Financial Regulation: Tech and Brexit Spur Action

By Adrian Whelan

If 2018 was a year of regulatory recalibration, 2019 will focus more on high level regulatory themes rather than detailed specifics. 2019 will be a year where global regulators assess certain common strategic themes impacting global investors. In no particular order, here are five regulatory trends we believe will shape the asset management landscape in 2019:

1 Brexit, Brexit, Brexit

This year, at least one thing is certain: Brexit will remain a major area of focus for the asset management industry. Given current politics, we can't predict the future with any degree of precision, but there are several "known unknowns" that require resolution. These affect asset management and will play out as we move through the Brexit process in 2019.

With the March 29 Brexit deadline looming, and the probability of a no-deal Brexit seemingly more likely, both UK and EU regulators have begun executing their no-deal contingency plans. They agreed on a memoranda of understanding (MoU) which aims to mitigate the most adverse market consequences of a no-deal Brexit scenario. The MoU serves to ensure that the EU and UK regulations will be deemed equivalent and will retain information sharing and supervisory cooperation for a transition period through March 2021. These agreements help to retain reciprocal market access for regulated entities in the EU and UK even in the ultimate instance of a no-deal Brexit. The Financial Conduct Authority (FCA) has also recently requested special legislative powers from the UK government to implement the required regulations needed to address issues arising from a no-deal Brexit, without the need for government approval.

Despite the MoU for equivalence, firms that have invested significant resources in restructuring their business have not taken action in vain. It is expected that the FCA and UK politicians will use Brexit as an opportunity to distinguish UK rules from key EU requirements for funds and banks. One of the underpinning political goals of Brexit was to make the UK a distinct and attractive financial market place that can compete globally.

The FCA has long been an influential voice within the EU's policy making framework. It has often led the way with regulatory requirements as well as critical financial services architecture such as MiFID 2. Now, through EU Trialogues and FCA Q+As, the industry has a clear indication as to how the FCA views certain requirements and where it may seek to re-assert its own standards in the UK market. We expect in many areas the requirements may become more, not less, stringent.

There remains a wide spectrum of possible scenarios which may play out before we have any kind of clarity on the manner of the UK's exit from the EU and any detail on the nature of the future relationship. Follow the continuation of the Brexit story and what it means for asset managers throughout 2019 here.

2 The Value for Money Debate

The investor "value for money" debate in asset management has been ongoing for several years now. Regulators and the industry have discussed the meaning of the term "value" at length, but it generally refers to the reasonableness of the costs incurred by an investor weighed against the net returns accrued from being invested in the fund. 2018 became the year of the first ever "zero fee fund" where certain fund providers acknowledged investors should pay a lower cost for very simple low-cost strategies. Regulators too have become increasingly focused on fees and are taking measures to ensure they are adequately disclosed, fair, and capable of being understood by investors. Global regulators have already enacted a wide number of investor protection regulations and the focus on fee levels and value to investors will likely only intensify in 2019.

"Closet tracking" is a concept also coming under the watchful gaze of regulators in more jurisdictions. In short, the practice refers to investment portfolios that claim to be actively managed, but actually so closely track a chosen benchmark, that they are in effect a passive strategy. Previously, regulators in the US and Asia have raised concerns about this practice, but now regulators in Europe are looking even more closely. The most recent example of this scrutiny may be found in Ireland, where the Central Bank announced in December that they would review UCITS funds for closet tracking behavior. In the UK, the FCA also places investor value high on their agenda. The debate will persist in the coming year, but the ultimate European response to mitigating closet tracking risks to investors, as in so many of these rules, is likely to shape future regulations on a global basis.

Already in early 2019, we have seen two high profile regulatory publications released in quick succession, showing how consistent the theme of investor value is within global asset management. First, in Australia, the 950-page Royal Commission report highlights areas of significant deficiency, misconduct, and frank criticism of the country's financial services industry. It has resulted in much political debate about restoring trust in the financial sector; 76 market recommendations, 19 instances of misconduct across 22 entities, and a proposal to create a new independent regulator to oversee the market.

