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MARKETING TO HNWs IN THE UK: A NEW REGULATORY LANDSCAPE

On the first of this month the UK's Financial Conduct Authority made some important changes to its restrictions on financial promotions to high-net-worth customers and others. Gillian Roche-Saunders, David Aylward and Ashley Kovas of the Bovill Group survey the new landscape.

Section 21 *Financial Services and Markets Act 2000*, as amended, prohibits anyone, in the course of business, from communicating an invitation or inducement to engage in investment activity unless certain criteria are met. This is commonly referred to as the financial promotion restriction. There are a number of exemptions to it and these are set out in the *Financial Services and Markets Act 2000 (Financial Promotion) Order 2005*. Other exemptions are to be found in the *Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001*.

According to these statutory measures, a financial promotion can only be 'communicated' (a) by an 'authorised person' or (b) in cases where an authorised person has approved the contents. At first sight this sounds as if criminal charges might beckon for anyone who extols the virtues of certain investments to his friend in an email or to his mother on a seaside postcard.

There is, however, a statutory exemption in *section 21* for such one-off promotions if they are not made 'in the course of business.'

"A financial promoter can circumvent the Conduct of Business Sourcebook in two alternative ways"

The financial promotion in question must also conform to certain rules set out in the FCA handbook (the 'conduct of business' section or COBS). A financial promoter, however, can circumvent COBS in two alternative ways: by following the routes set out by the order of 2001 (which tends to involve specific promotions of fund-like products) and the order of 2005 (which firms that are not 'authorised' might use). There is an overriding rule (*PTO*)

INSIDE

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that all communications should be “fair, clear and not misleading.”

NON-MAINSTREAM POOLED INVESTMENTS: RESTRICTING UCIS PROMOTIONS

For units in unregulated collective investment schemes (UCIS) the statutory restriction in s238 FSMA still applies. This states: “An authorised person must not communicate an invitation or inducement to participate in a collective investment scheme.”

For units in a UCIS, an authorised firm should consider using either the *Promotion of CIS Order 2001* or the new COBS 4.12 exemptions, whereas an unauthorised person should have recourse to the *Financial Promotion Order 2005*.

For a non-mainstream pooled investment (other than a UCIS) everyone should consider the *Financial Promotion Order 2005* or the new COBS 4.12 exemptions. ‘Mainstream’ broadly describes the investments that ordinary people invest in and are familiar with. ‘Non-mainstream’ covers investments, such as unlisted shares, that ordinary people are unlikely to know about.

“There are exclusions for some SPVs, such as venture capital trusts and investment trusts”

NON-MAINSTREAM POOLED INVESTMENTS: EXTENDING THE RESTRICTION

COBS 4.12 states: “a firm must not communicate or approve an invitation or inducement to participate in, acquire, or underwrite a *non-mainstream pooled investment* where that invitation or inducement is addressed to or disseminated in such a way that it is likely to be received by a retail client.”

- non-mainstream pooled investment covers:
- a unit in an unregulated collective investment scheme;
- a unit in a Qualified Investor Scheme;
- a security issued by a special purpose vehicle (SPV);
- a traded life policy investment; and
- rights to or interests in the above.

There are exclusions for some SPVs, such as venture capital trusts and investment trusts. Funds in the Government’s Enterprise Investment Scheme and Seed Enterprise Investment Scheme are outside the ambit of our discussion here. The EIS provides tax incentives for investors who invest in smaller, unquoted, trading companies. The maximum amount an individual can invest in an EIS company is £1 million per tax year. The maximum amount of investment that a qualifying company can receive is £5 million. The trade must be carried on wholly or mainly in the UK, and must be conducted commercially.

SWINGS AND ROUNDABOUTS

What have we lost and what have we gained from the reform of the COBS rules? On the ‘lost’ side we have:

- advised sales – previously used by firms to promote the schemes where advice was also provided;
- existing participants – now only when the non-mainstream

pooled investment is closing and the scheme being promoted is intended to absorb the assets; and

- capability assessment – where the firm assessed the investor’s expertise, experience and knowledge.

On the ‘plus’ side of the equation, there are now two tiers of retail business: ordinary retail clients on one hand and, on the other, certified high-net-worth investors, certified sophisticated investors, and self-certified sophisticated investors.

On top of this, in COBS 4.12 there is an exemption that allows a firm to promote non-mainstream pooled investments to retail clients. This exception used to apply only to UCIS but has now been widened in its application.

In fact, COBS 4.12.4 contains a whole table of exemptions from the restrictions on the promotion of non-mainstream pooled investments. These take in replacement products and rights issues; certified high-net-worth investors; enterprise and charitable funds; eligible employees; members of the Society of Lloyd’s; exempt persons; certified sophisticated investors; and solicited advice. We shall return to some of these categories shortly.

COBS CERTIFICATION ROUTES

The following types of investor have long been described in the statute but have only been incorporated into the FCA rules this month. The terminology only applies to people to whom a firm can promote investments and not to advice.

“We now have certified high-net-worth investors, certified sophisticated investors, and self-certified sophisticated investors”

- *A certified high-net-worth investor.* A certified HNW investor is defined in the FCA handbook as an individual who has signed, within the period of 12 months ending with the day on which the communication is made, a statement to the effect that he had, throughout the financial year immediately preceding the date of signature, an annual income to the value of £100,000 or more; or held, throughout the financial year immediately preceding the date of signature, net assets to the value of £250,000 or more.

Net assets for these purposes do not include:

- (a) the property which is his primary residence or any money raised through a loan secured on that property;
- (b) any rights of his under a qualifying contract of insurance; or
- (c) any benefits (in the form of pensions or otherwise) which are payable on the termination of his service to an employer or on his death or retirement and to which he is (or his dependants are) or may be entitled.

He also has to accept that he runs a significant risk of losing all his money.

- *A self-certified sophisticated investor.* In September Compliance Matters asked Clive Adamson, the FCA’s head of supervision and

the sponsor of its new private banking and wealth management department, whether the FCA had ever thought about cancelling any HNWs out of COBS altogether, and saying “when you get past such a level, when you’re super-rich, we cancel you out” in the American style. His reply was in the negative, saying that the FCA thought that “there are basic standards that should be applied to everybody.” The entry of this new class of investor to COBS seems to fly in the face of that policy or at least represent a slight retreat from it. Anyone who promotes investments to this class, however, must still undertake a ‘preliminary assessment’ and find out whether the investment is ‘likely’ to be suitable for that client, in accordance with his profile and objectives.

This type of investor is one who has signed, within the period of 12 months ending with the day on which the communication is made, a statement to the effect that he satisfies this criterion because:

- (a) he is a member of a network or syndicate of business angels and has been so for at least six months prior to the date of signature;
- (b) he has made more than one investment in an unlisted company in the two years running up to the signature;
- (c) he is working or has worked in the last two years in a professional capacity in the private equity sector, or in the provision of finance for small and medium enterprises; and
- (d) he is or has in the last two years been a director of a company with an annual income of at least £1 million. He, too, must admit that he risks losing all his investments.

