Seeing Through the Forest of Financial Regulations

An Overview of the Changing Global Regulatory Landscape

Jeremy Skaling, Managing Director,
Head of Product Development, Eagle Investment Systems

The entire financial services community has had a rude awakening in recent years. The concept of light-touch regulation has evaporated rapidly and a plethora of more stringent requirements has begun to fall into place for the investment management industry. As we heard from Senator Christopher Dodd at Eagle's Client Conference last year, politicians have been moved to act in response to the dire situation and public ire posed by the financial crisis both in the U.S. and around the world. Regulators and politicians have also been seeking desperately to exorcise the ghosts of the Bernie Madoff scandal, the biggest white-collar swindle of all time. As investment managers everywhere come to grips with a veritable forest of new requirements, we want to take this opportunity to examine the latest developments, the challenges at hand, and the overall regulatory landscape facing our clients around the globe.

Indeed, in the U.S., the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 has created a new regulatory framework awash with new rules touching almost all aspects of the asset management business, including investment advice, securities trading, clearing of exchanged-cleared swaps and the marketing of funds. The Act even requires hedge fund managers to register with the SEC by the end of the year.

New rules aside, the SEC itself is stepping up the intensity of its scrutiny. In addition to establishing a special enforcement taskforce for the asset management industry, the SEC is prepared to deem a firm "higher risk" if it considers that the business does not have a serious and healthy attitude towards compliance. The emphasis is very much upon a strong compliance ethic and tighter internal controls to protect investors. The advent of the Financial Stability Oversight Council (FSOC), the Office of Financial Research, and the Consumer Financial Protection Bureau, also creates a more complicated space and more interested overseers.

A REGULATORY TIDAL WAVE

Of course, the regulatory challenge is not simply a direct response to the Madoff scandal and thus specific to the United States. The scale of regulatory change that the investment management industry faces at the global level over the next five years is perhaps unprecedented and undoubtedly due to the global financial crisis felt in every market around the world and still making waves in nearly all of the interconnected economies.

Major market events precipitate action by both regulators and government and, regrettably, it is too early to say that we are out of the woods. The Greek debt crisis continues to cast a shadow and prompt regulators and politicians to keep their thinking caps firmly on about more rules to shore up the economic landscape in the future.

In Europe, the formation of the triad of European Supervisory Authorities has further complicated the landscape, with the European Security and Markets Authority (ESMA) becoming the watchdog for the investment management arena.

As James Hockley of Investit noted in a recent Eagle client webinar on regulatory changes, there are numerous different organizations with the power to examine and/or request information from investment managers. A complex web of jurisdiction makes the industry answerable to a host of masters. Keeping up with the rules and operating requirements of so many potential supervisors is an inordinately difficult task. James identified over 30 different regulations at the European level alone affecting the asset management industry.

Fortunately many of these regulations do have significant overlap in the areas they address, such as increasing transparency, decreasing systemic risk, improving capital adequacy, putting in place further investor safeguards for protection or tightening loopholes to enable more efficient tax collection.

The impact of new regulations will span across the whole firm; it will impact the front office and trading areas, it will impact the client areas, it will impact the operations process, it will impact the data that underpins the whole business and it will impact the systems that are applied across the business. That's why at Eagle we leverage our scale and global resources to closely monitor regulatory changes and then devote the significant R&D necessary to develop the financial technology solutions our clients need to help comply with these regulatory changes.

Tough new laws from the European Union, such as the Alternative Investment Fund Management Directive, provide more difficult conditions for hedge funds to operate on European soil. Switzerland, long a stronghold for the alternative investment industry, is embarking on its own journey to tighten up rules.

Investment firms are not only going to be hit by asset management regulations in many countries but if they manage pensions, bank or insurance funds, or are owned by banks, insurance companies or venture funds, then they are subject to regulations for those industries, too. Solvency II is an example that is starting to impact asset managers and insurance companies servicing European clients, if not their own subsidiaries as well. FATCA as well is having many non-US based investment firms re-evaluating their business strategy to manage money for wealthy Americans.

FEARS OF EXODUS?

Fears abound that this regulatory tidal wave might drive funds to move to Asia, where environments like Singapore are deliberately trying to lure U.S. and European asset management firms by providing a more conducive regulatory environment.

There is a flip side to the tightening up of rules in Europe and the U.S., however, with many institutional investors keen to see the rubber stamp of compliance in order to feel protected with additional security. The adoption of UCITS (Undertakings for Collective Investments in Transferable Securities) funds is a compelling example. The hedge fund industry has been eager to create products that are compliant with the latest European Union directives, enabling them to make an enticing pitch to those investors seeking the hedge fund potential alpha, but the security of a heavily-policed product. The Financial Times recently quoted Geneva-based Alix Capital Assets' research which showed that "alternative" UCITS IV funds have quadrupled in the last three years.

The phenomenon, sometimes referred to as "onshoring", sees exotic, offshore funds, redesigned as compliant, onshore alternatives, providing a comforting degree of security for pension funds and other institutional investors.

So, the future of global investment management might be more vanilla than exotic, but if investment managers are able to meet all of the regulatory requirements from a compliance point of view, there is still a very healthy market for their services.

Such vast and sweeping changes will necessarily impact operations and technology employed by investment managers. The challenge is to manage the abundant regulations and their associated requirements for new processes and reporting infrastructure, as efficiently as possible. This is going to take a big effort from industry and vendors in order to ensure that the costs of compliance do not begin to eat further into income.

