FINANCE DUBLIN

SPECIAL REPORT SEPTEMBER 2012

INVESTMENT FUND SERVICES IRELAND 2012

INSIDE:

- Leading promoters on Ireland
- Twenty five years of investment funds
- Fund servicing profiles
- Attractions of the domicile

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Going from strength to strength

THIS is the third edition of the *Finance Dublin Investment Fund Services Ireland* report and it is published as the industry records another leap forward with the release of statistics by the Central Bank showing an increase of €42.179 billion in NAVs in the month of July 2012. A year has not yet passed since the industry surpassed €1 trillion in total NAVs of Irish authorised funds, and July's increase puts in mind an earlier milestone, less than 15 years ago, when a survey conducted by *Finance Dublin* recorded the first €100 billion plus total for both domiciled and non domiciled funds administered in Ireland. This July proved to be a record breaking month with Cumulative NAVs of Irish Authorised Collective Investment Schemes reaching €1,199.2521. This represents a 12.1 p.c. increase on a total of €989.0374, a year earlier.

The main reasons the industry has been successful has been its relentless customer focus since the earliest days, as industry pioneers spread the world in markets around the world. The report reflects this focus, with profiles and contributions from customers of the Irish funds industry amongst world-leading fund promoters and money managers, such as Lawrence Fink's (above top left) Blackrock, and Bill Gross's (top right) PIMCO.

The report illustrates how the jurisdiction continues to evolve and its ability to adapt to the needs of the global market in ways that no other funds domicile can. The corporate and business profiles in this report include many of the stakeholders who are pushing the agenda of the jurisdiction and making it the success it has become. These companies are: Brown Brothers Harriman; Citco Fund Services; Citi; Dillon Eustace; Ernst & Young; Hainault Capital; HSBC; The Institute of Bankers in Ireland; KPMG; Linedata Services; Matheson Ormsby Prentice; RBC Investor Services; State Street; William Fry.

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As Ireland's funds industry surpasses all-time records, the opportunities from the coming wave of changes are profiled

As the Irish funds industry goes from strength to strength this third edition of the *Finance Dublin Investment Fund Services Ireland* report looks at the evolving product and service offerings of the industry which prepares for the profound challenges and opportunities spurred by regulatory changes such as AIMFD, FATCA and UCITS V that promise to consolidate the jurisdiction's global leading position.

The fund promoter customer base of Ireland's investment funds industry

Irish fund administrators service assets in more than 11,000 funds from almost 170 countries from American Samoa to Zambia and offer support capabilities in 28 languages and 23 currencies. Some 850 investment managers across the world use Ireland as their international hub to distribute across the globe. We asked a number of the leading fund promoters, among them the world's biggest money managers, to comment on their business in Ireland.

Goldman Sachs Asset Management

Goldman Sachs Asset Management has $714.60 billion in assets under management.

What has made the Irish funds industry such a success?

A regulatory environment which seeks to be simple and flexible across a range of different fund structures, including corporate and unit trust vehicles, which qualify as UCITS for retail distribution or Qualifying Investor Funds for non-retail distribution;

Shoqat Bunglawala

A broad range of fund service providers with full service offerings (custody, fund administration, transfer agency);

Multi-lingual client servicing and

A good range of legal firms supporting the funds industry.

Why does your company continually choose Ireland as a domicile or why your company chooses Irish based companies to provide services to your funds?

Investors often seek funds that are appropriately regulated.

Shoqat Bunglawala, managing director at Goldman Sachs Asset Management.

Insight Investment

Insight is a specialist asset manager launched in 2002. It has grown to be one of the largest asset managers in the UK. As of Q2 2012 it has €182 billion in assets under management. It is a subsidiary of The Bank of New York Mellon.

Charles Farquharson

What has made the Irish funds industry such a success?

A successful financial centre needs to satisfy the requirements of product and service providers. At the same time, it also needs to encourage investors through a demonstrable commitment to investor protection. Ireland has reconciled these competing issues in relation to funds very successfully, and arguably more effectively than other financial centres.

Why does your company continually choose Ireland as a domicile or why your company chooses Irish based companies to provide services to your funds?

A number of factors are at play here: a well-educated work force, a carefully constructed business and taxation framework to attract business to help them thrive, and a strong balance between investor protection and the promotion of innovation.

Now that a number of international players have established a significant presence, the outlook for Ireland as a leading financial centre looks very positive.

Charles Farquharson, chief risk officer, Insight Investment.

Russell Investments

Russell Investments was founded in 1936 and is headquartered in Seattle, Washington, USA. It has $138 billion in assets under management globally and $32 billion EMEA. The company has over 2300 clients and over 600 independent distribution partners.

What has made the Irish funds industry such a success?

The Irish funds industry has been a success for a variety of reasons. It is English-speaking, it has a well educated work force and, particularly since the economic downturn, provides good value. But two very important reasons that Ireland has been successful are an open and commercial regulator and of course the 12.5 per cent tax rate. The former is becoming less true, and the government should be aware that that is the case. The latter is the jewel in the crown, and the government should do everything in its power to protect it.

Why does your company continually choose Ireland as a domicile or why your company chooses Irish based companies to provide services to your funds?

We chose Ireland as a domicile for the

reasons cited above. Over 19 years our funds business has come to be built on Ireland as our offshore platform, and we sell our Irish based products in more than 40 countries. As for service providers, Ireland has become a centre of excellence, and we generally use Irish service providers for our offshore products as well. However, the regulatory situation in Europe generally and in Ireland specifically is causing us to explore other domiciles, both regulated and traditional offshore domiciles like the Cayman Islands, and it is likely we will use those domiciles far more tactically in future.

Jim Firn

Jim Firn, head of product & governance at Russell EMEA.

State Street

State Street Global Advisors (SSgA) is the asset management business of State Street Corporation, one of the world's leading providers of financial services to institutional investors, with a heritage dating back over two centuries. The company has over 450 investment professionals and over 2400 employees around the world. Last year it acquired Bank of Ireland Asset Management (BIAM).

"Now that a number of international players have established a significant presence, the outlook for Ireland as a leading financial centre looks very positive."

'As clients seek opportunities in new markets, Ireland provides the platform for distribution on a global scale as we build increasingly sophisticated and integrated solutions to meet clients' evolving challenges. Through recent tough times, the expertise and resources available in Ireland have driven continued success for the local funds industry.'

Jay Hooley

Jay Hooley, chairman, president and CEO of State Street Corporation.

Ireland's Fund Milestones

1989
The AIG American Equity Trust becomes the first UCITS fund to be established in Ireland, and the first fund to be listed on the Irish Stock Exchange.

June: The UCITS directive comes into effect in Ireland. The Finance Act of 1989 grants UCITS funds a tax exemption from corporation tax, capital gains tax, withholding tax and other taxes laying the foundations for the industry to grow.

1990
December: The Companies Act 1990 is enacted, including Part XIII, which provides the legislative basis for Qualifying Investor Funds, (QIFs) which provides a bedrock for the long term development of the investment funds industry.

1998
July: The Irish Government and the EU reach agreement on the introduction of the new 12.5 per cent Irish corporation tax regime.

2000
April: First Exchange Traded Funds created in Europe, as UCITS, as two Merrill Lynch UCITS domiciled in Ireland. ETFs have taken off, having been first established in New York to track the S&P 500 in 1993. This ultimately grows to become a veritable asset class, in which the Irish funds industry administered a third of the European ETF business by 2012.

2001
June: UCITS II and I adopted at ECOFIN Council meeting.

2002
February: UCITS III Directive published.

December: Ireland becomes the first European jurisdiction to allow the authorisation of retail fund of hedge funds. Dublin registered funds grew by 15 per cent in 2002, surpassing €300 billion for the first time. The total number of Irish collective investment schemes is 3,300.

2003
October: Ireland is the leading domicile for European registered exchange-traded funds (ETFs), with almost 28 per cent of European funds domiciled in Ireland, according to the Morgan Stanley Exchange Traded Funds Worldwide Guidebook.

2005
September: The net asset value (NAV) of Irish registered investment funds passes €500 billion mark for the first time. As of June 30th, 2005, the NAV of Irish funds stood at €513.9 billion.

2010
January: A change to Irish fund legislation will allow funds to redomicile in Ireland more easily. UCITS IV, and a rise in appetite for regulated products eg. 'Newcits' will bring opportunities to Ireland.

2011
Ireland is amongst the first group of EU member states to sign the UCITS IV Directive
The Central Bank relaxes Ireland's 'Minimum Activities' regulations, originally introduced in 1995.

The changes implement proposals in a Central Bank Consultation Paper (48) that proposed the relaxation of restrictions that required Irish domiciled fund administrators to perform minimum activities, such as fund NAV calculation and investor correspondence in Ireland.

November: Figures from the Central Bank of Ireland show that the cumulative net asset value for Irish authorised collective investment schemes surpasses €1 trillion for the first time.

HSBC

HSBC Global Asset Management had assets totalling $409 billion at the end of June 2012. It has offices in 30 countries around the world.

"Ireland offers many appealing features. When choosing a fund domicile, at HSBC we look at 5 factors: membership of international organisations, regulation, tax, operations and infrastructure and brand. Ireland ticks boxes across all of these. Clearly it shares common ground with other locations in terms of its EU membership, but it also offers the right infrastructure, has a solid reputation for development of new products giving it first mover advantage, backed up by an uncomplicated tax regime and strong regulation. Above all, it has a clear government commitment to the industry. At HSBC Global Asset Management we

continue to invest in Ireland, in particular where it stands out as a centre of excellence in such diverse areas as liquidity funds, ETFs and alternative fund administration."

Adam Fairhead

Adam Fairhead head of product development, HSBC Global Asset Management Ltd.

Blackrock

BlackRock has over 260 funds and €162 billion of assets domiciled in Ireland which includes over 130 iShares funds, a wide range of institutional pooled vehicles and Europe's largest range of Irish domiciled Money Market funds.

Blackrock launched its first Irish fund in 1995. Blackrock employs about 10,100 people in 27 countries and maintains a major presence in key global markets, including those in North and South America, Europe, Asia, Australia, the Middle East, and Africa.

BlackRock, is one of the biggest investment managers in the world with USD3.5 trillion under management, it announcedearlier this year that it is opening a new base in Dublin. BlackRock's client business in Ireland stands at over €5bn.

'This office opening represents our commitment to serve BlackRock's growing client base in Ireland better. Our team in Dublin will be able to leverage BlackRock's global expertise and breadth of product offerings to best serve clients and their advisers locally,' said James Charrington, Chairman for BlackRock's EMEA business.

Northern Trust

Northern Trust Asset Management had $704 billion in assets under management as of June 30, 2012.