- *A certified sophisticated investor.* To qualify for membership of this class, the investor needs a certificate written in the last 36 months by an authorised firm to say that he has sufficient knowledge to make sophisticated investment decisions on his own behalf. This type of investor has to be certified by the private bank or other institution that deals with him. The bank can promote any non-mainstream pooled investment to him and does not need any third-party firm to sign the certificate.

“Each firm must check that the promotion is in the interests of the self-certified sophisticated investor”

ALL CERTIFICATION ROUTES

The new COBS rules have increased the regulatory emphasis on the client’s best interest rules and the FCA principles. These measures apply to both orders and COBS 4.12.

- For the certified high-net-worth investor: (a) the firm should take reasonable steps to ascertain that the client does meet the income and net assets criteria; and (b) it should check that the promotion is in the interests of the client and that it is fair to ‘communicate’ it to him.
- For the self-certified sophisticated investor: (a) the firm must satisfy itself that the client has the requisite experience, knowledge or expertise to understand the risks he is running; and (b) it must check that the promotion is in the interests of the client and that it is fair to communicate it to him.

- For the certified sophisticated investor: the firm should check that he has been fair and reasonably assessed as a sophisticated investor in the light of the complexity of non-mainstream pooled investments.

“A CF10 must make a record to certify that a financial promotion for a non-mainstream pooled investment is compliant”

SIGN-OFF AND RECORD-KEEPING

A compliance officer, in other words a holder of ‘controlled function 10’ status, or an employee who reports to and is supervised by a CF10 – must make a record to certify that a financial promotion for a non-mainstream pooled investment is compliant. If an employee is used for this task, the CF10 must have reviewed and approved the process for certification of compliance within the last 12 months. The record must state the exemption that was used and why it applied, and make a record of any relevant certificates, ‘investor statements’ and warnings or indicators required by the exemption.

DISCRETIONARY INVESTMENT MANAGEMENT

Before purchasing a non-mainstream pooled investment in a discretionary management arrangement, the discretionary investment manager should ‘have regard to’ whether that product could have been promoted to the client (even though the purchase itself does not involve a promotion).

If it could not, the discretionary investment manager should ‘exercise particular care’ to satisfy himself that the transaction is suitable for the client and in his best interests.

“Firms may struggle to keep a tight enough reign on their distribution networks now that these new rules are in place”

SOME LAST THOUGHTS

Further consultations might follow, widening the net of the non-mainstream pooled investments and raising the monetary limits for HNW certification. Right now, however, your firm should ensure that it is only promoting the right products to the right people. It must be able to demonstrate to visiting regulators that it is using the exemptions correctly and must ensure that reliable procedures exist for ‘compliance sign-off’. Firms may struggle to keep a tight enough reign on their distribution networks now that these new rules are in place. ■

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THE SWISS PRODUCE A SHARED KYC UTILITY FOR PRIVATE BANKS

One would never guess from the advertising blarf that KYC Exchange Net has been publishing about its 'know your customer' communication platform that this new, stress-tested software is not designed to contain any information at all about actual bank customers. Its aim is far more commercial: to preserve the tangled skein of correspondent relationships that exists between tiny private banks in 'highly risky' jurisdictions (notably in Eastern Europe) on the one hand and the massive onshore banks of New York, Hong Kong, the City of London et cetera on the other by keeping bureaucratic costs down in the face of higher and higher regulatory hurdles. Chris Hamblin investigates.

These days, it takes a good deal of effort for banks to establish correspondent relationships with each other in the correct regulatory way. They not only have to swap identifying documents such as articles of incorporation, regulatory status, information about board-members and proof of ownership; they also have to look into each others' KYC policies and procedures to ensure that they are adequate and that the relationships are worth commencing - or continuing. KYC now stands for 'know your counterparty' as well as 'know your customer'.

The way the software works is simple yet, until now, nobody seems to have constructed a secure platform for the purpose. Private bank A uploads all the information it might wish to reveal about itself, plus supporting documents, onto the platform, which keeps it confidential for as long as the bank wants. Private bank B, with which it is trying to form a relationship (or with which it already has one but the time for renewal has arrived) wants to access some or all of its documents to see whether its home regulators and/or Bank A's regulators will approve of the relationship if it comes to their attention. It receives only as much information as Bank A allows. Bank A decides whether to yield up this-or-that document for inspection at the moment of Bank B's request and not before.

Joachim von Hänisch, one of KYC Exchange's two founders, commented: "We're talking about periodic reviews here. They have to reconfirm all the AML policies and take another look at existing board members. This process was fairly easy until a couple of years ago, then the requirements became more onerous and the fines for non-compliance went much higher. Another of the issues of today is that the Financial Conduct Authority and other regulators don't publish very clear rules."

When asked whether the platform adhered to the Wolfsberg principles of anti-money-laundering best practice for banks (named after UBS's training centre in Switzerland), von Hänisch said: "We are going beyond it. A while ago Wolfsberg published a questionnaire containing 22 questions that banks ought to ask each other about their AML policies, but they were vague ones such as 'do you take a risk-based approach to due diligence?' and regulators grew dissatisfied with them. What we did to improve on that was to ask a dozen or so big European banks what they wanted to know from their counterparties. As a result, we compiled a list of 150-200 questions and asked Protiviti, the compliance consultancy, to vet them and make further suggestions. The result was about 450 questions, all contextual depending on the banks' answers, i.e. the questioning process resembled a set of 'decision trees' [tree-like graphs in which one answer leads the reader on to a particular set of other questions]."

"We did a survey recently and found that when a US bank goes through a KYC process once a year, it costs perhaps \$15,000 – \$20,000 for it to look at a bank in a high-risk jurisdiction. Very often, it finds

that it does very little business with that bank throughout the year, so the KYC process – and therefore the relationship – isn't worth it! Many big banks therefore decide not to bother, preferring to cut the other banks off rather than make the effort. It is these big banks – very many of which are private banks – that form our main audience. The whole tenor of our platform is to stop KYC from being a barrier to correspondent banking. Without it, a lot of Tier 3 and Tier 4 banks will be cut off. At the moment, the whole correspondent banking network is under threat."

Von Hänisch was the regional head of bank business at Standard Chartered for Eastern Europe until last year. He has long stood against banks doing 'KYC' in a competitive way instead of co-operating with other banks over it. His discussions in the European Council of BAFT-IFSA (the association for organisations actively engaged in international transaction banking) have also convinced him that countless other banks share the same KYC problems and ought to be helping each other surmount them.

"At the moment, the whole correspondent banking network is under threat"

As this publication has itself often commented, compliance should be a collaborative effort because banks share common aims when confronted with regulations and other legal obligations, but all too often the habitual, centuries-long tendency of banks to keep their operations secret and treat each other with suspicion gets the better of them. Von Hänisch thought that this attitude was extremely wasteful to the banking industry and commented further.

