include several 'lines of defence'

In areas of expenditure outside external research, governance would conventionally involve a prior-year budget process, intra-year controls, management information, financial officer oversight, and end-of-year audit. These are expected minima in order to demonstrate stewardship and accountability in the interest of a key stakeholder group – the shareholders.

It is not suggested that these controls be replicated in their entirety for dealing commission. The focus is rather on a control-side dominated oversight process for the entire commission budget, with escalation of management information. For example, control may lie with an independent oversight committee (just as remuneration might be) but a Board might receive reports on research commission spend if similar-sized spend from their balance sheet would be flagged within other reports the Board receives.

Some managers, use a rolling average of expenditure to assist with this, as trading peaks and troughs unrelated to stock selection (for example, driven by large inflows from customers) can distort the numbers over the shorter term.

Embrace wholly qualitative evaluations appropriately

An individual portfolio manager's opinion as to what research was valuable will always be needed. This will also support evaluations as to how well ideas are tailored to any individual's needs. Appropriate internal challenge and internal consistency checks can guard against excessive reliance on opinion alone.

Ensure the commission distribution is tested against objective factors where practicable

Appropriate records, both in type and volume, should be kept (or accessed from brokers) to provide a sense check as to the reasonableness of the value an investment manager ascribes to the broker concerned. Brokers could be asked to supply records of: access to analysts; the commissioning and delivery of bespoke research; and key pieces of research which appeared to be used. Too small an amount of records will of course make it difficult to form a view but, equally, there is a danger of being swamped in data that cannot then be assimilated.

Services which were not used or did not add value to the investment process cannot (under FCA rules) be provided with any distribution of commission. To make this practicable, sampling could check that the services being provided do meet the definition of substantive research.

Provide feedback to research providers in a form and with a frequency which connects the payment made with the resource valued

Whilst investment managers may allocate votes to research providers and tell them how many votes they obtained, it is often far from clear to the broker

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- Limits to the notion of industry
- Lack of evidence - of the counterfactual
- They would say that wouldn't they?
- The role of politicians vs industry – how the crisis was a wake-up call