'Ireland is the European service centre of choice for hedge funds, a leading domicile for cross-border fund administration, a major and growing centre for internationally distributed UCITS, and a leading European domicile for exchange-traded funds.

Frederick Waddell

While no country is immune to the challenges presented across the global economic landscape, Ireland has developed an effective and robust regulatory framework which has seen the number of funds (including sub funds) administered in Ireland increase to 11,211 as at September 2011, representing total assets under administration of 1.8 trillion euro.

We believe leading asset managers will continue to look to Ireland as a domicile of choice - as will Northern Trust.'

Frederick H.Waddell, chairman and CEO of Northern Trust.

The funds listing business of the Irish Stock Exchange

Despite challenges including a 'wait and see' approach pending clarification of the AIFMD, the ISE has seen some recent growth, with 80 per cent of its new listings in 2012 consisting of Irish domiciled funds.

The development of the ISE's fund listings business began in 1989 with the listing of its first UCITS, AIG American Equity Trust. By 1995 the ISE had built a successful international funds business.

Following the emergence of asset backed securities as an asset class in the USA, by the mid 2000s it had become the European venue of choice for the listing of structured debt, eventually eclipsing established rivals like the Luxembourg Stock Exchange with a 70 per cent market share.

It has also commenced partnership arrangements with European providers to ensure the Irish market has world class trading, settlement and clearing facilities.

The success of Irish domiciled funds is reflected in the fact that Irish funds represent 80 per cent of the ISE's new listings in 2012. According to Gerry Sugrue, listing manager for investment funds at the ISE, 'This year, many large, well known ETF providers continue to use the ISE as their choice of listing venue. The ISE offers a streamlined listing process for all Irish funds which means issuers can move to market very quickly. The QIF, for example, has a 24 hour turnaround.'

The ISE has listed funds from a variety of jurisdictions in 2011. 'On the offshore side, the activity levels indicate there is a wait and see approach being taken by many managers regarding single fund launches until the finer details of the Alternative Investment Managers Directive (AIFMD) are known,' notes Sugrue. 'Notwithstanding that, the ISE has listed funds from Jersey, Cayman Islands, Bermuda, BVI and Delaware this year. Earlier in 2012, a policy change formalised an approach to cash deposits adopted by the ISE following the financial crisis that facilitates a listed fund in reducing their exposure to a single prime broker. London and New York continue to be the primary investment management centres for most of the 2,800 listed funds on the ISE but the ISE has funds managed from over 40 different jurisdictions admitted to its regulated market and some, such as Switzerland and South Africa, feature prominently in 2012.'

The ISE's fast-paced reaction to industry changes is one of its key facets in attracting listings. According to Therese Redmond, head of listing services at Walkers Ireland, 'The ISE is recognised internationally as a leading exchange for the listing of investment funds, and continues to be the exchange of choice for promoters and managers who view a listing on the ISE as an invaluable marketing tool when seeking to attract investors and open distribution channels for their funds. One of the key success factors of the ISE has been its responsiveness to challenges faced by market participants. In particular, in the past 18 months the ISE has enhanced its listing rules to accommodate changes in the investment funds landscape e.g. bolstering its independent director requirements; prescribing amended prime broker suitability criteria in response to regulatory and credit rating changes in the prime broker environment; broadening its investment restrictions/diversification requirements regarding investments in open-end funds and the holding of cash on deposit, subject to specific requirements being met. As a dynamic exchange offering a robust, sound listing regime, we expect the ISE to continue to attract listings to Ireland.'

Unlock the Regulatory Code

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Irish funds' corporate governance in rude good health

The Irish funds industry has proved that the standard of its corporate governance is one of the best in the world. PETER O'DWYER, director and secretary of the Investment Director's Forum in Ireland, looks at the history of the independent fund director in Ireland and explores some of the recent changes to the corporate governance regime for funds in Ireland.

Following the global financial crises of 2008-2009, one of the areas which began to receive significant attention internationally was the corporate governance of financial institutions. In Ireland, the Financial Regulator indicated early on that this would be an area of increased focus for the regulatory authorities in Ireland.

In April of 2010, the Financial Regulator announced that a new detailed statutory corporate governance regime was to be introduced for banks and insurance companies under existing financial services legislation. This came into effect for boards and their directors from 1 January 2011.

In announcing the new regime, however, the Regulator, Matthew Elderfield, specifically stated that on a risk based assessment 'a one size fits all approach is not appropriate for all sectors. On this basis we consider that the rigorous corporate governance standards we are now proposing for banks and insurance companies may not be appropriate for the funds sector'.

"Another indicator of the success of the Irish based non-executive directors in the recent past has been their demonstrated ability to survive and thrive during the world's greatest real time stress test of the financial crisis of 2008 – 2010. In this time a lot of boards were faced with unprecedented stress events at their funds, or with their funds' investments."

For the funds sector, the Financial Regulator instead proposed that the Irish Funds Industry Association would be invited to prepare a voluntary code, in consultation with the Central Bank of Ireland.

History of good corporate governance in the international financial service sector in Ireland

In carving out a separate voluntary regime for the international funds industry in Ireland, the Regulator was giving effective recognition to one of the strong pillars on which the unprecedented success of the IFSC has been based. The requirement to have two Irish resident directors on the boards of regulated entities has meant that Irish directors have been exposed to best international practice, while the foreign promoters have had strong experienced colleagues, who are available to share their knowledge and experience, in particular of Irish regulation, law, accounting and taxation.

Peter O'Dwyer

Over the past twenty years, many experienced Irish professionals with significant international financial services experience have contributed to IFSC boards, increasingly as a full time professional non-executive director. With the ever increasing tsunami of international changes in law and regulation, it has greatly assisted promoters, funds boards and their investors to know that they have independent non-executive directors, who are actively keeping up with developments. The days of the 'generalist' are likely to become more numbered, not least as recent court judgements, as in the Weavering Case, have required that non-executives be professionally up to speed with the industry in which their companies are operating.

The establishment of the Investment Directors' Forum in 2008, a group of Irish based directors active in the funds and fund management sector, to encourage knowledge dissemination and liaison with the financial regulator is an example of the increasing professionalisation of the sector.

Another indicator of the success of the Irish based non-executive directors in the recent past has been their demonstrated ability to survive and thrive during the world's greatest real time stress test of the financial crisis of 2008 – 2010. In this time a lot of boards were faced with unprecedented stress events at their funds, or with their funds' investments. The Friday 5.30 pm call from a promoter was not an unusual event for some directors during this period, when directors would be required to step up to protect the interests of investors.

Corporate Governance Code for Collective Investment Schemes (CIS) and Management Companies

The IFIA's voluntary code adopts the IOSCO definition of governance as a 'framework for the organisation and operation of CIS that seeks to ensure that CIS are organised efficiently and exclusively in the interests of their investors, and not in the interests of CIS insiders.'

The Code seeks to implement what IFIA and the experienced directors, who were consulted in its drafting, consider to be established best practice. Matters such as the appointment of independent chairmen and the definitions of independence and non-executive directors are addressed. Directors are required to have sufficient time to devote to each fund, or management company during any one year, with a time buffer for unexpected events, although no specific limitation on the number of directorships has been set. However, there is a rebuttable presumption that a maximum of 8 non-fund directorships may be held without impacting on a director's time.

The code became effective on 1 January 2012. Funds and management companies have a 12 month transitional period in which to adopt the Code.

Where a board adopts the Code, but decides not to apply any provision of the Code, it should set out the reasons why in the Directors' Report to accompany the annual audited financial statements, or alternatively publish the information through a publicly available medium, such as a website detailed in the annual report.

In 2011, the Central Bank of Ireland also introduced a new Fitness and Probity regime, whereby appointments to fund boards will in future require to be pre-approved by the Bank under an agreed template. Under the regime existing directors have been grandfathered, subject to due diligence by the fund board.

Peter O'Dwyer is a director of a number of funds and director of the Investment Directors' Forum.

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Ireland's 'plug and play' compliance with AIFMD gives it the edge

Ireland is in a more advanced stage of preparedness than any other domicile ahead of changes to the regulatory environment as a result of AIFMD, UCITS V and FATCA writes Citi's CATHERINE BRADY.

Ireland's geographic location, its pool of talent and experience, its sound regulatory environment and the political will to promote Ireland as a centre of service excellence have collectively been the cornerstones of its success to date as a domicile for investment funds and their service providers. Ireland has grown in the last 25 years to become the second largest fund domicile in Europe and the largest centre globally for hedge fund administration. Pure custody, fund administration and transfer agency services have been core to this unparalleled success.

The head start that Ireland enjoys over other European domiciles can be demonstrated by analysing some of the more onerous impacts AIFMD, UCITS V and FATCA will have on the asset management industry.

AIFMD

Increasing numbers of alternative investment managers are turning to Ireland for solutions ahead of the finalisation of the Level 2 implementing measures of AIFMD. In June 2012 the IFIA reported that the number of Qualifying Investor Funds (QIFs) in Ireland had reached an all time high of 1,420 with assets reaching a new peak of €182 billion. This represents an increase of 20% since 2011 and 35% since 2010. Some of the motivating factors for many investment managers looking to Ireland as the domicile of choice for AIFMD readiness can be summarised as follows:

Valuations experience: Ireland is a leading centre for the administration of alternative investment funds, both globally and within the EU. Almost 70 per cent of EU domiciled alternative investment funds are administered in Ireland with approximately 40 per cent of global assets serviced from here. The wealth of experience here puts Ireland in good stead ahead of some of the new requirements that will be introduced under AIFMD such as the new concept of a 'proper and independent valuation' of the assets. Valuations can be carried out by an external valuer or internally if conflicts of interest are mitigated. Although not a requirement, an Irish fund administrator can assume the overall responsibility of becoming the 'valuer' of the asset.

Catherine Brady

Depending on appetites and the existence of the necessary strict conflict of interest mitigants and Chinese walls there are significant opportunities to leverage existing administrative services in Ireland to discharge this function under contract with the AIFMs.

Regulatory regime and the requirement for a Depositary: the Irish investment industry is a regulated one which makes the Qualifying Investor Fund (QIF) the ideal choice for alternative investment managers due to its 'plug and play' compliance with many of the AIFMD key provisions. For example, Irish QIFs are already required to have independent depositaries and Central Bank of Ireland authorised/supervised administrators.

"The QIF regime is one where the Irish depositary must already appoint Prime Brokers as their global custodians for assets that are not rehypothecated. Ireland is therefore the only European domicile with a pre-existing legal framework and systems connectivity between depositaries and the prime brokerage community."