"No bank will change its internal procedures to fit in with a shared utility"

"When you look at existing KYC solutions, the most important thing to look at is shared utilities. These cause problems because the requirements of a shared utility are the same for every bank and all banks' internal procedures are different but no bank will change its internal procedures to fit in with a shared utility. You can't expect them to change policies but you can standardise the format and leave it at that. The banks are able to upload their documents (e.g. their articles of incorporation of association) on our system.

"We are merely allowing two banks to talk to each other. There is a live link between you and your counterparties - it's a bit like LinkedIn."

KYC Exchange Net AG was incorporated in Zurich in June 2013. ■

WILL CHINA'S TRUSTS GET TIC'ED?

As China's economy rapidly changes, we ask whether the trust companies that currently operate in the shadows will undergo the dramatic restructuring that the country's Trust and Investment Companies (TICs) have experienced in the past twenty years—will they get 'TIC'ed? Sara Hsu, the assistant professor of economics at the State University of New York at Paltz, foresees changes.

China's trust companies are wily institutions. They currently hold over nine trillion renminbi (RMB) in assets under management, and they are quite apt at skirting regulation. Before 2010, trusts gladly removed risky bank loans from bank balance sheets and repackaged them as securities for banks to sell to customers. When this practice was banned, trusts continued to extend loans themselves or through third parties and sell them to banks to bundle as wealth management products. Many borrowers are companies that are too risky to qualify for a bank loan—not a good sign.

As of the second quarter of 2013, trusts had invested 35% of their funds in infrastructure and real estate projects, and another 21% was invested in financial institutions and products. These sectors stand to lose as growth stalls—real estate and infrastructure are starting to slip because property price growth is declining, and financial institutions will likely decline as credit growth slows. Only 29% of trusts' funds are invested in industrial and commercial enterprises—real economy firms that may stand a chance at remaining profitable. So there is reason to worry.

Even if a decline in underlying loan quality does not result in the sector's decline, a recent report by McKinsey and Company confirms that, as the financial sector is reformed and other institutions are allowed to use the trust structure, up to 88% of trust revenue would be at risk. This would mean that trust companies would have to find a new business model—or perish.

Today's trust-industry conditions parallel those surrounding China's TICs, which began operating when the reform period began, and incurred significant losses in the real estate sector in the late 1990s. Trusts are a recent manifestation of TICs, similar in that they invested in a wider range of assets than commercial banks. Some of the TICs, including Guangdong International Trust and Investment Corporation (GITIC), suffered bankruptcy in the late nineties; all were ordered to stop business and become recertified in 2000. In 1999, GITIC represented the biggest bankruptcy in China to date.

The company had borrowed billions of dollars in foreign currency and expanded into real estate, hotels, and securities trading. Holders of GITIC debt suffered the fallout from the firm's bankruptcy in 1999, despite the fact that the institution was believed to be “too big to fail.”

The China Banking Regulatory Commission, which took over the regulatory role for the TICs in 2003, established many guidelines for their operation. A serious investigation into the TICs was launched in 2004, and a number of scandals were uncovered; by 2005, the number of TICs had unsurprisingly diminished.

The reincarnation of TICs as trust companies is a result of a 2007 regulation that improved corporate governance and restricted the use of trust companies' own assets. With the CBRC as a regulatory body, new regulations, and new names, trust companies became quite appealing to the Chinese public. Between 2008 and 2013, trust industry assets under management increased more than seven-fold. Without quite realizing that these companies have a tendency to encumber excessive risks, taking on loans that banks might be prevented from extending directly, the public has viewed trust products simply as deliverers of yield.

The difference between the TICs and the trusts is that risk among trusts is concentrated among domestic, rather than foreign, holders of trust assets. CBRC officials have been adamant that (domestic) holders of shadow banking products, particularly wealth management products, are the ultimate bearers of risk. In an increasingly market oriented economy, allowing institutions and individuals who take on risks to bear the cost of the risks will likely be more commonplace. And why would the government prop up a flagging industry that has behaved badly in the past, should the economic climate turn sour? The simple truth is that it seems unlikely. The trusts are in danger of joining the TICs in yet another restructuring debacle. This may be the least surprising event in China's restructuring mix. ■

CHINA REVEALS 2014 FINANCIAL REFORM PRIORITIES

China's four major financial authorities have announced their priorities for 2014. The People's Bank of China, the central bank, will continue to expand the cross-border use of the Chinese currency, the renminbi, this year. At the same time, it will stick to prudent monetary policy and maintain steady credit growth, improve the multi-tier capital market, and engage further in international financial regulation policy-making.

The China Banking Regulatory Commission (CBRC) will pilot three to five private banks that will bear their own risk, opening up the banking sector to domestic and foreign private capital.

The banking industry watchdog will gradually reduce the threshold for foreign banks to enter the banking sector and ease their RMB

operation requirements. The CBRC will keep a close eye on major housing developers, and reduce the risk of default through weak links in the construction industry's money chain. Also on the banking regulator's radar are restructuring and technological upgrades in overcapacity industries, liquidating their assets and reducing the risk of default.

In pursuit of a more efficient market, the China Securities Regulatory Commission (CSRC) will switch IPOs from the current approval system to one based on registration. Under the new system, the timing of IPOs and how shares are issued will be determined by the market, as long as issuers disclose all relevant information as required. In order to streamline approval procedures, the CSRC will also abolish approval requirements on 21 items over the next three years starting from 2014. ■

Vietnam

A NEW MARKET OPENS UP - BY DECREE

The Vietnamese government has extended the possibility of ownership of shares in its credit institutions to a wider variety of foreign investors. It issued Decree No 01/2014/ND-CP on 3rd January to lay out the provisos and procedures for share purchase, maximum shareholding levels for foreign investors, the maximum shareholding percentage for a foreign investor in a Vietnamese credit institution; and the conditions under which a Vietnamese credit institution can sell shares to foreign investors. The decree applies not only to banks but also to finance companies and finance leasing companies. An inrush of capital from wealthy investors and institutions from abroad seems to be on the cards.

“Shareholding percentage of a foreign individual and organisation shall not exceed 5% and 15% respectively of charter capital of a Vietnamese credit institution. Meanwhile, the shareholding percentage of a foreign strategic investor shall not exceed 20% of charter capital of a Vietnamese credit institution,” the Ministry of Justice says on its website.

“In case of share purchase that leads the shareholding level to be 10% or more of charter capital; share purchase and becoming foreign strategic investor of a Vietnamese credit institution, the Vietnamese credit institution or foreign organisation shall make a dossier and send directly or via post, electronic network to the State bank of Vietnam for acceptance before performing transactions. Within 40 days after receiving full and valid dossier, the State Bank of Vietnam shall consider and decide on acceptance or refusal in writing for foreign organizations’ share purchase,” it continues.