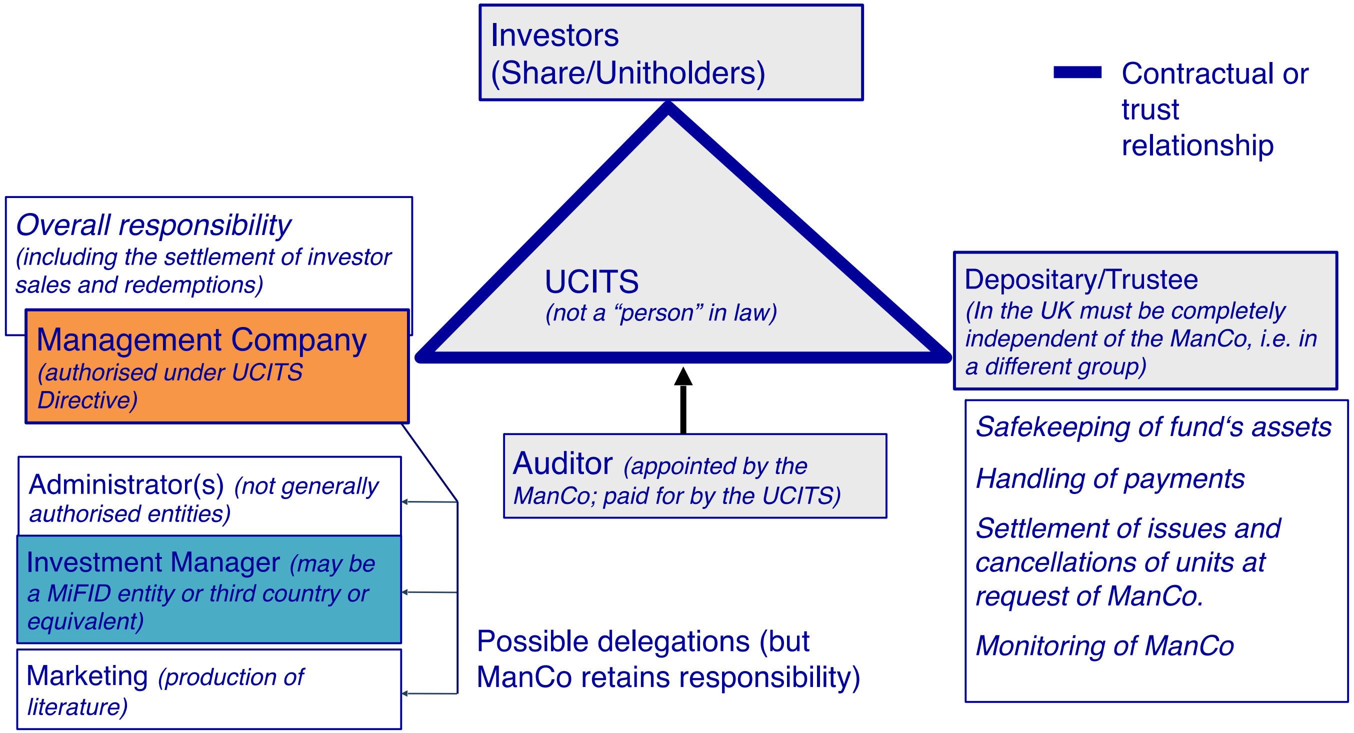
challenges

The buyside – asset management

- Discretionary managed / Separate Account
- Open-Ended Collective Investment Scheme/Mutual Fund
  - UCITS
    - Money Market Fund (MMF)
    - Exchange-Traded Fund (ETF) and authorised participants
    - Synthetic ETF
  - AIFs
    - Hedge funds
- Closed-End Mutual Fund
  - Private equity and venture capital
    - venture capital - early-stage startups;
    - buyout funds - acquire existing business units or business assets;
    - mezzanine funds - the “mezzanine” between senior debt and equity of buyout transactions; and
    - distressed asset/ “vulture” funds.
  - Real estate and infrastructure funds.

example of unit trust

Contractual/trust-based UCITS



<u>Note:</u> The ManCo may have distribution agreements with a number of entities such as platforms, banks, wealth managers, advisers etc.

global market I

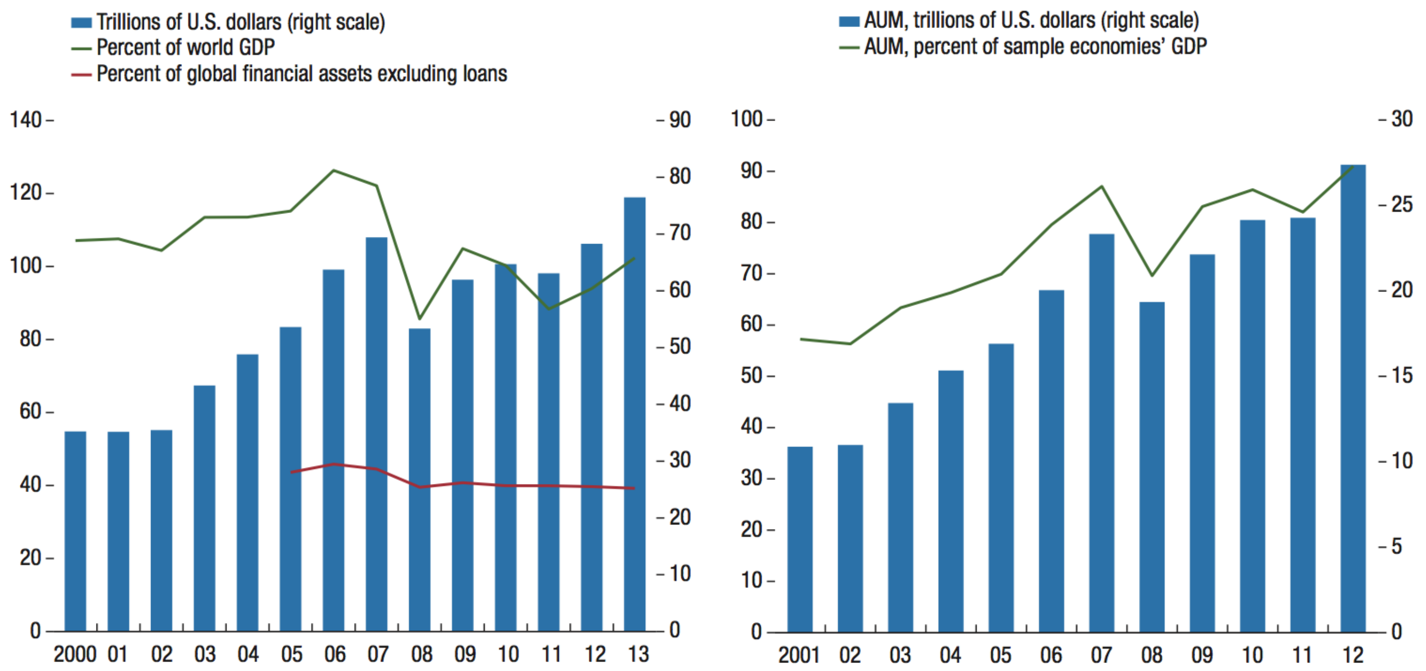
Figure 3.1. Financial Intermediation by the Asset Management Industry Worldwide

The asset management industry intermediates substantial amounts of money in the financial system.