Most importantly the QIF regime is one where the Irish depositary must already appoint Prime Brokers as their global custodians for assets that are not rehypothecated. Ireland is therefore the only European domicile with a pre-existing legal framework and systems connectivity between depositaries and the prime brokerage community. The requisite oversight processes and controls are already established.

UCITS expertise and middle office requirements: Ireland has a comprehensive infrastructure in place which has supported UCITS funds since 1989. At the end of 2010 EFAMA reported that the total assets of Irish domiciled UCITS amounted to €5,990 billion which represented 14 per cent of the total European UCITS market, an increase from 10 per cent in 2007. This expertise will prove invaluable for some of the UCITS-inspired restrictions AIFMD will impose on AIFMs. Some examples of these would be the new risk management requirements, leverage disclosures and monitoring arising from financial derivative instrument exposure and liquidity stress testing. Irish service providers' experience with monitoring the compliance of complex UCITS funds with the detailed VaR and commitment approach methodologies for measuring derivative exposure will prove particularly advantageous in the face of some of these new requirements.

UCITS V

The European Commission published proposed amendments to the UCITS Directive on 3 July 2012. Colloquially referred to as UCITS V, one of the primary areas covered by the proposals is the setting down of uniform rules in relation to the depositary's core safe-keeping and oversight duties. Inter alia, the proposals restrict delegation of the depositary's duties to the safe-keeping of the assets of the UCITS and also outline the conditions under which the depositary may entrust its safekeeping duties to a third-party, in line with the corresponding conditions under AIFMD. The proposals have amended the oversight duties of the depositary to remove references to the different fund legal structures (i.e. corporate vs contractual) in place of a generic 'UCITS' reference, presumably with the intention of ensuring the complete harmonisation of depositary duties irrespective of the different UCITS fund structures available. Ireland is already UCITS V-ready in this regard as no differentiation has ever been made in the transposition into Irish law of the various iterations of the UCITS directive between the different fund structures for the purpose of the depositary's oversight duties.

Once agreement on the proposals is reached, it is expected that Member States will have two years to transpose the new provisions into national law meaning that the new rules could apply by the end of 2014.

FATCA

FATCA is aimed at combating U.S. tax evasion by U.S. persons who maintain offshore financial accounts either directly or through ownership of a foreign legal entity. FATCA requires financial institutions to apply enhanced due diligence to identify U.S. persons that may be trying to evade U.S. tax - either through individual offshore accounts or through accounts of foreign legal entities of which the US person is a substantial owner. The Act establishes a new reporting regime on shareholder information and account balances, US sourced income and gross proceeds from the sale of US securities and also creates a new 30 percent withholding tax that is intended to enforce new information reporting requirements on foreign financial accounts that are directly or indirectly owned by certain types of U.S. persons.

As one of the primary obligations introduced under FATCA involves the identification of underlying fund investors, the offshore experience in Ireland of established anti money laundering practices across multiple domiciles globally where Irish funds are already distributed in addition to offshore tax reporting practices will prove invaluable. This experience of dealing with investors from multiple jurisdictions and thereby working with various different tax issues and considerations gives Ireland a considerable advantage when looking to leverage the flexibility of existing systems and processes in helping to achieve the successful identification of US investors in Irish domiciled funds.

Intergovernmental agreements (IGA) are being put in place by the IRS with a number of EU jurisdictions which will allow for registration with local tax authorities instead of entering into agreements with the IRS. Ireland's anticipated inclusion in the IGA framework will significantly reduce reporting costs for Irish domiciled investment funds.

Finally, it is of historical significance that Ireland is already seen as the domicile of choice for US fund promoters. Many Irish service providers therefore, and particularly those with U.S. parents have already developed U.S. tax reporting functionality for both their Irish domiciled and hedge fund business.

Ireland is in a more advanced stage of preparedness than other domiciles to service its clients ahead of changes like these through a combination of its regulatory environment, the experience of its service providers, its established fund structures and the pre-existing focus of Irish service providers to expand their product offerings beyond core fund administration services.

Catherine Brady is managing director, head of funds product (Europe Middle East Africa) at Citi.

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The hedge fund industry's movement towards a more institutional model is increasing the appetite for middle office service offerings

HSBC Securities Services, which is on the verge of the transfer of $40 billion in alternative funds from its US location to Ireland, is actively looking to establish its Dublin office as its hub for alt funds globally, writes TONY MCDONNELL.

Irish based administrators now service more than 40 per cent of the world's hedge funds and while global competition for fund administration is intensifying both between service providers and domiciles, overall industry trends point to increased opportunities for Ireland in the coming years. That's testament to the way the industry in Ireland has positioned itself over the last twenty years and the body of experience that has been developed.

There has been a significant increase in funds establishing themselves in Ireland, most of which has been via initial launch rather than re-domiciliation. An expected wave of re-domiciliation from the Hurricane Belt has been slow. Instead, managers have favoured a diversified approach, launching a new product in Ireland to enable them to appeal to the investor that requires a more regulated product.

What is being seen is the adoption of a diversification strategy on the part of many of the fund managers. They are retaining funds in offshore locations while establishing new products in Ireland and elsewhere which are targeted to specific markets.

"An expected wave of re-domiciliation from the Hurricane Belt has been slow. Instead, managers have favoured a diversified approach, launching a new product in Ireland to enable them to appeal to the investor that requires a more regulated product."

HSBC Securities Services in Ireland has been actively working to establish our Dublin office as the hub for alternative fund services globally. This strategic decision enables continued investment of the significant sums needed in products, in an ever-changing regulatory environment where demands on service providers will increase exponentially.

For example, we are near completion of a transition of circa $40 billion in alternative hedge and fund of hedge fund assets from our US location. This has added some highly prestigious hedge fund managers to our client list and they have been universally impressed with Ireland as a fund service location.

Tony McDonnell

The global funds sector has not been immune to the overall economic environment over the past few years. Yet the impact here has not been as significant as with some other sectors and the Irish fund industry continues to grow both in terms of assets managed and number of funds serviced.

Ireland has striven to be the European domicile of choice, especially for alternative fund managers. Firms based in Ireland have certainly become more cost competitive in the global fund industry of late. This is supported by the fact that managers continue to gravitate to a jurisdiction where the regulator is considered efficient and the service providers understand their product.

Some observers initially considered the advent of the Alternative Investment Fund Managers Directive (AIFMD) in July 2013 and the increased costs it entails as a threat to hedge funds and therefore Ireland's emergence as a major global centre for their management.

Yet the implementation of AIFMD will actually provide opportunities for future growth.

The directive is aimed at bringing hedge funds and other types of funds without a UCITS passport within the scope of regulatory supervision as well as introducing greater transparency to the way these funds operate.

The overall objective is to create a single market in Europe for alternative investment funds (AIFs) and the directive will increase public accountability of AIF managers, make them subject to new authorisation and registration requirements, introduce new reporting obligations, and provide a common approach to investor protection.

The directive is to be transposed into national law by July 22, 2013 and once in effect, all alternative investment fund managers operating within the EU will have to be authorised by a relevant member state and demonstrate that they are appropriately qualified to provide alternative investment fund management services.

There is common agreement that further clarity is needed on a number of central issues, including depositary liability, delegation to third countries, and leverage reporting. Notwithstanding this, HSBC are pressing ahead with our preparations for implementation.

As a large universal bank with a substantial network of sub-custodians, HSBC is exploring how to deal with the liability requirements of the directive but has an advantage as many HSBC entities are acting as sub-custodians. The operational complexity and oversight responsibilities that will be thrust on the depositary are also being mapped out with a view to meeting AIFMD requirements in time.

Another area not properly defined as yet is the relationship between the depositary and the prime brokers and this means there remain grey areas.

While the legislation promises complete investor protection this will come at a price; it is virtually impossible to eliminate all risk from a portfolio and the law of diminishing returns eventually takes over. A depositary does not currently price in the risks assumed under AIFMD liability. Another issue is whether investors wish to have this level of protection are or prepared to pay for it at all.

Industry representatives in Ireland have been working hard to highlight these issues but the primary response has to be that regulation is coming and there is a need to practically design workable models to implement the requirements for clients. In that respect, it is generally accepted that Irelands QIF product is already considered to meet many of the mandatory provisions of the AIFMD.

The new rules will appeal to certain types of investor and many others will insist on choosing AIFMD compliant

funds. These include large European institutional investors, multinational banks located within Europe, pension funds and insurance funds who are required to seek maximum protection for their clients for a variety of reasons. While funds will not have to re-domicile to a European location to become AIFMD compliant and tap into this market, many will do so nevertheless and, once again, Ireland is well placed to benefit from this trend.

There will of course be managers who choose not to market to European investors due to the additional cost of these regulatory requirements but this should not represent a significant threat to continued growth in funds administration in Dublin.

"While funds will not have to re-domicile to a European location to become AIFMD compliant and tap into this market, many will do so nevertheless and, once again, Ireland is well placed to benefit from this trend."

AIFMD is by no means the only regulatory change with which the Irish industry has had to contend, some of them more high profile than others. Among the more prominent changes was the planned new corporate structure for Irish SICAVs that meets United States tick-the-box taxation rules but there have been many other initiatives that have been implemented that will also stand to reinforce the regulated environment in which Irish administrators operate.

One example is the recently published proposed amendments to the Criminal Justice Act, the CJA Amendments Bill 2012, which will give comfort to investors that the funds in which they invest, operate within a highly regulated environment and to the highest level of AML standards. Another example is an Enhanced Fitness and Probity Regime whereby there is now a requirement for approved persons to be deemed fit and proper by the Central Bank to perform certain core functions and duties. These are enhancements that will benefit any hedge fund appointing an Irish administrator, irrespective of fund domicile.

The hedge fund industry itself is also changing and is continuing to move towards the institutional model, driven mainly by regulation, risk management and investor demand. This has led to an increased appetite for our alternative middle-office offering, an area where HSBC is making significant investment. Managing the changes to the OTC derivative model on the back of the US Dodd-Frank Act and the EU's EMIR provisions will be key.

As part of its reaction to solve the puzzle of the causes of the financial crisis the EU is introducing the AIFMD. The directive poses a risk to Ireland's hedge fund industry, in particular a risk that some managers both EU and non-EU will perceive AIFMD to be too strict and will move funds to other jurisdictions, however it will make Ireland's 'AIFMD-Ready' QIF product more attractive to managers.

Similarly, FATCA requires significant attention for managers and service providers alike and will require additional support with investor classification, withholding and annual reporting requirements.

An ability to fully service managed accounts is now a basic requirement for any hedge fund administrator, enabling clients to respond to the increasing investor demands for transparency. In such cases, a cost effective operating model is key and an ability to leverage global talent pools represents an increasingly important component of the offering.