Couched though it may be in language reminiscent of Borat, this declaration obscures evidence of a great liberalisation in Vietnam’s ownership rules. Very soon, the central bank will no longer insist on approving deals unless 5% or more of the shares are being acquired, or have been acquired and there is to be another acquisition; or at least 10% of the shares are held by a foreign non-strategic investor; or if a foreign strategic investor who already holds between 10% and 20% of the shares is trying to acquire more. In this last case, a strategic acquisition of between 15% and

20% will no longer require the approval of the Vietnamese premier, as it does today. “Foreign strategic investor,” according to Article 3, means a foreign organisation which “has financial capacity and has a written commitment of competent person to bind its long-term benefit with Vietnamese credit institutions and support Vietnamese credit institutions in transferring modern technologies; developing banking products and services, raising the administration and financial capacity.”

At present, Vietnam’s interpretation of the phrase “foreign investor” covers entirely foreign persons and entities, i.e. organisations which are set up and operate under foreign law. When the decree takes effect, however, that will change to include branches of such foreign organisations in Vietnam, and indeed branches in foreign countries as well. It will also include closed funds, member funds, companies of securities investment which are set up and operating in Vietnam with a percentage of more than 49% of capital contributed by foreign parties. ■

Global

SURVEY SHOWS GLOBAL DISCONTENT OVER REGULATORY POLICY

Almost half of financial services professionals responding to a global survey do not believe any regulator has achieved the appropriate balance of protecting consumers and supporting economic growth – suggesting a high level of concern about the sheer volume of rules being imposed on the sector.

A survey by Kinetic Partners, the consultancy, found that 49 per cent of respondents felt the right balance had not been achieved. Overall, fewer than one in five highlighted any single national regulator as having found the right balance between stabilising the financial system, protecting investors, reacting to public opinion and creating the right atmosphere for growth, the survey found.

The survey was conducted at a time when the financial services industry, including wealth management, has faced an unprecedented level of regulatory measures in the wake of the 2008 economic crisis – although some of the actions pre-dated it (such as the Sarbanes-Oxley account-

ing rules and updated Basel bank capital rules). The costs of regulation have hit wealth managers’ margins, playing a part in causing a flurry of mergers, acquisitions and rocketing technological bills.

Only 12 per cent of respondents throughout the world believed that the US Securities and Exchange Commission had struck the right balance between growth and the protection of consumers, with the figure the same for US respondents; 18 per cent thought that the UK’s Financial Conduct Authority had achieved this balance, although the figure for respondents in the UK itself was 20 per cent; and a mere 12 per cent thought the Securities and Futures Commission of Hong Kong had struck the right balance, although 41 per cent of those from Hong Kong said that it had.

When asked to mention the single most important factor that might create an effective regulatory policy for financial services, more than three-quarters of professionals cited single global regulatory standards (29 per cent), principles-based regulatory standards (26 per cent) or better communication from regulators (22 per cent).

“Despite a slight home country bias, those most directly affected by financial legislation feel that regulators are still struggling to find their way. What many would like to see in the future is principles-based regulation that’s consistent across the borders,” said Monique Melis, the global head of regulatory consulting at Kinetic Partners.

Doug Shulman, Kinetic Partners’ director of regulatory compliance in New York, said: “Despite calls for greater coordination, there are far too few examples of cross-jurisdictional approaches between regulators and that has...often been confusing for banks, asset managers and hedge funds,” .

Whilst a minority (43 per cent) say that, in seeking to impose burdens on firms outside their domicile, regulators have increased competition, 62 per cent say the effect has been to push up prices for asset management services and products. ■

Singapore

MORE SURVEILLANCE FOR BANKS’ AND FUNDS’ STATEMENTS

Singapore’s Accounting and Corporate

Regulatory Authority is going to scrutinise the financial statements of more companies than ever before, thanks to a new alliance with the Institute of Singapore Chartered Accountants.

Under the terms of a new agreement, the institute will share its views on financial statements that do not fully meet regulatory standards. This will allow ACRA to take action under the *Companies Act* if necessary. Josephine Teo, the senior minister of state at the Ministry of Finance, told reporters recently that the surveillance programme could be extended to firstly non-listed companies, and even those without modified statements, but which are of public interest. The chief of the institute warned companies with weak finance teams to expect trouble. ■

Turkey

DUE DILIGENCE ON THE DECLINE UNDER ERDOGAN

Things are looking up for private bankers who wish to shade Turkish clients' money from home country inspection. The government of Prime Minister Recep Tayyip Erdogan has conducted a mass cull of law enforcers, especially on the financial side of operations. 350 policemen in Ankara have lost their jobs along with the men in charge of the country's organised crime, financial crime and anti-smuggling units.

The premier has said that judges and the police have been conspiring to topple his government, in the same way that Silvio Berlusconi railed against "politically motivated, left-wing" investigative judges in the run-up to his being found guilty of various crimes and sentenced to make a tough choice between community service and house arrest.

It does not take a historian or a political analyst to predict that this is the beginning of a money-laundering bonanza. Private bankers are expected to find inspections, as far as they occur already, less onerous and their correspondent relationships less well policed. Intra-bank payments from Turkey to the wider world will be less well scrutinised, although the affairs of 'politically exposed persons' might be exposed more readily if they are caught in the cross-fire between Erdogan's supporters and opponents.

Turkey is both a transit and originat-

ing country for drugs and humans that are smuggled through the Balkan route. The exact value to Turkey of its heroin exports is unknown but experts estimate a range in the tens of billions of dollars per year. Most of the heroin going to Europe is manufactured in or passes through Turkey, which is in trouble with the Financial Action Task Force for its lax financial controls.

Turkey is also a conduit for the nuclear black market and terrorist money that flows between Western countries and the Kurdish PKK. For the record, Dubai, Spain and South Africa are other nuclear proliferation 'hotspots.'

Turkish high-net-worth individuals and/or PEPs have recently been embroiled in terrorist financing allegations as well. Photos of Prime Minister Erdoğan's son meeting a suspected al-Qaeda financier in an Istanbul hotel have been leaked to the press and have caused damage to the premier's reputation. The photos allegedly show Bilal Erdoğan meeting Saudi Arabian businessman Yasin al-Qadi, whom the US blacklisted in April 2013 as an al-Qaeda funder. The premier's security men allegedly escorted al-Qadi to meet Bilal to discuss a real-estate deal worth \$1 billion in Istanbul's Etiler neighborhood. Also in December, Erdogan ordered the sons of three members of his own cabinet to be rounded up on suspicion of corruption, but only dismissed the leading prosecutor when his own son had been arrested. ■

Thailand

BANGKOK TO BECOME REGIONAL HUB WITH NEW LEGISLATION

The Securities and Exchange Commission in Bangkok has unveiled its strategic plan for the next two or three years. It plans to make itself more efficient and improve corporate governance and enforcement. Vorapol Socratyanurak, its secretary-general, is looking forward to the introduction of "professional wealth advisors to provide a service of personal asset allocation," which could be a reference to a Thai version of the UK's retail distribution review, and a series of financial literacy project. Greater variety among investment channels is another aim. Another aim is to "promoting the duties of directors, independent directors and audit committees" and to support something called "the private sector collective action coalition against

corruption project," beefing up this initiative in an amendment to the existing securities law, with tougher punishments for non-compliance.