The growth of investment funds has been particularly pronounced among advanced economies during the past decade.

1. World Top 500 Asset Managers' Assets under Management[1]

2. Size of Investment Funds in Selected Advanced Economies



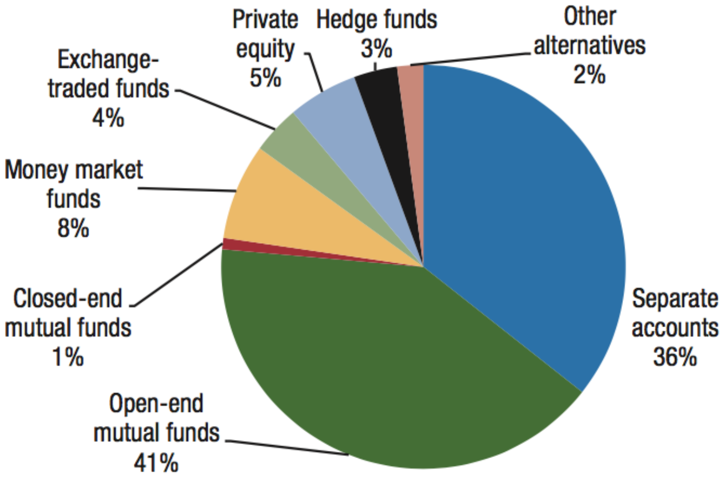
Sources: Bloomberg, L.P.; McKinsey (2013); Pensions and Investments and Towers Watson (2014); IMF, World Economic Outlook database; and IMF staff estimates.
[1]The change of asset under management is determined both by valuation changes of underlying assets as well as net inflows to funds.

Sources: Organisation for Economic Co-operation and Development; and IMF World Economic Outlook database.
Note: AUM = assets under management. Economies comprise Canada, Germany, Ireland, Japan, Luxembourg, United Kingdom, and United States. Investment funds include mutual funds, money market funds, and exchange-traded funds.

Figure 3.2. Products Offered by Asset Managers and Their Recent Growth

Plain-vanilla products and privately offered separate account services dominate the markets as measured by assets under management.

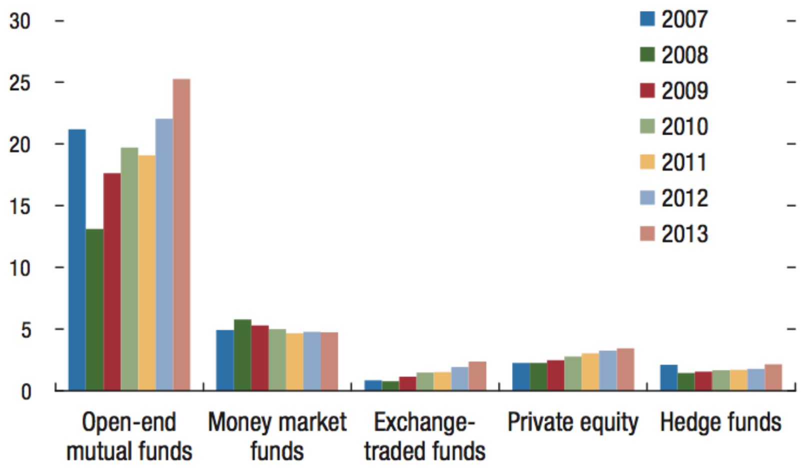
1. Asset Managers' Intermediation by Investment Vehicles
(Percent of $79 trillion total assets under management, end-2013)



Sources: BarclayHedge; European Fund and Asset Management Association; ETFGI; Organisation for Economic Co-operation and Development; Pensions and Investments and Towers Watson (2014); Preqin; and IMF staff estimates.

Open-end funds, exchange-traded funds, and private equity funds have shown strong growth since the global financial crisis.

2. Recent Growth of Selected Investment Vehicles
(Assets under management in trillions of U.S. dollars)



Sources: BarclayHedge; European Fund and Asset Management Association; Organisation for Economic Co-operation and Development; Preqin; and IMF staff calculations.