Most of the bigger servicing firms are broadening their offering rather than becoming more specialised. As managers are focusing on producing alpha and managing tail risk, they are looking for their administrator to provide a broader offering (the build-out of middle office and collateral management services being a typical example).

Outsourcing from the big providers is more driven by the aim to create efficiencies in the processes, for example, by using offshore locations for processing, vendors for distribution of investor statements and annual reports. To reduce valuation risk and provide truly independent pricing, there is probably also an increased use of external pricing vendors, along with the development of internal pricing capabilities, which only the top-tier providers such as HSBC can accommodate.

Further growth opportunities will open up during the next 12 months due to the veritable tsunami of regulatory change which the industry is about to experience. An organisation's or a location's ability to manage that change effectively and engage proactively with its client base on the impact of those changes will set it apart from the competition. There are some risks ahead, in particular a risk that some managers both EU and non-EU will perceive AIFMD to be too strict and will move funds to other jurisdictions. However, on balance with regard to the large asset allocators, pension funds, insurance companies and other EU investors the 'AIFMD-Ready' QIF product is likely to become more attractive.

That said, it will be vitally important for the Irish hedge fund industry is to ensure its administrators continue to capture market share in the alternatives service offering space. If it can do this it is set to continue growing for the foreseeable future.

Tony McDonnell is regional head of the alternatives sector for Europe and North America sales and business development at HSBC Securities Services.

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The new Irish corporate structure: the iCav will solve US tax problem for Irish PLCs

FERGUS MCNALLY of Ernst & Young looks at the new services and offerings that seek to commercialise opportunities as a result of the Alternative Investment Fund Managers Directive.

Ireland as a jurisdiction is well positioned to assist managers impacted by the emergence of the Alternative Investment Fund Managers Directive (AIFMD) as many of the global leaders in custodial and administration services are located here. Ireland also has a regulatory framework consistent with the directive and a range of investment structures for alternative investment funds (AIFs).

The directive has been designed to regulate heretofore unregulated hedge fund managers or alternative investment fund managers (AIFMs). One of the difficulties with the directive is that it does not necessarily allow for size and scale. A lighter regime is proposed for AIFMs where cumulative AIFs under management are below €100m and for AIFMs with unleveraged AIFs up to a maximum of €500m and subject to 5 year lock-ups. Once an AIF breaches these thresholds, they are subject to full compliance with the directive and managers need to be aware that they may need to radically reshape their businesses as a result.

'The impact of these changes mean that to comply with the directive, an AIFM's organisational structure may need to change and staffing levels and outsourcing arrangements rethought.'

As an example, within many AIFMs the risk management and portfolio management functions can be carried out by the same team. Under the terms of the directive these functions will now be required to be performed by persons who are functionally and hierarchically separate in the organisation. The same requirements exist for asset valuation and other requirements are being mandated for regulatory and investor reporting. The impact of these changes mean that to comply with the directive, an AIFM's organisational structure may need to change and staffing levels and outsourcing arrangements rethought.

Ireland's readiness

In developing solutions to assist investment managers navigate some of the directive's obstacles Ireland has a number of key competitive advantages:

1)the technology platforms that third party administrators have put in place provide 'first class' services to alternatives and in many cases are also designed to handle middle office processing and cash collateral management. Each and every type of investment strategy is catered for, all asset classes and this infrastructure is matched with internationally recognised financial reporting standards including US GAAP and IFRS;

Fergus McNally

2)the Irish regulatory framework is already aligned with many of the requirements of the directive. For instance Irish regulated AIFs are already required to have an independent depositary and are already administered by entities authorised and supervised by the Central Bank of Ireland. In respect of the directive, the Irish regulator is expected to ensure that the provisions of the directive are implemented into national law without haste. In doing so the regulator will seek to have existing guidance notes updated to ensure Ireland is ready for implementation;

3)Ireland operates a simple tax efficient and transparent framework for AIFs; and

4)Ireland offers a significant pool of industry experienced people already with skills in the operational aspects of alternative and Irish funds.

AIFMD opportunities

Outsourcing or delegating functions is permitted under the directive, provided that the AIFM has notified and received approval from their relevant regulatory authority. This is capped with a proviso that the AIFM cannot delegate out such substance so it becomes no more than a letter box entity.

Examples of new opportunities exist in the creation of a risk management offering, liquidity and leverage computational services. These will not necessarily be straight forward to carry out. In the case of certain individual directive requirements, systems may need to be improved, re-designed or even transformed to allow service providers use existing platforms to provide such new service offerings. For example, should regulatory reporting required under AIFM be anything like Private Fund Reporting mandated by the SEC, chances are that providers will have approximately 50 - 60 per cent of the data required. To ensure data is in the correct format, programs may need to be developed to map existing data into regulatory reporting formats and to do this, providers may need to hire and/or assign teams responsible for these service offerings.

For valuation, the directive looks for functional and hierarchical separation at the AIFM level and while larger managers may be able to demonstrate this, smaller managers may struggle. In such cases, outsourcing or delegating the function to one or more external valuation agent(s) may be considered. An appointed valuation agent would need to demonstrate the necessary skills and expertise to value specific assets and would ultimately assume risk and possible liability in carrying out this role. For managers faced with this choice, finding the right fit from a cost/benefit point of view will be a challenge.

"In the case of certain individual directive requirements, systems may need to be improved, re-designed or even transformed to allow service providers use existing platforms to provide such new service offerings."

Ireland has an excellent reputation for provision of net asset value (NAV) calculation services for alternatives and currently administers 40 per cent of all global hedge funds. NAV calculation should not however be confused with the valuation requirements of the directive where the valuation of a fund's individual assets is under consideration. While there are elements associated with the NAV calculation process that include price verification procedures to sources such as Bloomberg, IDC and other well known data providers, these stop short of independently assigning a value across different asset types and classes.

Depositary

The single most controversial aspect of the directive concerns the depositary and their role and responsibilities. The directive requires the appointment of depositaries for

structures that previously have operated without them. Under the directive, the obligations of a depositary are to ensure the proper monitoring of cash flows; perform safekeeping of financial instruments and other assets belonging to the AIF, and to carry out a number of monitoring and oversight tasks.

Out of all the text in the directive, it is the matter of depositary liability that has caused the most debate. Under the directive a depositary is, as a general rule, liable to an AIF or its investors for the loss of financial instruments in its custody. The depositary will not however be liable where it can prove that the loss has arisen as a result of an external event beyond its reasonable control, the consequence of which would have been unavoidable.

Under the directive, an AIF appoints one depositary and it is the depositary's responsibility to oversee any further relationships. The directive allows for the delegation of safekeeping duties to a third party, which will allow the continuance of multiple Prime Broker (PB) relationships. Notwithstanding multiple PB relationships,

"Ireland is well placed for an AIFM compliant product with it's current Qualifying Investor Fund (QIF), which allows a flexibility of investments, while at the same time subjects the fund to a high standard of regulatory requirements in Ireland."

under the directive it is the AIF's depositary that will ultimately be liable if something goes wrong.

The attraction of the multi-PB model has enabled managers to spread risk and maintain secrecy over individual trading strategies. Each individual PB operating as a custodian of sorts for certain client assets, providing leverage and margin as required, allowing a fund to borrow securities to sell short and generating investment research that clients may use to supplement their own trading programs. The assignment of ultimate responsibility to the depositary under the directive may cause a shift in the balance of power and lead to additional considerations around the appointment of PBs to AIFs. There will also be a learning curve associated with how these relationships are managed.

In Ireland, the requirement to appoint a depositary for non-UCITs funds already exists, together with work practices over the oversight and management of PB relationships. Certain nuances will need to be ironed out, but from a regulatory point of view, Ireland's framework is broadly consistent with the directive.

Marketing and distribution

The ultimate goal of the directive is to protect end investors and guarantee certain practices. It therefore follows that having an AIFM brand or accreditation will bring with it a certain amount of respect and may assist with 'branding' for capital raising purposes. AIFMD compliant products will also be afforded the ability to passport across the EU similar to UCITS which open new distribution routes for managers.

Following transposition of the directive it is likely that new questions will appear on investor due diligence programs, enquiring as to how an investment manager conforms with certain provisions of the directive (be they regulated or not). Investors will always be attracted by historic absolute returns, however in today's market they also want to see appropriate security measures in place and not be duped by a future fraud.

Today, some investors seek this protection through the establishment of single segregated managed accounts. In an AIFMD compliant environment, some of these careful investors might be satisfied to invest directly in a core fund, safe in the knowledge that they are afforded certain guaranteed practices, transparencies and protections under the directive. From a fund managers viewpoint this will help eliminate duplicity of process, increased costs and explaining unforeseen tracking errors.

With registration required for AIFMs in July 2013, many EU and non-EU managers are reviewing their product ranges as they figure out what type (if any) offering they want to propose to comply with and considering whether they want to or need to register.

Ireland is well placed for an AIFM compliant product with it's current Qualifying Investor Fund (QIF), which allows a flexibility of investments, while at the same time subjects the fund to a high standard of regulatory requirements in Ireland.

Furthermore, recent legislative changes such as those allowing a non-Irish fund to migrate to Ireland without changing their corporate structure have certain tax benefits. Solving the problem of an Irish PLC not being able to 'check the box' for US tax purposes, is also being resolved, with the Irish Legislature committing to have in place new legislation at the beginning of 2013 that will allow the establishment of a new Irish Corporate Vehicle, the 'iCAV', which is not a PLC. Should this iCAV elect its classification under US 'check the box' tax rules, it will avoid certain adverse tax consequences. The inclusion of the iCAV within Irish legislature certainly increases the variety of structures available to Ireland, and ensures we are not at a disadvantage vis a vis other jurisdictions.

For non-EU managers avoiding possible

"The inclusion of the iCAV within Irish legislature certainly increases the variety of structures available to Ireland, and ensures we are not at a disadvantage vis a vis other jurisdictions."

dual regulatory oversight in the EU as well as in their home country is a consideration. For non-EU AIFMs, the directive imposes requirements to ensure that your investment management activities are subject to equivalent standards of regulatory oversight and supervision in the AIF's home country as would be required/mandated in the EU under the directive. Some managers considering this are contemplating whether or not the establishment of an internally managed EU AIF might solve this potential headache. Internally managed fund structures have been used frequently in the past for both Irish QIFs and UCITS vehicles. As it stands, these entities have been able, through their board of directors, to delegate much of their activities including portfolio management functions to managers in jurisdictions based outside the EU. It's reasonable to expect that the directive will not be stricter than UCITS on this and will follow established UCITS practices on the supervision of delegated tasks.