The SEC also plans to make the Thai capital market a regional investment hub. New regulations are on the way to accommodate overseas equities, bonds and mutual funds. It is even planning a major battery of studies to compare various countries' laws and regulations with each other. The eventual aim is to facilitate the listing of foreign securities on the Thai bourse for the first time.

Meanwhile, the Stock Exchange of Thailand, the country's foremost front-line regulator, has promised to proceed with plans for its new derivatives trading system to go live by mid-2014. It is also planning to improve Thai capital markets in four key areas, namely financial literacy, the bond market, the gold market and agricultural commodities. In the last case it plans to encourage the state sector to use derivatives to hedge against volatility in food prices.

In 2013, average daily trading value rose to an all-time high of 51 billion baht (\$1.6 billion), the highest in the Association of South-East Asian Nations; market capitalisation from initial public offerings jumped to a record high of 340 billion baht, with BTS Rail Mass Transit Growth Infrastructure, an infrastructure fund IPO, being the biggest IPO in the ASEAN are; five Thai stocks were added onto the MSCI Global Standard Indices, the highest number of additions in Asia, three Thai-listed companies appeared on the Dow Jones Sustainability World Index, the highest number of additions in ASEAN, and the ASEAN corporate governance 'scorecard' showed that the average corporate governance score of Thai-listed companies topped that of all other ASEAN companies. The exchange is now trying to describe itself with the phrase "key sub-region connector."The exchange says that it will focus on expanding business in Cambodia, Laos, Myanmar and Vietnam, as both their growth potential and their need for funds is high. In addition to listing holding firms that invest abroad, SET plans to revise regulations to support foreign listings.

Thailand has been in political turmoil since early November and has experienced 18 coups d'etat since monarchical absolutism was abolished in 1932. In spite of this, it has developed and prospered throughout. ■

IRISH CENTRAL BANK TO REGULATE THE ICAV

The Central Bank of Ireland (Ireland's all-in-one banking regulator and fund regulator) has said that it will be the supervisory authority for the incoming ICAV structure and will take a similar approach in respect of filings and reviews to the one it takes to the fund vehicles that it authorises at the moment, depending on whether the scheme in question is an Undertaking for Collective Investments in Transferable Securities (UCITS) or an Alternative Investment Fund. The team at Mattheson Partners, which helped frame the legislation, comments.

The Central Bank of Ireland (Ireland's all-in-one banking regulator and fund regulator) has announced that it will be the supervisory authority for the incoming Irish Collective Asset-management Vehicle structure and will take a similar approach in respect of filings and review to the one it takes to fund vehicles that it authorises at the moment, depending on whether the scheme in question is a UCITS or an AIF.

The Irish parliament is making progress with the Bill which will, in due course, introduce the ICAV, a new corporate structure for the establishment of collective investment schemes in Ireland, and increase the range of fund structures available to promoters.

The ICAV Bill was published in mid-December. Its preparation, with which we have been and are extensively involved, underlines the Irish Government's commitment to beefing up the funds industry and represents the fulfilment of one of the initiatives outlined in its "Strategy for the International Financial Services Industry in Ireland 2011-2016."

WHAT IS AN ICAV?

The ICAV will sit alongside the public limited company structure, which has been the most successful and popular of the existing Irish fund structures to date. The ICAV is expected to be incorporated with the Central Bank (although this has yet to be confirmed) and will provide a tailor-made fund vehicle to which ought to be available as a corporate structure to both Undertakings for Collective Investment in Transferable Securities (UCITS) and alternative investment funds (AIFS).

WHY IS IRELAND INTRODUCING IT?

The ICAV will represent a modernisation of the corporate fund structure and is conceived specifically with the needs of investment funds in mind. The advantage of a bespoke funds vehicle is that an investment fund established as an ICAV will not suffer from endless amendments to certain pieces of European Union and domestic company legislation which are targeted at trading companies rather than investment funds.

"The ICAV will have its own legislative regime to distinguish it from ordinary companies"

The ICAV will be able to 'elect' its classification under the US 'check-the-box' taxation rules. The present-day Irish plc is not permitted to 'check-the-box' for US tax purposes, meaning that it is treated as a separate entity and subject to two levels of tax: one at the corporate level where the income is earned and the second at shareholder level

when distributions are made. An 'eligible entity', i.e. an entity that can 'elect' its classification under the 'check-the-box' rules, can elect for alternative, more favourable tax-treatment. The ICAV will be an 'eligible entity' for these purposes.

FEATURES OF THE ICAV

The primary features of the ICAV are to be as follows:

- An ICAV will not have the status of an ordinary Irish company that has been established under the Irish *Companies Acts*. Instead, it will have its own legislative regime which will help to ensure that the ICAV is distinguished from ordinary companies and therefore will not be subject to those aspects of company law that would not be relevant or appropriate to a collective investment scheme.
- An ICAV may be established as an 'umbrella structure' with a number of sub-funds and share classes. It may be listed on a stock exchange, which itself will act as a front-line regulator. Investors are to own shares in the ICAV and the ICAV should be able to issue and redeem shares continually according to demand from investors. In this regard, there is to be no difference between the ICAV and other open-ended collective investment schemes.
- The ICAV will have a governing document which is likely to be known as an instrument of incorporation or IOI. Similar to the memorandum and articles of association of an investment company, this will be the constitutional document of the ICAV. The primary reason in differentiating between a memorandum and articles of association and an IOI is to emphasise the distinction between the ICAV and existing plcs as different types of corporate entity.
- In the case of changes to the IOI, it is envisaged that there will be no need for the board to obtain prior approval from investors as long as the depositary certifies that changes to the IOI do not prejudice the interests of investors (similar to the requirements relating to changes to the trust deed of a unit trust).
- Like a plc, an ICAV will have to have a board of directors to govern its affairs. Similar to other collective investment schemes, the ICAV may either be managed by an external management company or be a self-managed entity.
- Depositary requirements that resemble those that currently exist for an investment company will apply to an ICAV (although, of course, these will vary depending on whether the ICAV is a UCITS or an AIF).
- It is likely that the directors of an open-ended ICAV will be permitted to elect to dispense with the need to hold an annual general meeting by giving written notice to all of the ICAV's shareholders.
- Existing funds established as plcs will have the option to convert to ICAV status. ■

** Michael Jackson, Tara Doyle, Dualta Counihan, Liz Grace, Philip Lovegrove and Shay Lydon of Matheson Partners wrote this summary.*

THE COMPLIANCE IMPLICATIONS OF THE 'TRUE CLOUD' PLATFORM

As the Retail Distribution Review bites Britain, the competition between platforms is warming up. Chris Hamblin of Compliance Matters interviews a recent arrival on the scene.