global market II

IMF Global Financial Stability Report April 2015

uk big numbers

As at Nov 2016

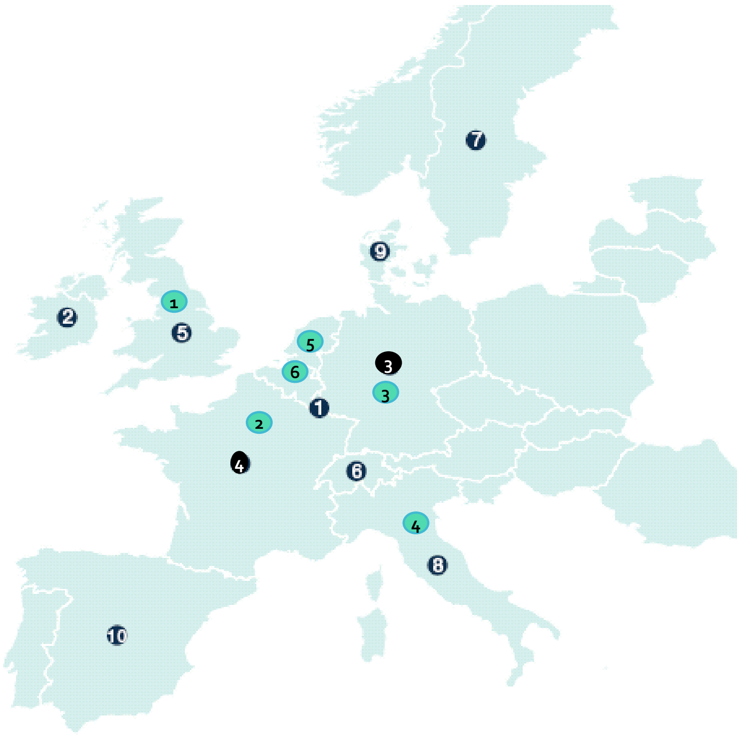
- £1 trillion in UK authorised funds

As at Dec 2015 (latest figures)

- £6.9 trn managed in and from the UK
- £2.2 trn managed for overseas clients by IA members in UK
- As many as 90,000 employed directly or providing functional services

The information on this slide is sourced from The Investment Association's 2016 annual Asset Management Survey

european asset management



Assets under Management[1]

1. UK 37%
2. France 20%
3. Germany 10%
4. Italy 5%
5. Netherlands 3%
6. Belgium 1%

Fund Domicile

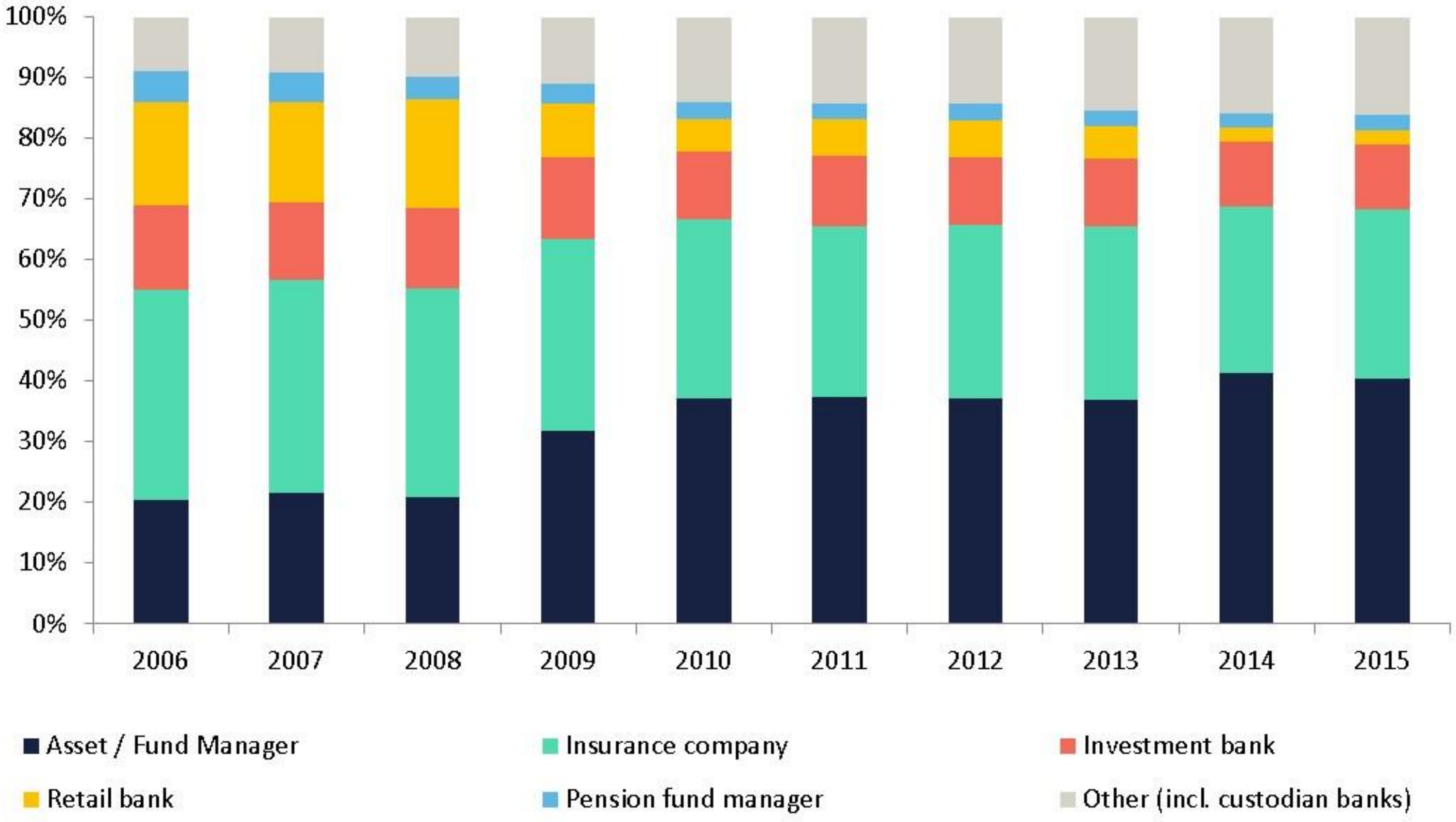
1. Luxembourg 28%
2. Ireland 15%
3. Germany 14%
4. France 14%
5. UK 12%
6. Switzerland 4%