Ireland is ready for AIFMD, the sophistication, international depth of the players located here, their know-how, resilience and commitment to change will ensure that Ireland continues to strengthen as a domicile and service centre for alternatives. Additionally, Ireland offers a choice of appropriate tax efficient products/vehicles for AIFs and the regulatory background and oversight regime to ensure that the implementation of the directive will be effective. Commercialising the opportunities associated with the directive may be a challenge and being able to articulate scope increases in services and new offerings will be important to stay in the game.

Fergus McNally is an associate partner in financial services in Ernst & Young.

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Risk management strategies for investment funds

As the supervisory environment becomes more complex and with the introduction of new regulations such as UCITS V and AIFMD, investment funds will need to put a particular emphasis on risk management. LUKAS ZIEWER of KPMG looks at risk management strategies.

There are several macro-trends supporting the continued growth and success of the investment-funds industry at the upper end of the complexity scale. In particular, ageing societies need suitable vehicles to manage the flow of financial savings and provide savers with measurable upside potential and downside protection over the lifetime of the investment.

Related to this trend is that many institutional investors such as insurers and pension funds - in their attempt to focus their own resources where they have a compelling competitive advantage - are looking for ways to outsource mandates for certain investment classes and strategies in cost efficient ways.

While the economic environment is supportive, the supervisory environment is becoming stricter and more complex, mostly as a consequence of the financial crisis.

"Developing a risk framework starts with a determination of risk appetite in all its dimensions. For an investment fund, there are a number of stakeholders that the board needs to consider..."

To protect the stability of the financial system, regulators will increasingly focus on funds' investment strategies, leverage and inter-connectedness with the global financial industry. This brings funds with alternative investment strategies, which so far operated in a relatively benign regulatory environment, much more into the focus.

At the same time, the cost of failure is high and rising. We have recently seen a number of unusually high penalties for failures to comply with supervisory requirements which were caused by oversight and a lack of attention to detail. Such examples are live evidence of the Central Bank of Ireland's commitment to intrusive supervision and strict enforcement. With the presence of international alternative-investment funds in this country, the Irish supervisor will be expected to step up and take a central role in managing systemic risk in this global sector.

Consistent with developments across the financial sector, regulation will increasingly require funds to manage their risks in a more formalised and integrated way; both UCITS V and AIFMD contain additional requirements for the risk management of investment funds. Also, more and more information on a fund's risk profile will need to be reported to investors and the CBI. Ensuring the robust implementation of these requirements needs to be a top priority for funds' boards.

Lukas Ziewer

Risk management for investment funds has typically been focused on the investment manager's risk/return considerations, and the management of legal and tax compliance. However, this is not enough to meet the future requirements, and funds' boards need to develop broader strategies for how the overall risk profile is being managed.

Developing a risk framework starts with a determination of risk appetite in all its dimensions. For an investment fund, there are a number of stakeholders that the board needs to consider, in particular its investors, the investment manager and other business partners, and the supervisor. The investors' risk appetite will be dominated by the fund's performance in line with the mandate, not only in 'normal' times but also in stress scenarios. However, this is broader than pure investment performance; investors are also concerned with the development of the fund's cost base, and also in many cases with the fund's adherence to an investment theme such as sustainability or 'ethical investments'.

The risk appetite from the perspective of the investment manager and other business partners are dominated by their commercial interest to provide continued services to the fund and source a sustainable stream of fee income from it. Also, the investment manager will look to use the franchise that is being developed with the fund to launch additional vehicles and grow assets under management.

The risk appetite of the CBI as the supervisor will be determined by its objectives to protect financial stability and market conduct. Historically, the focus has been on market conduct and consumer protection, which for alternative-investment vehicles had been of limited relevance. However, now financial stability has come under greater scrutiny in particular for alternative-investments funds, and the CBI will take its role in ensuring global financial stability very seriously indeed.

In parallel to clarifying the risk appetite of different stakeholders, the board needs to have available a register of all the sources of risk that the fund and its stakeholders are exposed to. While investment risks are the most obvious and typically the biggest risks, investment funds are exposed to significant other risks, in particular liquidity, counter-party and operational risks.

"In order to make risk manageable, risk appetite needs to be quantified. The investment manager's Value-at-Risk (VaR) numbers are relevant, but the fund's board need to look at other metrics as well. In particular, funds will need to look at the loss potential in stress situations..."

In particular operational risks are typically diverse, and include a long list containing, for instance, risks associated to IT, third-party outsourcing, and the performance of contract indemnities and protections; not mandated trades (rogue traders and 'fat finger'); errors in valuations, models and NAV reporting; and errors in filings, disclosures, and notifications to the CBI.

In order to make risk manageable, risk appetite needs to be quantified. The investment manager's Value-at-Risk (VaR) numbers are relevant, but the fund's board need to look at other metrics as well.

In particular, funds will need to look at the loss potential in stress situations, including liquidity stresses in key market segments and counter-party defaults; sensitivities for key assumptions and models of the investment manager; systemic risk, in particular its inter-connectedness through leverage,

derivative contracts, and funding arrangements; and various operational key risk indicators, which help to quantify operational risks, and may be based on investment consultant/advisor feedback, a record of 'near misses' etc.

Finally, as the board has described and quantified the fund's risk appetite, it will need to ensure adequate monitoring, and timely intervention in the event of adverse developments. In particular, it will need to ensure that it has at all times full visibility of all the metrics and indicators how the fund's current risk profile relates to the risk appetite.

The board also needs to be sure that their view of risk is synchronized with what is being reported to the CBI; given the gravity of potential repercussions, there needs to be a 'zero-tolerance' policy for errors and lapses in communication with the supervisor.

In practice, the actual 'doing' of risk monitoring and mitigation will be performed by the investment manager on behalf of the fund's board.

While this is justified for practical reasons, the fund's board need to retain ownership of the outcome. In the first instance, this is achieved through the board's ownership of the risk framework, rather than relying solely on the picture as it presents itself through the eyes of the investment manager.

Risk management for investment funds has typically been focused on the investment manager's risk/return considerations, and the management of legal and tax compliance says Ziewer, but to meet the future requirements this will not be sufficient and funds' boards will need to develop broader strategies for how the overall risk profile is being managed.

In addition, boards need to implement safeguards. These can include the periodic validation of valuation and risk models; periodic review of the scenarios and assumptions used in stress testing; and engaging with the investment manager in 'themed' investigations into certain risk exposures, such as a rogue trader, counter-party concentrations, and the systemic impact of failure.

Lukas Ziewer is head of financial risk management with KPMG in Ireland.

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PRISM regulatory approach differentiates degrees of risk and provides a proportionate approach

DONNACHA O'CONNOR of Dillon Eustace analyses the European and domestic regulatory response to the financial crisis. He pinpoints the introduction of a single European rule book as well as the Central Bank's focus on governance and its new risk-based supervisory approach, PRISM (Probability Risk Impact SysteM), as key developments.

The financial crisis exposed the failure of supervision of the financial sector in many countries, including Ireland. There has been an understandable criticism of the private sector and the regulators and their respective roles in the crisis. The crisis also exposed weaknesses in the EU and domestic legal and institutional framework in which regulators operated. Fundamental changes have been made to the laws governing the EU financial sector and to the institutional infrastructure underpinning European financial regulation and supervisory practices. Within this EU framework, Ireland's law makers and regulators have taken a number of steps to change the way in which firms are regulated.

"The Central Bank's enforcement strategy is to engage in "pre-defined enforcement" which concentrates on high impact areas such as market conduct, consumer protection and financial crime, focussing on firms with significant market share."

There were a number of short-comings in the European system of financial regulation which were identified during the crisis. There was an absence of monitoring of systemic risk at a domestic and European level, as well as a lack of specific regulation and transparency in relation to certain systemically relevant aspects of the financial system. These included the activities of offshore funds, securitisation vehicles and rating agencies, as well as the operation of the OTC derivatives market and of remuneration structures within financial firms. In addition, the rules set out in certain core laws, such as the Capital Requirements Directive (made up of Directives 2006/48/EC and 2006/49/EC, as amended), the basic purpose of which were to ensure the financial soundness of credit institutions and investment firms, were ineffective in preventing firms from failing.

There was also an absence of a coherent set of rules across the EU (the so-called single European rule book) due to variations in the transposition of EU Directives, ambiguities or gaps in the rules, exceptions made, derogations granted or gold-plating of EU rules by individual Member States. Several Directives left Member States significant options and discretion. The Lamfalussy committees of supervisors (the predecessors of the three new European supervisory authorities) were only able to issue non-binding technical standards which were often ignored by national regulators.

Donnacha O'Connor

In response to the crisis, the European Council adopted new rules to reform the EU framework for the supervision of the financial system and a plethora of new or revised financial laws are in the process of being enacted.

The two pillars of the new EU supervisory framework are the European Systemic Risk Board (ESRB) and the European System of Financial Supervisors (ESFS). The ESRB is broadly responsible for macro prudential supervision and the ESFS, which is made up of an integrated network of European financial supervisors working with three new supervisory authorities, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA), is broadly responsible for micro prudential supervision. The powers of the EBA, EIOPA and ESMA now include the development of binding technical standards and interventions relating to the supervision of individual firms in certain circumstances.

In Ireland, at the institutional level, the Central Bank Reform Act, 2010 abolished the separation between central banking and financial regulatory functions introduced in 2003 and the Central Bank of Ireland is now also responsible for maintaining the stability of the financial system and the proper and effective regulation of markets and financial service providers. This 2010 law and subsequent legislative enactments have given the Central Bank enhanced supervisory and enforcement powers. One of the key tenets of Central Bank supervisory policy is to promote strong and effective governance. To this end the Central Bank has issued or endorsed a number of industry specific corporate governance codes containing requirements in relation to Board composition, independence of Directors, attendance at meetings and other matters.

The approach to supervision in Ireland has also changed. Principles based regulation has been replaced by a risk based supervisory approach known as PRISM (Probability Risk Impact SysteM). This focuses the most resources on firms considered to have a potentially high systemic impact on the financial system and a high risk to the consumer. While PRISM is intended to result in a common basic approach to regulation across all financial sectors, it is also intended to identify where risk is concentrated most highly within the financial system. Furthermore it differentiates between types and degrees of risk in different financial sectors and so avoids an investment fund being regulated to the same degree as a bank or insurance company for example.

The Central Bank's enforcement strategy is to engage in 'pre-defined enforcement' which concentrates on high impact areas such as market conduct, consumer protection and financial crime, focussing on firms with significant market share, and 'reactive enforcement' which is event or report based, and to operate in a proportionate, consistent, targeted and transparent manner.

EU institutional reforms and particularly the introduction of a single European rule book can be expected to strengthen the integration of EU financial markets. Additionally, Ireland's own regulatory reforms are likely to boost confidence in its financial sector and increase the appeal of Ireland as a financial centre and gateway to the EU.