HedgeGuard, the Parisian hedge-fund and asset-management technology firm, has opened an office in London and announced the creation of the first fund management platform to use cloud technology in the true sense of that term, to be released in summer 2014.

Compliance functions are built in and testing has begun. *Compliance Matters* interviewed its CEO, Imad Warde, who explained what the new venture means for high-net-worth investors and compliance officers at fund firms.

Warde commented: "The platform is for hedge funds, for investment managers, for funds-of-funds, and for family office asset-managers. Investment managers have the choice between working on our owned platform or have full ownership by implementing only the underlying technology. Moreover, investment managers can grant access to their investors which means that the HNW individual can follow his investment in real time. We can help an HNW set up his own platform and have full ownership, but this might be costly for him."

THE FIVE MODULES

The platform allows the investment manager to follow his investments by way of five functions or 'modules', which are:

- (a) EMS as a service (execution management service), which allows the manager to send an order to the broker;
- (b) position-keeping, whereby he monitors his profit-and-loss, exposure, and making allocations;
- (c) risk management, which helps the manager keep an eye on the risks from derivatives and structured products;
- (d) compliance, which sends him alerts every time he exceeds a limit that he has set for his investments, e.g. a maximum 10% exposure to the US market; and
- (e) reporting - a consolidation of risks and exposure by currency, security type, sector, type of debt, etc.

ANYWHERE, ANYTIME, ON ANY DEVICE

To date, every fund manager who uses a platform has to sit behind his desktop computer to do so. Platforms typically offer remote access, as this is called, and claim that this is the same thing as cloud computing. In fact, remote access (which first appeared about 15 years ago) is not the same thing as the cloud, even though most platforms claim that it is. The real cloud delivers information to smart phones, tablets, and any other devices anywhere. On a typical platform of today, all the user can hope for is web access (which the platform markets as 'revolutionary' when in fact it is not).

Imad Warde told *CM* that with HedgeGuard, uniquely, the fund manager will be able to use any device, anywhere: "The platform delivers intelligence that the client accesses through an extremely user friendly interface".

The software will be downloaded through 'application stores', online stores where users can browse through different categories

and genres of applications and download and install them onto their devices. Warde added: "You needn't bring your computer to the beach; you need only bring your mobile phone.

"There's a 'server side' and a 'client side' to every application. We are going to offer the client side on a smartphone. We are starting with Windows Phone and it's a new way of seeing your portfolio as it's not on computer."

AIDED BY HARDWARE

HedgeGuard has taken advantage of new developments in hardware as well as software. There have been three big developments in the hardware industry lately, all of which have helped it in its evolution.

1. The introduction of SSD, the latest hard-drive technology.
2. Enormous progress in cheaply available random access memory or RAM. This is not the memory held on the hard drive but the other kind of data storage, which allows data to be accessed directly by the program. Up until last year, only 16-24 gigabytes of RAM were available cheaply or 'democratically' on one computer. Now that figure has leapt to 128 per computer. Warde noted: "The big companies bought data centres with big servers and now they're stuck with them. We rent servers and thereby get round that problem of pre-programmed obsolescence. We could change all our servers in one day, shifting all our intelligence from one to another. Our cloud is a private cloud within a data centre."
3. Fast Internet connections.

NORMAL LIMITATIONS ARE INEVITABLE

One problem that plagues ordinary computer users in public places such as tube stations or outdoor areas is the need for passwords or 'keys'. This is still unavoidable with the HedgeGuard platform, as with everything else. Warde explained: "On the beach you do need keys but you don't need your computer. You are going to have a different interface. If you don't have a connection on the tube, you won't have access to your cloud. You need two things: (i) professional communications in your office and (ii) a decent Internet connection outside.

THE COLLOQUIAL CLOUD AND THE REAL CLOUD

"The cloud is nothing but a data-hunter. On your server you can have data or software running intelligence. Most providers today are only selling data-hosting and calling it 'the cloud'. You can run intelligence on the server and deliver it to the client's device within a client-rich application and not a web application. That is the use of the real cloud.

"This platform is the first platform to do this in the financial services industry for the purpose of running a front-to-back portfolio management system. This industry is the most complex of all in terms

of intelligence. In customer relations management or CRM, you already have it but these systems are really easy. There is no real-time calculation."

The platform has been 18 months in the preparation and will have taken up about 24 months in all when the tests - being held now - are over in Q3 or Q4 of 2014. The compliance specialist who works with Hedgeguard is Franck Lesage.

A LOWERING OF FEES

The new platform seems to represent one more bit of downward pressure on fees in the advice and portfolio management sector - a trend that has become inexorable in the face of the Retail Distribution Review or RDR. *CM* asked Warde how many basis points it will cost the customer to use. He replied that the final figure will be influenced by, but not entirely dependent upon, the amount of assets under management in the paying fund. Economies of scale, in other words, will apply.

"It's user-based pricing really. We have a floor of £2,000 a month for all users and we cannot go below that. If your fund is managing

£10 million, it would be paying £24,000 and that would be 24 bps. If you are managing £50 million, it would be 5bps. Even when our fees are most expensive, we are offering about half the prices of our competitors."

WHY THE FINANCIAL SECTOR DOES NOT DOMINATE BANKING IT

The competitiveness in fees is not, however, a function of RDR but of new technology in this case. Warde recollected that he had not paid a penny to anyone while he was developing the platform; instead, he built the whole thing from scratch, first by himself in his own time and then with the help of a small team, in the way that new software is so often developed.

Warde also drew comfort from the fact that his platform was a rare example of software being developed in the financial services industry rather than being bought in from outside. He told *CM* that every big bank was spending \$1 billion on technology every year and that this was wasteful: "There are no inventions coming up from this (financial services) industry. We could rival Silicon Valley if we wanted to. The financial industry is spending money in the wrong way!" ■

A NOTE TO ALL RELATIONSHIP MANAGERS FROM THE EDITOR

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How is compliance affecting your work?

This publication would like to know. RMs often have to deal with many conflicting business imperatives and these are likely to become more challenging still in the next year. My question, therefore, is this: what are your most important regulatory concerns and fears? I would like to hear from you in total confidence, with anonymity secured.

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LABUAN'S NEW FINANCIAL CRIME GUIDELINES SPELL EDD FOR DOMESTIC PEPs

The Labuan Financial Services Authority has issued new guidelines to tackle money-laundering and terrorist finance. Chris Hamblin of Compliance Matters looks inside the package.

The guidelines came into effect on 30 December 2013 and are in accordance with the *Anti-Money Laundering and Anti-Terrorism Financing Act 2001*. They are designed to give effect to the Financial Action Task Force's revised 'recommendations' which date from February 2012 and require Labuan's financial reporting institutions to take a risk-based approach to identifying, assessing and understanding their ML/TF risks for the first time. The period of grace for adjustment is a short one, ending on 1 February 2014.