Source: EFAMA. 2014 (AUM data for December 2013)

The information on this slide is sourced from The Investment Association's 2016 annual Asset Management Survey

more autonomous asset managers

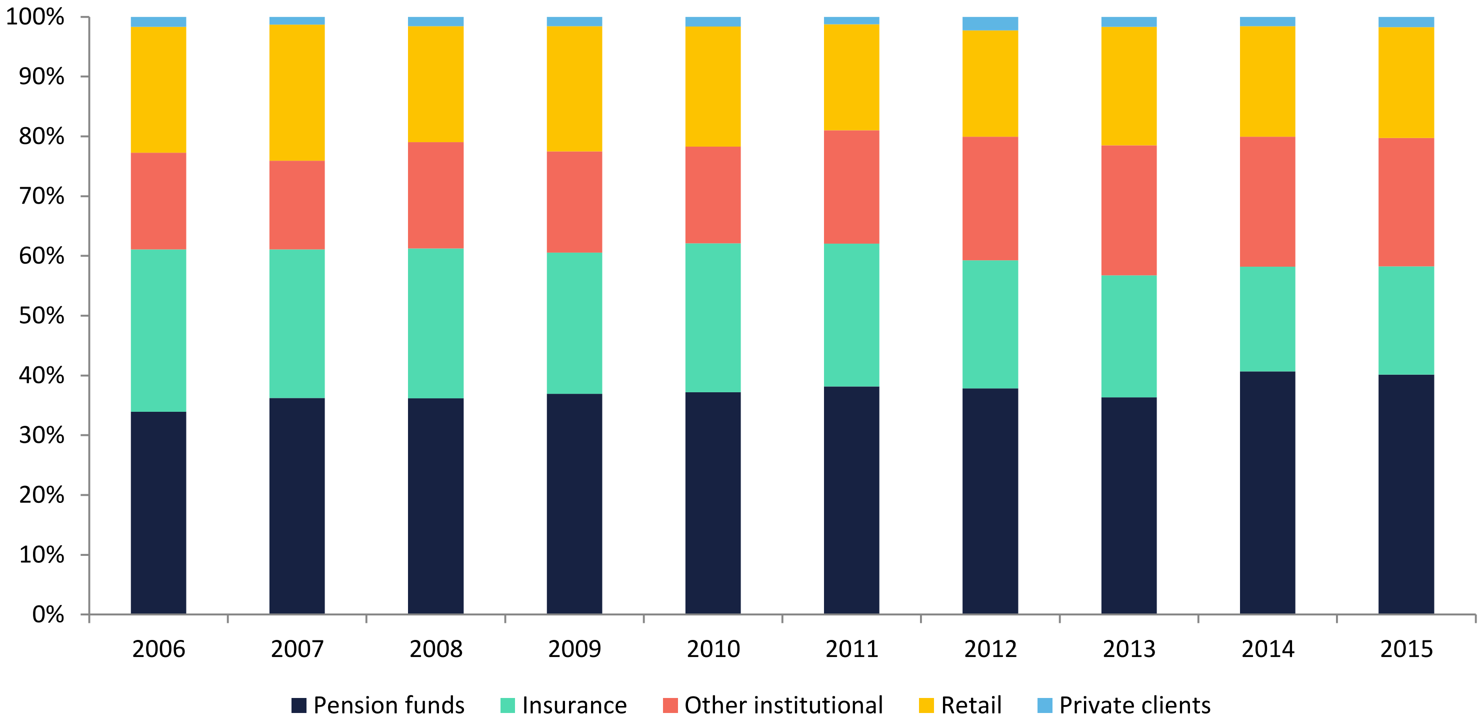
UK assets under management by parent type (2006–2015)