Donnacha O'Connor is a partner at Dillon Eustace.

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Irish fund products facilitate a wide range of investment mandates

The flexibility of Ireland's fund regime is the overriding theme in its success as a fund servicing domicile writes ADRIAN WHELAN of Brown Brothers Harriman. The adaptable service provision and regulatory environment promotes innovation and products that meet global investor appetite, he says.

With assets of Irish domiciled funds breaking through the €1 trillion mark, a gain in UCITS market share, and net inflows outstripping the next nearest domicile in 2011, the question is not whether Ireland is a successful fund distribution channel for global fund promoters but rather, why?

The universal plug

'Adapt or perish, now as ever, is nature's inexorable imperative' - *HG Wells*

The Irish domicile acts as conduit for global investment into regulated funds. A colleague of mine recently described it very succinctly as being like a universal plug, meaning you can connect with the world, no matter what region you are plugged into. Irish fund structures are fully mobile and very adaptable.

The reasons for the success of the domicile are neither exhaustive nor specific; moreover the success factors cannot be said to be exclusive to Ireland since many of the elements are mirrored in other regulated fund domiciles, in particular Luxembourg which also acts as a hub for fund investment from Asia, Middle East and Latin America. It's fair to suggest a form of healthy competition between these two primary fund domiciles serve to offer choice to global asset managers which serve to ensure the evolution and development of globally distributed fund products.

Importantly, one can point to flexibility as the overriding theme. This flexibility is proven by the wide range of investment mandates that are capable of being facilitated through UCITS or QIF products. Further, the adaptable service provision and regulatory environment in the Irish fund industry promotes innovation and products that address investor appetite regardless of investor domicile.

This flexibility is strongly underpinned by robust levels of oversight from practitioners and the Central Bank of Ireland which give comfort to fund buyers and foreign regulators alike. This is evidenced, for example, by certain Asian, Latin American and Middle Eastern regulators who formally acknowledge the UCITS structure. When product flexibility is combined with a strong governance infrastructure the result is positive performance and outcomes for promoters and their clients. This UCITS 'badge of honour' has resulted in significant and growing asset flows to Irish funds from these regions.

Adrian Whelan

From a client alignment perspective, BBH believes that it is critical to partner with clients on distribution strategy. Our perspective includes expertise in fund structures and their respective attributes as they pertain to the specific desired client outcome. We believe that BBH provide thoughtful commentary on applicable regulatory matters and the nuances of particular jurisdictions, and we align this perspective with operational support and platform stability that drives efficiencies to our clients globally. Client distribution strategies drive our own approach to servicing and our global service model has evolved and advanced to match the increasingly global nature of our clients businesses.

Execution must match ambition

'Ambition never is in a greater hurry than I; it merely keeps pace with circumstances and with my general way of thinking' - *Napoleon Bonaparte*

Most UCITS managers plan for expansion into multiple regions at some point and it is obviously critical that such ambitions are married with solid execution. This is where the capabilities of Irish service providers play a critical role. An illustrative example is found given the rapidly increasing number of investor jurisdictions transfer agents must deal with greater cross-border distribution, as well as multiple products, fee types, commission structures, distribution channels and investor groups. In addition to providing core processing, transfer agents' services have evolved to include complex fee calculation, tailored shareholder servicing, customized and flexible data reporting, and distribution support.

A striking example of the global success of UCITS is the fact that 70 per cent of authorised funds in the main hubs of Hong Kong, Singapore and Taiwan are structured as UCITS. One of the more interesting recent product developments in Asia has been the addition of Renminbi denominated share classes to fund offerings matching the global investor appetite for Renminbi exposure with the Chinese goal of internationalisation of the currency.

Moreover, second mover advantage is quite noticeable in the region. A successful investment strategy and marketing campaign of last year may often be either replicated or improved upon by a slicker or larger player to take advantage of positive sentiment attached to a particular 'recent winner.'

> **"When product flexibility is combined with a strong governance infrastructure the result is positive performance and outcomes for promoters and their clients. This UCITS 'badge of honour' has resulted in significant and growing asset flows to Irish funds from these regions."**

The Middle East is obviously an attractive region for the sellers of funds. Whilst Shariah compliant funds remain important in the region, our experience has been that more evident asset flows from the Middle East in recent times have been to asset classes ranging from fixed income to real estate, but most evidently to passive strategies index trackers and ETFs. The appetite for passive and ETF type products from the region is large. Interestingly, the first Abu Dhabi based fund promoter to launch an Irish UCITS scheme was authorised last year to launch a range of ETFs into the market, which was a prime example of the internationalisation of Middle Eastern investment managers into the UCITS market.

Despite the well known dynamic of Chile, Irish funds have done extremely well in tapping into certain Latin American fund channels. Much of this success is driven primarily by the fact that

many Latin American governments have privatised their government pension plans, Administradoras de Fondos de Pensiones (AFPs). These large and accessible pools of capital have a natural affinity and historic track record in investing into UCITS schemes and this has been matched in recent times by other institutional investors in the region also.

BBH has a leading market share as global administrator servicing Latin American corporate and pension funds. Our relationships with the largest allocators to offshore funds drive insights on these markets to our clients who distribute Irish product into these markets. A distinct trend we have noted in recent times is that wealthy non-resident Americans based in the Latin American region are an investor group targeted by many of the larger Irish fund promoters. This pool of assets is normally targeted through distribution agreements with Floridian and surrounding area wealth managers.

The road less travelled

'There are no foreign lands. It is the traveler only who is foreign' - *Robert Louis Stevenson*

Another key component of geographic expansion is the fact that like any journey into the unknown, with such adventure brings an additional amount of downside risk and challenges. One of the most visible themes of the recent raft of regulatory repapering is the fact that many of the headline regulations are actually multi-jurisdictional. Concepts such as FATCA, UK Retail Distribution Review, AIFMD, and Volcker Rule do not just have local impact, but reach across borders and touch on the various aspects of a fund promoter global strategy.

BBH has deployed dedicated resources to continuously monitor and assess regulatory developments. We keep our clients informed by communicating interactively with them throughout the process. Our goal is to establish a culture of awareness and thoughtfulness as to market and regulatory developments and drive value to our clients.

Each of the key markets in Latin America, Middle East and Asia have nuances, specific local registration or compliance requirements and certain market participants or decision makers who play essential roles in distribution. BBH's view is to sensibly share our experience with clients in order to enable their success.

The future?

'Study the past, if you would divine the future' - *Confucius*

It is our belief that Irish funds will continue to evolve and expand generally into the future. A significant portion of this future growth will come from these particular territories. As in the past, our industry will adapt and innovate to match the growing complexity and market demand in terms of facilitating fund flows and product development from new and existing investor channels and growth markets. Great change brings challenges, as well as opportunities, and the extensive global reach of the Irish funds industry is ideally positioned to continue to drive value to its diverse and wide ranging client base within the global market.

Adrian Whelan is a relationship manager at Brown Brothers Harriman.

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The recent aquisition of Complementa has enhanced State Street's data management services

SUSAN DARGAN of State Street outlines the services currently available for data management outsourcing partnerships and the benefits of using these services.

Changes sweeping across the institutional investment and regulatory landscape pose profound implications for data management. As investors develop new approaches to asset allocation and risk management, their demand for enhanced information is accelerating. Compounding this challenge for asset managers are the many regulatory directives now emerging that include additional reporting and recordkeeping requirements. As a result of these changes, asset managers can foresee increased pressure on costs and operating models. The mounting need to achieve efficiencies in their overall operations is driving many firms to consider innovative options, including strategic partnerships with servicing providers that can deliver scalable, outcome-driven solutions.

Today's growing focus on data management stems largely from the investor- and regulator-driven pursuit of greater transparency and risk awareness. Responding to a difficult investment climate, Europe's pension funds, insurers and sovereign wealth funds are revising allocation strategies to accommodate a broader range of asset classes. They are also adopting more robust methods for managing risk in a volatile low-return environment. To support these efforts to balance risk and reward, investors seek high-quality data to guide them.

Amplifying this trend, incoming directives contain significant new reporting and record-keeping requirements. For example, the Markets in Financial Instruments Directive (MiFID II) will have far-reaching implications that include changes in client categorisation and best execution rules from 2014. In response, asset managers may be obliged to develop and target products more narrowly at specific types of investors.

Another example is Solvency II which is scheduled to come into effect in January 2014. It calls on insurers to provide far more rigorous and expansive data to regulators than ever before. Although insurers have become good at gathering liability data over the years, Solvency II puts an increased need for them to focus on high quality asset data too. The knock-on effects will be felt by asset managers who manage assets for insurance companies, as they will be required to provide more granular data on investments held within portfolios.

Susan Dargan

Client Reporting Demands

The gravity of the upcoming data management challenge emerged strongly in a new State Street survey of European asset managers conducted by the Economist Intelligence Unit. With responses from more than 160 asset managers in 25 European countries, the survey was an opportunity to assess the state of the industry at a critical point in its evolution. When asked to identify the biggest data management challenges facing them today, 49 percent of asset managers highlighted the provision of a high level of detailed and quality data to clients (see chart). In addition, they recognise that these demands will put significant pressure on their existing infrastructure, with 44 per cent saying they would struggle to achieve sufficient scale with their in-house systems to deliver on the data management challenges ahead.

In the face of mounting complexity and growing reporting burdens, the benefits of leveraging the scale and expertise of third-party providers through outsourcing partnerships look increasingly attractive. After several years of difficult market conditions, when asset managers have undertaken many of the easier cost-saving measures, they must now look to more radical solutions. For example, they are looking to the advantages of single-platform infrastructures and centralised data management systems, often replacing multiple systems inherited through acquisition. While it has been possible to avoid the challenges of such projects during boom times, the current cost-conscious and risk-averse climate gives such undertakings a new urgency. Streamlined platforms provide a consolidated picture of global exposure for reporting to investors and regulators, possibly at a lower cost. Furthermore, these platforms offer the flexibility and agility needed to launch new products quickly as asset managers seek to grow through innovation. Costs to develop, maintain and upgrade new infrastructure, however, can be daunting.

The operational challenges of data management are just one driver of the increasing trend toward outsourcing. Managers' preparedness to outsource extends right through the investment value chain, comprising not simply the back and middle office but increasingly front-office activities, too, where there may be scope to outsource virtually everything beyond core investment decisions.

Increased reporting and compliance burdens that add to the complexity of data management certainly represent important factors in the decision to partner with external providers.

"Today's growing focus on data management stems largely from the investor- and regulator-driven pursuit of greater transparency and risk awareness. Responding to a difficult investment climate, Europe's pension funds, insurers and sovereign wealth funds are revising allocation strategies to accommodate a broader range of asset classes."