The US State Department, which produces an annual report on the anti-money-laundering efforts of countries, has this to say about financial crime in the territory: "Malaysia's offshore financial centre on the island of Labuan is subject to the same AML/CFT laws as those governing onshore financial service providers. The financial institutions operating in Labuan include both domestic and foreign banks and insurers. Offshore companies must be established through a trust company, which is required by law to establish true beneficial owners and submit suspicious transaction reports.

RISKS IN THE REGION

"A number of terrorist organizations have been active on Malaysian territory, and authorities have taken action against Jemaah Islamiah and other terrorist networks. Terrorist financing in Malaysia is predominantly carried out using cash and relies on trusted, clandestine networks."

This last is more than likely a reference to *hawala* banking, the informal underground network that spans the Far East and the Indian sub-continent. It is quite remarkable how easy it is for a hawala operator to use his bank account to facilitate the necessary deals even when the bank has a fully-functioning compliance/AML department. British high street banks were still closing down home-grown hawala operations on their accounts as late as 2008, while of course avoiding the wrath of the UK Financial Intelligence Unit by saying nothing in their suspicious transaction reports and hoping for better luck next time.

The thought that private clients are using their accounts for the same purposes in Labuan today is not an outlandish one. Whether or not a hawala member of Jeemah Islamiah would be brazen enough to use the private banking system to help him settle up with other hawaladars is a moot point, although he would be aided by the fact that terrorist finance usually involves tiny amounts, unlike the average drug laundry.

HNW-RELATED RISKS

The banking sector part of the guidelines contain a list of risky factors. These include: high net worth individuals; non-resident customers, i.e. the bulk of people to whom Labuan is designed to appeal; legal persons or arrangements that are personal asset-holding vehicles; legal arrangements that are complex (The Labuan FSA's examples of this are trusts and nominees); persons from locations known for their high rates of crime (e.g. drug producing, trafficking, smuggling); and companies that have nominee shareholders or shares in bearer form. All these are relevant to the wealth market. The Labuan FSA, meanwhile, has responded to the problem of 'politically exposed persons' with a panoply of measures. These, for the first time, include Malaysians, i.e. domestic PEPs. Note 13.5.1 states

that senior management sign-off is needed before the entity can start a relationship with a PEP. Senior management sign-off is required for correspondent relationships also. As ever, every reporting institution must identify the beneficial owner (note 13.3.1) and may even wait for verifying documents after the business relationship begins – a piece of flexibility not available in some other jurisdictions.

The guidelines are as pathologically wary of explaining the term 'senior management' as their British equivalents, to which they owe much detail. The vague definition of the term in the glossary is "any person(s) having authority and responsibility for planning, directing or controlling the activities including the management and administration of a reporting institution (Labuan Entity) including Principal Officer [CEO]." The only time the notes mention any job descriptions at the level of 'senior management' are when they describe the kinds of PEP who lead intergovernmental organisations: "directors, deputy directors and members of the board or equivalent functions." They do not even describe the money-laundering reporting officer as "senior management" although, intriguingly, the UK's Financial Conduct Authority did so recently in passing. This does not, however, seem to have begun an international trend.

Rather more disturbingly, the document attempts to make reporting institutions march in lock-step with the opinions of the FATF's inspectors – long since proven to be biased, politically motivated and easily 'hoodwinked' by regulators in the more advanced jurisdictions – when evaluating country risk. Note 11.1 states that reporting institutions are required to closely monitor the reporting institution's foreign branches, subsidiaries and offices operating in jurisdiction with inadequate AML/CFT laws and regulations "as highlighted by the FATF or the Government of Malaysia."

THE NEW BLACKLIST

Hovering in the background is another of the FATF's policy decisions in February 2012: the decision to resurrect the discredited 'blacklist' that the governmental club had been forced to abandon years earlier because of its reputation as a political football. The Americans always tended to want to use it to target 'axis of evil' countries, whereas the Europeans were generally more interested in making life difficult for offshore tax-havens. The current blacklist, at the time of writing, has mushroomed to accommodate Iran and North Korea, Algeria, Ecuador, Ethiopia, Indonesia, Kenya, Myanmar, Pakistan, Syria, Tanzania, Turkey, and Yemen. These are "high risk jurisdictions"; there is another list of "improving" jurisdictions: Afghanistan, Albania, Angola, Antigua and Barbuda, Argentina, Bangladesh, Cambodia, Cuba, Iraq, Kuwait, Kyrgyzstan, Laos, Namibia, Nepal, Nicaragua, Sudan, Tajikistan, Vietnam and Zimbabwe. Mongolia is at the end of the list as it is "not making sufficient progress."

"Super-equivalence" has come to Labuan in the shape of note 11.2 in the banking sector notes, which orders reporting institutions to ensure that their foreign branches, subsidiaries and offices apply ML/TF measures consistent with home country requirements. If the host country's rules are less stringent than those of the home country, the latter must apply. ■

THE LATEST SWISS REGULATORY CHANGES FOR FOREIGN FUNDS

Laven Partners present a panorama of the marketing and distribution of foreign funds in the light of a recent FINMA rule.

On 10 September 2013 FINMA, the Swiss financial regulator, published a circular on the distribution of Collective Investment Schemes (CIS) in Switzerland. The circular entered into force on 1st October 2013. This update for the country's fund distribution rules has been made necessary by the revision of the *Collective Investment Schemes Act (CISA)* on 1st March 2013 and its corresponding ordinance (CISO).

With a view to protecting investors from sharp practice, regulatory requirements to do with fund distribution have become more onerous, notably in respect of foreign funds marketed in Switzerland by private placement. We list the salient features of the new regime here.

FINMA has removed the concept of a public offering replaced it with the so-called 'distribution concept,' which is broadly defined in the circular as "any offer or advertisement for collective investment schemes which is not exclusively addressed to regulated financial intermediaries (banks, securities dealers, fund management companies, asset managers of collective investment schemes, central banks and insurance companies)". According to the circular, distribution now therefore includes marketing to both qualified and/or non-qualified investors.

A NEW DAWN FOR 'QUALIFIED INVESTORS'

Although anyone who wants to distribute such funds to non-qualified investors has to be authorised to do so, distribution to qualified investors does not require a FINMA authorisation. However, one should note that the definition of the phrase 'qualified investor' has been amended, with significant consequences.

It is crucial for anyone who distributes a foreign fund in Switzerland to make sure that the target investors meet the 'qualified investor' criteria. If not, the foreign fund and its promoter/distributor will be considered to be carrying on "unauthorised distribution to non-qualified persons" in Switzerland, which entails substantial criminal penalties that are provided for in *CISA*.