The information on this slide is sourced from The Investment Association's 2016 annual Asset Management Survey

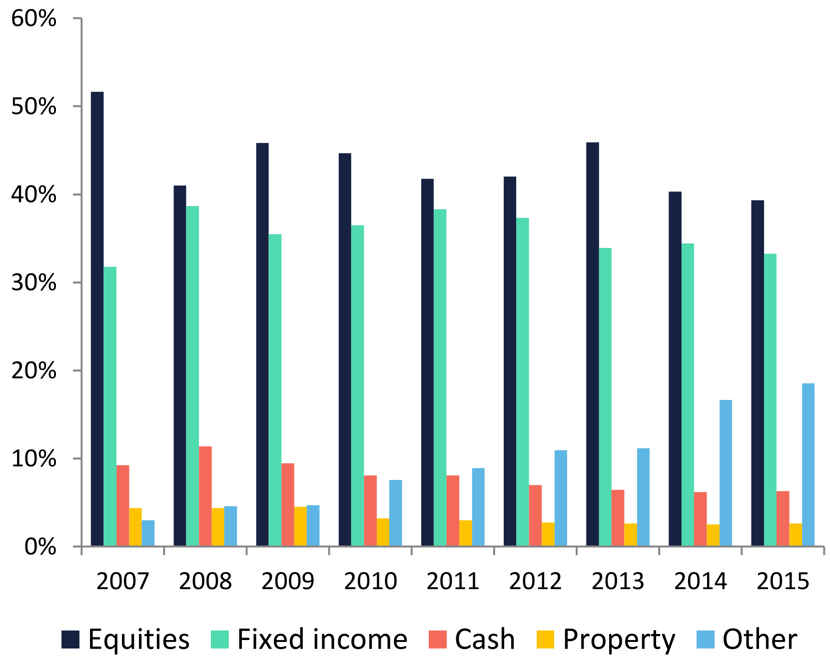
client group composition

Assets under management in the UK by client type (2006–2015)

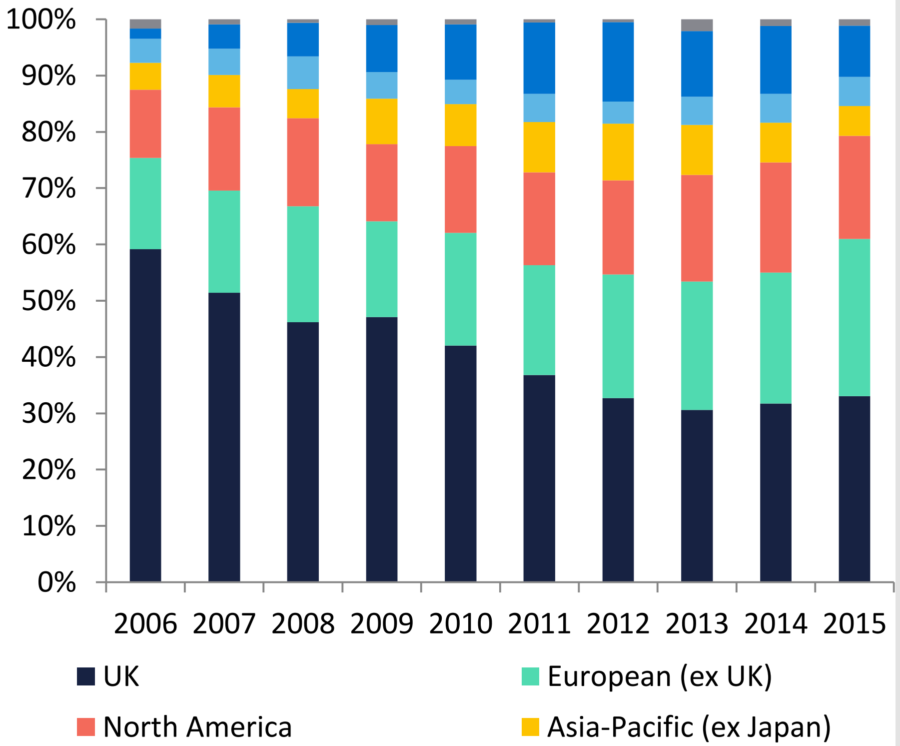


diversified asset allocation

Overall asset allocation (2007–2015)



Regional equity exposure (2006–2015)