Outsourcing enables asset managers to delegate these and other key administrative responsibilities that threaten to distract them from their core investment focus. At the same time, managers recognise that they may need to invest substantially in expertise and technology to keep pace with evolving compliance requirements over the longer term. While the largest asset managers may have the scale to absorb this investment, other firms will view outsourcing as a compelling opportunity to benefit from the resources and efficiencies of scale of a third-party provider.

With this in mind, leading providers are continually seeking to add new capabilities that deliver on the increasingly complex needs of asset managers and asset owners. With the recent acquisition of Complementa

Investment-Controlling AG, an investment performance measurement and analytics firm based in Switzerland, State Street, for example, has enhanced its existing capabilities in this sphere. Complementa is a recognized leader in the precise and independent consolidation of assets, performance measurement and investment controlling for institutional and large private investors.

Effective data management - an asset management necessity

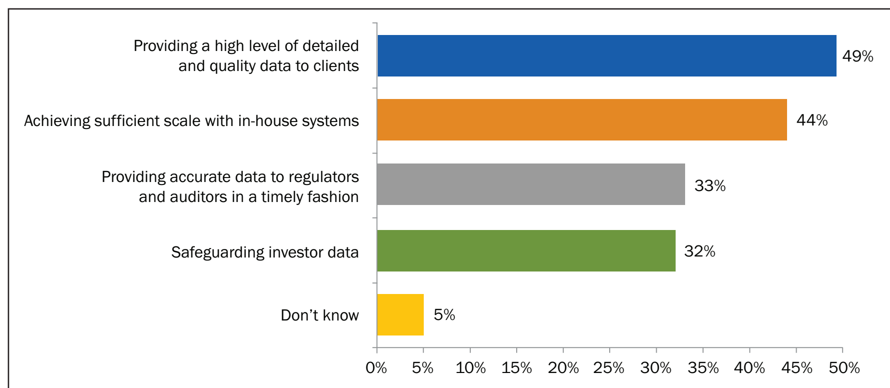
With a rising focus on risk, effective data management has become a necessity for asset managers, investors and regulators. Indeed, with 42 percent of respondents to the State Street survey rating their ability to capture and report regulatory data as only adequate, it also poses significant challenges. In addition to the regulatory requirements, investors expect to gain a consolidated picture of their assets, a task made vastly more difficult by today's more complex global and derivatives-heavy investment portfolios. Only robust data management capabilities can produce the answers investors demand, with the memory of the financial crisis still fresh in their minds.

As a result, data management now plays a central role in the integrated solutions for assessing risk and performance that can help managers to maximise returns in a more risk-controlled environment. Far more than a record-keeping function, it has become an essential element on the frontier for investment analytics, addressing the defining dilemma for asset managers in today's climate, namely the need to drive enhanced returns in a world more risk-averse than ever.

As asset managers consider outsourcing among their data management options, they also recognise that asset servicing organisations — with their geographic breadth and local expertise — represent valuable sources of insight into ways to streamline their operations or refine their product offerings. Thus, whether supporting key reporting activities, helping to manage risk, or enabling managers to seek new markets and investors, servicing providers can become strategic partners for leveraging the value of data.

Susan Dargan is senior vice president at State Street.

WHAT ARE THE GREATEST DATA MANAGEMENT CHALLENGES TO THE ASSET MANAGEMENT INDUSTRY TODAY?



Source: 2012 State Street Survey of European Asset Managers conducted by the Economist Intelligence Unit.

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Irish fund industry rises to the regulatory challenges facing exchange traded funds

With a raft of changes affecting exchange traded funds, Irish fund services providers are working to ensure the effective implementation of new guidelines, writes TARA O'REILLY of William Fry. She looks at the impact of the changes and how the Irish funds industry aims to retain is position as a global leader in ETFs.

Ireland is a leading fund domicile for internationally distributed ETFs. It is home to long established global ETF promoters and also has been more recently chosen by many of the new entrants to the ETF market as the domicile for their European platform. So what is it that Ireland offers?

As a starting point, virtually all ETFs are UCITS and Ireland has a long standing reputation as a leading European domicile for internationally distributed UCITS. ETFs have been domiciled in Ireland since their first arrival in Europe in 2000. Ireland therefore offers expert knowledge and experience in all aspects of ETFs from a well informed regulator to established providers of administration, custody, registrar, legal and audit services. Ireland also offers an efficient, low cost and timely listing process through the Irish Stock Exchange with the advantage that once listed here a very straightforward and expedited process exists for admission to trading on other exchanges, such as the London Stock Exchange. Irish ETFs have also been registered and cross listed in a number of jurisdictions outside of Europe. Ireland also boasts a favourable tax position for funds and has a large network of double tax treaty agreements in place and Irish ETFs have long qualified for favourable withholding rates on investments in certain jurisdictions.

With the pace of growth and innovation, ETFs have become a high profile product and have come under the spotlight of European regulators. When first established, ETFs were regulated under UCITS I. Within that regime of limited eligible investments and broad diversification requirements, ETFs were index tracker funds directly investing in the securities of the relevant benchmark index (physical ETFs). The indices these ETFs tracked were typically broad based with equity or bond components. With the introduction of UCITS III an increased eligible asset range was introduced allowing the product to develop by tracking more concentrated indices. Significantly, UCITS III also allowed an alternative method of replication through the use of derivatives thereby introducing the synthetic ETF and through synthetic exposure allowing access to asset classes that could not be invested in directly. As ETF strategies continue to increase in scope, product development has included ETFs tracking more concentrated/customised indices, additional asset classes and even active strategies. ETFs are also using more sophisticated financial instruments to achieve replication. There have also been new entrants to the market with different models for structuring their ETFs. In the face of this, regulators have grown concerned about the risk of product confusion for investors. There has been much discussion of counterparty risk, liquidity impacts and possible destabilising effects on markets, making it difficult for investors to analyse investments. In addition to regulators, institutions such as the Bank for International Settlements, the International Monetary Fund (IMF), the Financial Stability Board and the International Organization of Securities Commissions (IOSCO) have expressed concerns, particularly about the systemic risks they believe are potentially posed by synthetic ETFs. Much debate followed the reports issued by these bodies and, in particular, the consultation and review process of the European Securities and Markets Authority (ESMA) culminating in the recent report paper, 'Guidelines on ETFs and other UCITS issues' of 25 July 2012 (the 'guidelines').

Tara O'Reilly

"ETFs have been domiciled in Ireland since their first arrival in Europe in 2000. Ireland therefore offers expert knowledge and experience in all aspects of ETFs from a well informed regulator to established providers of administration, custody, registrar, legal and audit services."

ESMA was examining the impact of ETF product innovation following the introduction of UCITS III on investor protection and market integrity and considered a number of structural matters of ETFs, from an investor transparency and protection perspective. There have been many and varying views on the issues raised coupled with questions as to why ESMA has chosen to focus on ETFs, given the size of the ETF market and its already highly regulated status. While the review was initially focused on ETFs, the issues raised related to general UCITS provisions and the guidelines therefore have a general UCITS impact with consequences for any index tracking UCITS or UCITS using derivatives or EPM techniques (repos/securities lending). The guidelines are effective two months after their official publication and while many of the requirements offer a grandfathering period for existing funds of up to twelve months, a couple of the provisions are immediately effective. The guidelines also apply immediately to new funds established after the effective date.

The guidelines are broad and address all aspects of the ETF structure. They first define an ETF and provide that only ETFs meeting that definition can use the term 'UCITS ETF' in their name. While that will bring clear brand recognition to contain ETFs, it comes with compliance and disclosure requirements outlined in the guidelines.

A fundamental part of the construct of an ETF is the index that it tracks\replicates and the guidelines focus on this. While indices are currently the subject of regulation, regulators looked at developments in index construction and in self-indexing. ETFs were originally developed to track broad based indices developed by specialist third party providers. Now some ETF managers are creating and calculating their own benchmark. While the trend towards increasing in-house provision by asset managers of their funds' benchmarks is stated to be aimed at reducing costs to investors, it can also bring into question issues of conflicts of interest and governance. The current position of

regulation on this issue differs between the US and Europe. In the US, the 1940 Investment Company Act places tight restrictions on investment companies' dealings with affiliated parties. In Europe, however, the rules governing acceptable indices focus on the suitability of the underlying index as an investment benchmark, not on preventing transactions with related parties. UCITS regulation requires that an index-replicating fund should use a benchmark that is 'adequate' for the market to which it refers, 'sufficiently diversified' and 'transparent'. The guidelines develop the criteria further and include a requirement to publish the full index calculation methodology for such indices and to disclose all index constituents.

ETFs will need to review their index against the new requirements to ensure compliance and also review if arrangements with providers need to be addressed in light of the new disclosure proposals.

"The Irish industry is also actively working to ensure that the impact of any regulatory reviews on ETFs are managed effectively"

Once the index meets the requirements, the next issue the guidelines address is how the index is replicated. Much of the debate in recent times has centred on the differing risks relating to the manner of replication by ETFs. For the synthetic ETF the debate has been around perceived counterparty risk and for the physical ETF the debate has been around the perceived risks of the ancillary activity of securities lending. In looking at synthetic replication, the guidelines look at the use of total return swaps or other financial derivative instruments with similar characteristics and impose requirements in relation to diversification of underlyings and ensuring any discretion granted under the instrument is reflected in an appointment of the counterparty as an investment manager. For OTC derivatives generally, new collateral arrangements apply including requirements on diversification, eligibility, haircuts and stress testing. For physical ETFs that engage in securities lending, the arrangements in relation to sharing of the revenue generated need to be reviewed with greater transparency being required in relation to such arrangements.

With transparency and investor protection key in the minds of regulators, regulatory focus is also on how ETFs are sold. Unlike the US, investors in European ETFs are mainly institutional. However, it is believed that initiatives in Europe as to how investment advice is paid for will, over time, result in European ETFs having a greater retail investor base. An example of one such initiative is the Retail Distribution Review (RDR) in the UK aimed at ensuring that investors are offered a fair and transparent charging system for advice and that investors are clear about the service they receive. Similar proposals are being considered in other jurisdictions to address the perceived loss of confidence of investors in advisers and to place additional responsibilities on advisers in the provision of their services to keep investors fully informed. If these changes do result in a diversification the ETF investor base, it is understandable that regulators would concern themselves about the ability of retail investors to understand the differences in product types and the investment strategies and risks in products with increasing complexity. The guidelines address this by requiring significant disclosure in the prospectus around the detail of the ETF. In most cases this disclosure was already required by the Irish Central Bank so there should be little additional disclosure needed for these ETFs.