In the UK, the FCA published its latest policy statement linked to last year's Asset Management Market Study Final Report which addressed concerns from the FCA's two-year assessment of the UK asset management industry. The latest publication outlines a set of remedies related to the adequacy of disclosures made to investors which aim to generally help investors better understand the products they are invested in and in particular make fund strategies, fees and other costs, and fund performance more understandable to investors.

3 Greater China Remains Key to Global Asset Managers

Despite recent volatility in China's stock markets (major indexes in Shanghai and Shenzhen saw significant losses last year), China remains on a path to regulatory and market liberalization, which should continue in 2019. There continues to be a broad range of investment and distribution opportunities in the Greater China region each developing on their own timeline, driving US and European asset managers to enter Greater China, and Greater China asset managers to expand beyond their own region.

Inbound investment into the onshore capital markets is an area to watch this year with A-shares and bonds being added to global indices. The China Securities Regulatory Commission (CSRC) expects foreign inflows into mainland stocks to double in 2019 to $89.5 billion.

In a policy attempt to increase participation in inbound investments, the CSRC recently released draft rules which foresee merging the Qualified Foreign Institutional Investor (QFII) and the Renminbi Qualified Foreign Institutional Investor (RQFII) schemes into a single scheme. The new rules will allow foreign investors to invest in private funds, bond repurchase agreements and derivatives, including financial futures, commodity futures, and options. Investors will also have access to the New Third Board (main over-the-counter equity market).

The introduction of access to private funds is a welcomed addition by foreign asset managers who have set-up private funds through their Wholly Foreign Owned Enterprise (WFOE). This will help WFOE's scale their onshore private funds through foreign investment as they build their track record and develop their onshore distribution strategy.

4 Technology Revolution

With a profusion of financial technologies coming to market, global regulators are trying to position themselves to understand these technology innovations and the areas they should and shouldn't regulate. This is an area that requires a balance between ensuring investors are protected and not stifling competition or new product solutions which may benefit markets and investors. Much of this technology remains nascent or aspirational, and regulators are waiting to weigh in, but we expect 2019 to represent a period of rapid product development and regulatory reaction.

For example, there has been a lot of market activity recently around cryptocurrencies. There is also a tendency to regulate after the horse has bolted on an event. It is highly likely that regulators will address areas such as Initial Coin Offerings (ICOs), Distributed Ledger Technology (DLT), and the use of artificial intelligence in asset management in 2019.

The amount of data generated, consumed, and transferred globally has increased exponentially in recent years. That growth has created new regulatory risks around the protection of such data, especially personal data. The EU is proceeding with implementation of its Directive on Information and Network Information Systems (NISD), a set of rules first issued in 2016 aimed at cybersecurity. In the US, the New York State Department of Financial Services cyber security regulation becomes fully effective in March, heralding in a higher standard that will likely influence future Federal US cyber regulation.

Global asset managers have another critical challenge: country or area specific regulations often do not consider how to integrate their rules with other cyber security regimes, greatly complicating the efforts of global firms to establish and maintain global compliance structures.

5 Making Investments More Sustainable

There's little doubt that there is a strong political will in Europe to move forward with fostering a greater degree of sustainable investments in the markets. The European Commission made a commitment to make the EU carbon neutral by 2050. Within the EU Capital Markets Union (CMU) plan is a "Climate Action Plan," which basically means tilting all European financial institutions, asset management, and assets and allocations, from pensions to banks, lenders to retail investors, toward a more sustainable focus on environment, social, and governance (ESG) issues. In rounding off 2018, the European Commission released a consultation paper related to potential ESG amendments to UCITS Directives and AIFMD, the two main regulatory pillars of European investment funds. Regulators and government officials are working on policy initiatives and the market is starting to see more activity and new launches of ESG and sustainable funds. These are likely to continue to grow in 2019 in reaction to market demand.

One issue still to be ironed out is the ESG taxonomy – global stakeholders still don't agree on definitions connected with ESG investing. The European Banking Authority (EBA) and European Securities and Markets Authority (ESMA) are working to issue an agreed taxonomy that will make it possible for European funds to use standard measures of ESG for the first time. Like certain previous EU policy initiatives such as MiFID 2, the decisions made within the EU are likely to become a basis for global standards for ESG investments, and as such should be of interest to global asset managers wherever they reside.

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