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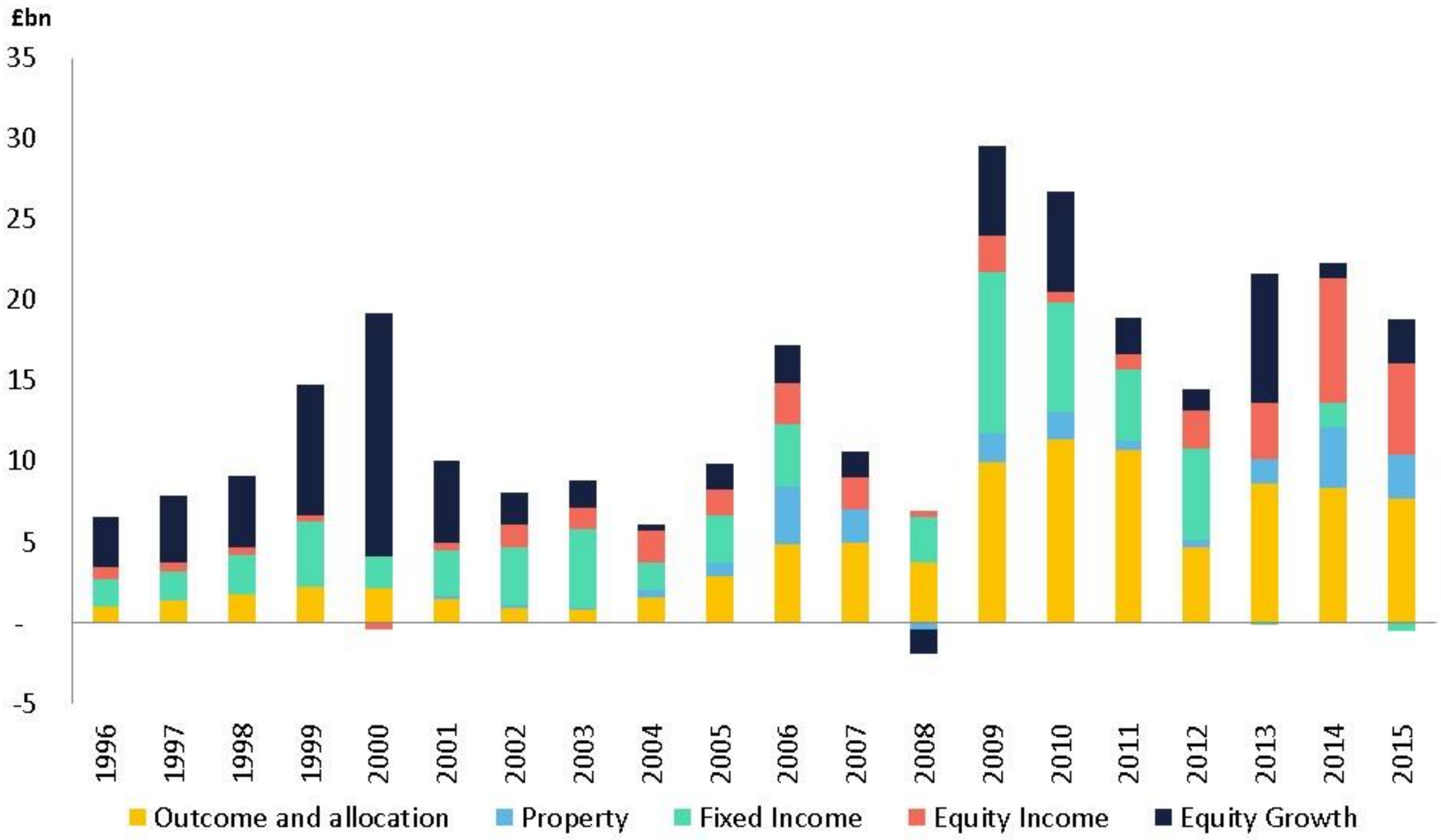
fund objectives



- Source: net retail sales IA, Morningstar

a question for the break

- You are offered a 5 year investment plan. At the end of each year you will get 10% dividend based on your initial investment but also you get one-fifth of your money back. What will happen?