Investor protection also drives a focus by regulators on how the products are sold. The selling of ETFs is looked at in the very ETF specific area of the secondary market, where many investors gain exposure to the ETF. The guidelines seek to offer protections to such investors where liquidity on the secondary market is impacted. A specific risk warning must now be inserted into the Prospectus and a direct right of redemption must be offered to the secondary market investors if certain conditions arise.

The selling of ETFs has also been looked at in terms of the obligations on the 'sellers'. Here there have been suggestions that the current blanket classification of ETFs, irrespective of strategy or structure, as non-complex under MiFID should be revisited with some being reclassified as complex. Generally, this is not favoured as it would effectively be the development of a 'two-tiered' UCITS potentially leading to confusion as to what UCITS represents and thereby damage the global UCITS brand. Current MiFID II proposals present the opportunity to address such concerns without the need for different classifications within UCITS.

While the debate on the appropriateness of MiFID classification of UCITS continues, there are other proposals in relation to MiFID that will impact ETFs. MiFID II aims to achieve transparency, competition, investor protection and to seek to develop available market data in terms of its quality, format, cost and consolidation. Efficient secondary market trading of ETFs is assisted by transparent trading information. Some current MiFID requirements have resulted in some data/market fragmentation and with a view to remedying this, MiFID II seeks to improve the quality and consistency of data by requiring that all MiFID regulated firms publish their trade reports through Approved Publication Arrangement. The intention is to deliver market data that is reliable, timely and available at a reasonable cost so as to enable investors access to market data which will allow an efficient comparison of prices and trades across market trading venues. While MiFID II, continues to exclude collective investment undertakings from its scope, the proposed MiFID II regulation applies the MiFID transparency rules (both pre and post trade) to ETF shares. As there can be a lack of transparency from market participants on the secondary market in relation to the actual price at which ETF shares are traded, the additional reporting required by MiFID II will provide greater transparency from market participants in relation to pricing and volumes of trade in ETF shares which would allow the aggregate volume traded in ETFs throughout all of its listings to be seen. This additional reporting is offset by the proposal for consolidating tape reporting. This reporting will give the ability to see the depth of the market place. Where APs understand where the best pricing is, it will ultimately be an advantage to all investors.

With significant development in ETF regulation, there are many operational matters that ETF promoters are working on with a view to being ready for their implementation. Irish service providers are actively preparing to ensure the guidelines can be efficiently implemented. The Irish industry is also actively working to ensure that the impact of any regulatory reviews on ETFs are managed effectively and that Ireland as a domicile remains well placed to address these and to allow promoters focus on continuing growth and development.

Tara O'Reilly is a partner at William Fry.

Preparing hedge funds for regulation

DECLAN QUILLIGAN outlines the advantage that the services that Citco Fund Services can provide to its hedge fund clients can give when dealing with the demands of regulations such as Dodd Frank, FATCA and AIFMD.

From 2012 to 2014 the hedge fund industry is entering a new age of regulation. The Dodd-Frank and FATCA regulations will vastly increase reporting requirements globally, while AIFMD has operational implications for Europe's managers and service providers. Preparing for these changes in a short space of time is a huge challenge, especially when regulators have yet to clarify important details.

Alternative investment managers, large and small are collecting data far more systematically than before in order to comply with new regulatory reporting requirements.

"Citco Bank currently acts as a depositary for both Irish and Luxembourg domiciled funds and as such is already in a position to fulfil many of the ESMA depositary requirements."

As the hedge fund industry's leading fund services provider, Citco has an important role to play, offering advice, reporting and infrastructure that will assist our clients in complying with the changes in regulation. Our leading regulatory and tax specialists are already helping clients to plan for regulation, and we have introduced new services and technology to reduce the burden of regulatory reporting.

Data for reporting

The US Dodd-Frank act is the first regulatory hurdle for hedge fund managers to overcome. Starting in the second quarter of 2012, managers in the US, and many from elsewhere, have had to register with the SEC. Amongst other requirements, managers have a responsibility to file 1,900 pieces of portfolio data every quarter, through a Form PF.

Citco's Regulatory Reporting service team has extensive know-how on many of the interpretive issues prevalent. Our team are already providing a service to help managers meet this demanding reporting requirement. We currently gather a significant amount of the data stipulated through our fund administration offering, and we have examined how best to collect data not already captured within our systems. In addition, Citco offers an advanced technology solution which includes the CFS Form PF Portal which enables investment advisors to complete Form PF online for ease of collaboration with our Regulatory Reporting service team and to ensure conversion to the .XML format required for submission to FINRA.

Declan Quilligan

Coming close behind on the regulatory horizon is FATCA, which effectively requires offshore funds to enter into agreements with the IRS to provide information on financial accounts held directly or indirectly by U.S. persons. Although FATCA withholding tax will not be enforced until 2014, the FATCA regulations are scheduled to phase in with effect from January 1, 2013. Accordingly, we have launched a service this year to assist our clients in categorizing their investors' in accordance with FATCA classifications.

"The Citco Value Added Approach involving people, process and technology will enable our clients to be in a position to request the required information on a timely basis from their investors in order to certify that the required due diligence has been performed as required under FATCA."

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Flexibility in Europe

In Europe, Citco's experience in servicing Irish and Luxembourg domiciled UCITS and non UCITS has proven invaluable as Citco and the industry readies itself for change post the AIFMD regime's introduction in 2013. While the ESMA technical body has still to publish its final advice containing critical details that could alter the make-up of the European hedge fund market's operational infrastructure, we are confident we will be able to assist hedge fund managers in meeting the challenges that AIFMD will pose.

"Citco with its capability of pricing complex financial instruments is well positioned to fulfil the valuation provisions of the impending regulation maintaining current best practice of independently pricing portfolio."

Citco Bank currently acts as a depositary for both Irish and Luxembourg domiciled funds and as such is already in a position to fulfil many of the ESMA depositary requirements. We have also built up a sub custody network of prime brokers which will enable clients to continue utilising a model similar to what they use today. For non EU funds that do not wish to use the 'marketing passport' the requirement for a single depositary will not apply and as such Citco will be able to carry out the cash monitoring and supervisory duties whilst allowing the custodians and prime brokers continue to fulfil the remaining duty of safekeeping of assets as they do today. Furthermore, Citco with its capability of pricing complex financial instruments is well positioned to fulfil the valuation provisions of the impending regulation maintaining current best practice of independently pricing portfolios.

Declan Quilligan is managing director of Citco Fund Services (Ireland) Limited.

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Risk management functions to support hedge fund growth

The hedge fund industry shares risk with mutual funds such as market risk, credit risk and liquidity risk, but these risks are combined with idiosyncratic risks, with model risk being the most substantial, writes MARK KENNEDY. Sophisticated risk techniques are required to mitigate model risk and hedge fund managers must create a strong risk management function to ensure sustainable and resilient growth, he says.

Mark Kennedy

The hedge fund industry has experienced steady growth since the beginning of the 1990s when total assets under management represented only $39 billion, as compared with $1,900 billion at the end of 2010. Over the same period, the number of registered hedge funds increased from 610 to 9,237. Trading strategies have shifted towards Event-Driven and Relative Value strategies while the share of assets managed in Global Macro strategies has significantly reduced. Equity Hedge strategies continue to be the most used in practice. At the same time, hedge fund business models have evolved, driven by institutional investors who seek efficient diversification as a means to preserve capital in an environment of volatile markets and low bond yields.

"The failure of Amaranth Advisers LLC appears to be a text book case and is to date the most notorious example of style drift"

These changes, however, do not necessarily mean that growth in the sector has been exclusively along sustainable lines. Regulation has in many jurisdictions been relatively light and risk management issues have only benefited from partial attention, potentially posing significant risks. The capacity of hedge funds to short positions, and to use complex and sometimes illiquid financial instruments, may make their exposure difficult to manage.

Key risks in the hedge fund industry

Risks shared with mutual funds (market risk, credit risk, liquidity risk) combine with idiosyncratic risks, among which model risk is the most substantial. The management of hedge funds is often based on technical models which are designed to respond to market signals and to continuously re-evaluate positions. Accordingly, model risk becomes central - and is in a way perhaps best described as the risk borne by the investor in relation to the hedge fund managers' ability to build a reliable model and to develop it appropriately over time. Model risk mitigation requires a structured approach and use of sophisticated risk management techniques.

Risk management in practice

Weak risk management has historically led to startling collapses. To take just one example, the failure of hedge fund Amaranth Advisors LLC appears to be a textbook case, and is to date the most notorious example of style drift (a change in a hedge fund's investment strategy). Its collapse appears to have been associated with lack of control, lack of transparency, lack of expertise and excessive concentration. A number of key indicators (e.g. VaR, Hurst exponent) seem to have been ignored. As a rule of thumb, risk management within the hedge fund industry should not deviate from the best practices used in any other investment vehicle or investment company. The risk function must adapt to each hedge fund's specific situation, depending on the strategy developed. The manager must create a well-tailored risk management system, proportionate to the nature, the size and the complexity of the hedge fund's activities and instruments.

Risk management responsibilities need to be clearly allocated within the team as well as being hierarchically and functionally independent from the operational units. Good risk management relies on human resources, key competences and well-adapted technical tools. Risk management policies must be approved, periodically reviewed and transparent to investors who can analyse their relevance. They must also be subject to appropriate and regular compliance and performance monitoring.

The risk management function's key role is to ensure the relevance of the risk profile set by the management team and to verify the consistency between the risk levels set and the strategies developed. Its role also involves validating and monitoring key risk indicators set by the management team and ensuring the relevance of thresholds and risk limits as well as the efficiency of risk identification tools.

"All stakeholders can be involved in the improvement of risk management within hedge funds. Investors, as part of their selection process, have a unique role. Regulators, too, must provide a regulatory framework conducive to the implementation of best practice."

Roles and responsibilities of risk management

Broadly speaking, risk management is an ongoing relationship between the management team and the risk function. Throughout the life of a hedge fund, the management team ensures continuous monitoring and adapts its profile to every change in market conditions or strategy, while the risk function carries out the necessary second-tier controls and validates those changes which occur.

Adequate risk management, combined with enhanced transparency and regulation, provides assurance of a hedge fund's continuous and long-term growth. All stakeholders can be involved in the improvement of risk management within hedge funds. Investors, as part of their selection process, have a unique role. Regulators, too, must provide a regulatory framework conducive to the implementation of best practice. It should be recognised that the nature of industry participants means that over-zealous and restrictive controls run the risk of constricting growth. Nonetheless, the experience of past crises and the structure of the industry as we perceive it today suggest that steps taken to strengthen risk management practices will, in the long term, support more resilient growth in the sector.

Mark Kennedy is head of financial services at Mazars.

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