BRINGING THE INDUSTRY TO ACCOUNT

In a world with so many different and overlapping bodies policing financial services businesses, the prospect of a global standard for accounting is an interesting one. Of course, any U.S. move to the International Financial Reporting Standards (IFRS) would create further reporting challenges and some blood, sweat and tears among companies trying to convert. As Marie King, a Partner with PWC recently told us in an Eagle client webinar on IFRS, the U.S. has been indicating a move to IFRS for years, and the key question now is how it will be done and when.

So it might be a small relief given all of the other new requirements besetting managers of taxable assets here in the U.S., that the SEC has postponed its decision on whether the U.S. should move to the global standard. The recently issued report produced by the SEC highlighted a litany of concerns surrounding IFRS for U.S. companies. The authors voiced fears that the international standard lacks guidance in key areas and that it may not be as flexible or responsive to change as the current U.S. guidelines. The report flagged a lack of industry-specific guidelines, issues with funding for the IFRS Foundation, and the worries of U.S. public companies concerning the short-term cost and confusion for investors, as other major roadblocks.

Still, the journey towards international accounting standards began over a decade ago, and many of its ardent promoters will not be deterred by this latest setback. It would have been a significant victory for the International Accounting Standards Boards if United States securities regulators had declared their intention to implement the standard, but the move is far from dead in the water. It has taken several rounds of negotiations and convergence to get IFRS and the U.S. Generally Accepted Accounting Principles (GAAP) this close, and the latest report clearly shows that there is still some way to go.

We may have to wait well into 2013 for a final decision, but it is imperative that our industry gets ahead of the curve and considers what such a move would mean for U.S. investment management firms.

A PRODUCTIVE DIALOGUE

The global financial crisis provided a harsh lesson in the interconnectedness of the world's economies and, to many, highlighted the need for a common accounting standard. Additionally, in this tough economy, investors have been more eager than ever to compare apples with apples and review investment opportunities on an equal basis. Add into the mix political pressure from G20 leaders and the advantages to global corporations of reporting in a single accounting standard and it is easy to understand why a consensus has begun to develop that, if approached cautiously and thoughtfully, a U.S. move to the IFRS standard would be a sensible move. The SEC report referenced many of these considerations in its recent report, in spite of the specific reservations it detailed.

Over time, this developing consensus has helped to enable a proactive and productive dialogue between the IASB and the Financial Accounting Standards Board (FASB) here in the U.S., thus facilitating a degree of convergence in some of the major differences between IFRS and US GAAP . The transition that the U.S. business and investment community will face now is consequently more akin to crossing the street than traversing the Atlantic.

Indeed, many large U.S. corporations are already well versed in the application of IFRS, by virtue of cross-border mergers and acquisitions and the non-U.S. resident subsidiaries that belong to their business family.

That is not to say, there continues to be significant differences in the two standards that the investment management industry will have to decide how best to support. In spite of the ongoing efforts to closely align IFRS and US GAAP, as it stands the treatment of securities and financial instruments can be very different under the two standards. Under US GAAP there are numerous specialized pronouncements providing for the classification of financial assets, where IFRS has just one standard, which divides assets into four categories. Classification drives measurement – whether a debt instrument is to be accounted for at fair value or amortized cost, for example – so these accounting differences can have an enormous impact. The differing treatment of unlisted equities, available-for-sale debt instruments, and the de-recognition of financial assets, to name but a few, ensure that the impacts of these differences expand beyond the realm of pure accounting. They are accounting changes, but they have significant ramifications from a systems and controls perspective.

At Eagle we have been anticipating this move for quite some time. Thankfully, we've been able to leverage both Eagle and our parent BNY Mellon's expertise from serving the investment management industry across the globe and specifically in regions where IFRS is already the de facto standard for reporting. Eagle and BNY Mellon's scale and global resources allow us to closely monitor regulatory changes and then devote the significant R&D necessary to develop the financial technology solutions our clients need to help comply with these regulatory changes. Whether our clients turn to us to provide them with software that will help them adopt IFRS in the U.S., or in the case of our international clients, continuing to help comply with the current standards, we are able to stay ahead of the curve through our investment in R&D and global scale and experience. We are therefore highly confident that we can support U.S. resident investment managers if and when they transition to IFRS.

We recently launched Eagle V12.0, which is a testament to our continued investment in the Eagle suite of products. We continue to be particularly focused on investing in our product suite to ensure that we have the most up-to-date processing capabilities as well as management and reporting solutions, so that we are prepared for major announcements when they come.

Americas +1 781 943 2200 Asia Pacific +65 6432 0581 EMEA +44 (0)20 7163 4132 sales@eagleinvsys.com

ABOUT EAGLE INVESTMENT SYSTEMS

Eagle Investment Systems LLC enables financial Institutions to grow their assets by creating operational efficiencies and delivering award-winning solutions for data management, investment accounting, and performance measurement and attribution, supported by an unparalleled level of service. Eagle deploys its solutions via a secure private cloud, Eagle ACCESS℠, which hosts and provides on-going support of the applications and systems infrastructure, reducing complexity and risk. Eagle Investment Systems LLC is a subsidiary of BNY Mellon. Additional information is available at www.eagleinvsys.com.

BNY MELLON

EAGLE INVESTMENT SYSTEMS