Regulation

- Banking has a long history – and even Medieval Florence gave us bankruptcy *banca rotta*
- Insurers too were being overseen (1851 New Hampshire)
- After the Wall Street Crash of 1929, the USA lead with the Securities Exchange Act 1934
- Now the SEC: to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation
- The UK followed in 1986 with the Financial Services Act
- EU wide began with the Investment Services Directive in 1993 but really took off with MiFID I and the FSAP in 1999-2004

From the outset a separation of three sectors

Banking

- Prudential
- Central bank interests
- Basle
- EBA

Insurance

- Prudential
- Some conduct
- Specialist regulators
- Solvency II
- EIOPA

Securities

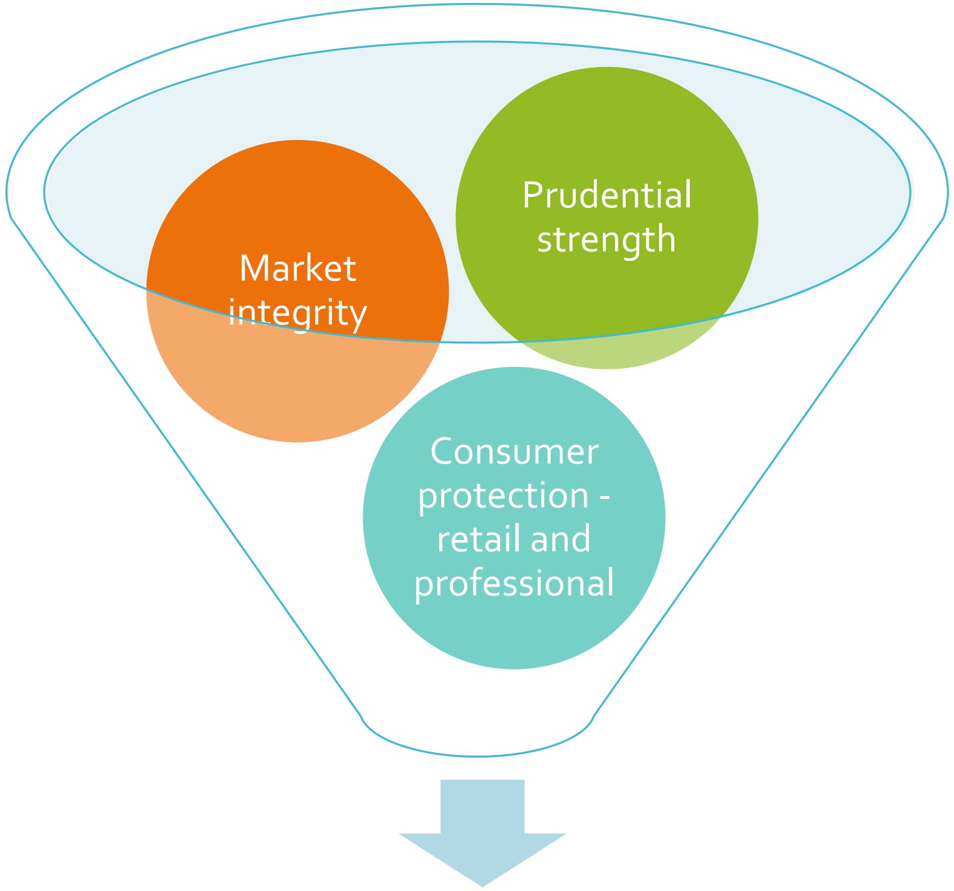
- Conduct
- Prudential
- Wide range of activities
- Investment business
- Capital markets
- ESMA

with different objectives

- The FCA strategic objective is to ensure that the relevant markets function well and its operational objectives are to:
  - Protect consumers – secure an appropriate degree of protection for consumers.
  - Protect financial markets – protect and enhance the integrity of the UK financial system.
  - Promote competition – promote effective competition in the interests of consumers.
- In contrast, the PRA's general objective is: promoting the safety and soundness of PRA-authorised persons.

- That objective is to be advanced primarily by—
- (a)seeking to ensure that the business of PRA-authorised persons is carried on in a way which avoids any adverse effect on the stability of the UK financial system, and
- (b)seeking to minimise the adverse effect that the failure of a PRA-authorised person could be expected to have on the stability of the UK financial system.

until 2007, three focuses



Good outcomes?

a few accidents

- Lifemark £330m
- PPI £25.8 bn (so far)
- Countless other issues – 633,620 complaints about banking and credit card products in 2016 H1
- The financial crisis - $13 trn economic output, $9 trn homeowners
- So, a reworking of the approaches and a new objective was needed
- Established after the 2009 G20 London summit the FSB:
  - Strengthened prudential oversight of capital, liquidity and risk management;
  - Enhancing transparency and valuation;
  - Changes in the role and uses of credit ratings;
  - Strengthening the authorities' responsiveness to risks; and
  - Robust arrangements for dealing with stress in the financial system.

the fourth focus

- Financial stability – systemically important financial institutions
  - Counter-cyclical buffers – UK's FPC
  - Clearing and exchange trading for OTC derivatives
  - Resolution and bail-in
- The problems of applying it to asset managers or even clients

- RDR and commission bias – UK, DoL, Canada and Japan
- Behavioural economics
- Personal responsibility – SMCR
- Competition powers at regulators

other drivers

Thank you