Pursuant to the new rules, the list of investors that are deemed to be qualified has been reduced (*Art.10 al.3 CISA*). 'Qualified investors' include regulated financial institutions, high-net-worth individuals (as defined in the law), AND (iii) investors who have signed a discretionary asset management mandate with a regulated financial institution.

As a consequence of the definition's revision, "non-regulated independent asset managers" and family offices are not to be considered as qualified investors per se. Instead, a look-through must be applied by the fund and its promoter/placing agent to qualify the ultimate client, which must be done at the time of any relevant promotion. The net effect is that non-regulated independent asset managers and family offices will be allowed to invest in foreign funds restricted to qualified investors (such as offshore hedge funds) only to the extent that their underlying investors are qualified investors. Such non-regulated independent asset managers and family offices will have to confirm in writing that the information received will be used for qualified investors only.

Finally, it is worth noting that the circular does not consider as dis-

tribution the provision of information on a collective investment scheme for execution purposes or when solicited in the scope of an advisory or asset management mandate.

NEW OBLIGATIONS: APPOINTMENT OF A SWISS REPRESENTATIVE AND PAYING AGENT

Although distribution of a foreign collective investment scheme to qualified investors is not regulated by FINMA, it is nonetheless burdened by new obligations as well (*Art. 120 par.4 and 123 CISA*).

A foreign collective investment scheme marketed in Switzerland (by private placement and to qualified investors only) will be required, as of 1 March 2015, to appoint a Swiss legal representative and a paying agent regardless of the type of investors to which the collective investment scheme is marketed. This is a new requirement as in the past only collective investment schemes registered for public offerings (the equivalent to the new "distribution to non-qualified investors") were required to appoint a Swiss representative and a paying agent.

As part of the new rules, the name of the collective investment scheme must not lead to confusion from the investor's perspective, for example by giving the wrong impression that the fund is a risk-free product, or that it is available for distribution to non-qualified investors if this is not the case. The collective investment scheme must also avoid confusion with a name that is similar to an existing fund or product. What is deemed as "confusion" according to the rules shall be interpreted in line with common sense.

These new rules are subject to a period of transition and as from 1st March 2015, a foreign fund shall not be available to investors in Switzerland unless a Swiss legal representative has been appointed.

The activities of fund representatives and distributors are now subject to FINMA's scrutiny in the name of 'investor-protection.'

Entities that currently act as fund distributors are required to register with the FINMA and to comply with the revised *CISA* by 1st March 2015. For foreign distributors, in the absence of a cooperation and information exchange agreement between their domicile's jurisdiction and Switzerland, the applicable deadline shall be 1st March 2014.

The circular regulates the use of websites or web forums and chat rooms quite strictly. It provides very specific and detailed guidelines for 'protection mechanisms' whose purpose it is to ban distribution to non-qualified investors. Marketing should, in general, be subject to access restrictions and disclaimers.

The fund's offering memorandum, subscription documents and marketing materials must also contain the appropriate disclaimers and risk warnings. It is also crucial that operational processes are in place to ensure that only eligible investors invest in the fund. Therefore, fund management companies will be well-advised to re-write their documents, especially at a time when this is being done for rules in the United States and European Union. ■

* *Laven Partners can be reached at www.lavenpartners.com on +44 20 7838 0010.*

THE AIFMD: SIX MONTHS ON

Six months have passed since the deadline for the implementation of the Alternative Investment Fund Managers Directive by EU Member States on 22 July 2013. Philip Lovegrove and Liam Collins of the Dublin law firm of Matheson look at the issues.

With a further six months remaining until the much-welcomed transitional period expires, it is timely to consider certain of the issues which are giving rise to most discussion in the industry, as asset managers seek to obtain alternative investment fund manager (AIFM) authorisations and align their fund documents with the AIFMD's requirements before the end of the transitional period.

Whether the AIFMD will develop into an international brand for alternative investments globally remains to be seen, but asset managers are increasingly looking at the opportunities that it can offer in terms of asset-raising through the "professional investor passport" to ensure that they are not left trailing behind their competitors by the end of this year. Notwithstanding the transitional period, a number of asset managers have already obtained their AIFM authorisations. The Central Bank of Ireland has confirmed a filing deadline of 21 February 2014 for Irish AIFMs that want to be authorised by 22 July 2014.

Among the many issues that the directive throws up, there are a number of "hot topics" which asset managers cannot ignore.

CONTRACTUAL DISCHARGE OF LIABILITY

The AIFMD states that the depositary is strictly liable (i.e. liable come what may) for the loss of financial instruments that can be held in custody but also that, subject to certain conditions, the depositary can discharge itself of that liability by transferring it to a delegate. AIFMs are understandably reluctant to release the depositary from the strict liability standard and the precise conditions of discharge, and how they may be met, often present a stumbling-block to negotiations over AIFMD depositary agreements.

"The AIFM is obliged at all times to act in the best interests of the fund and its investors"

The fundamental condition is that the discharge should be justified by an "objective reason" (an unexplained phrase) which must be detailed in the contract allowing the discharge (and disclosed to investors also). The establishment of "an objective reason" is not straightforward. For one thing, the AIFM is obliged at all times to act in the best interests of the fund and its investors and so it must be satisfied that it is doing so when it transfers liability from the depositary to its safe-keeping delegate (e.g., a prime broker). If the delegate is a greater credit risk than the depositary, this may be a difficult thing to do; objectively, a good reason would be needed to justify a transfer of liability to a less creditworthy entity. In addition, the AIFMD Level 2 Regulation (a European Union legislative term) provides that the objective reason must be limited to precise and concrete circumstances that characterise a given activity. It would appear, therefore, that the fact that a depositary seeks to discharge liability as a matter of course or as its standard practice would not be sufficient on its own.

"In some cases, the depositary can transfer its liability to a third party"

The AIFMD Level 2 Regulation also provides that certain circumstances are automatically deemed to constitute objective reasons, namely circumstances in which the depositary can demonstrate that it had no other option but to delegate its custody duties to a third party. In such cases, the depositary can transfer its liability to that third party. Particular examples of this are where the law of a non-EU country requires that certain financial instruments should be held in custody by a local entity or where the AIFM insists on maintaining an investment in a particular jurisdiction despite the depositary warning that this will increase the amount of risk. The AIFMD itself also provides for a specific case where an objective reason is not required, namely where the law of a non-EU country requires certain financial instruments to be held in custody by a local entity and no local entity satisfies the AIFMD delegation requirements.

Regardless of the reason itself, the AIFM will have to satisfy itself that options other than the discharge of liability were considered, for example, the procurement of an indemnity from the delegate to the depositary, and that those options did not represent the best interests of the fund or its investors.

Where liability is discharged, the AIFM's role with respect to custody can change also. As the delegate (e.g. the prime broker) is now the entity responsible for certain assets, the AIFM may be expected to conduct 'due diligence' to ensure that the delegate is capable of performing the custody functions delegated to it and may also be expected to monitor the performance of those functions continually.

This issue is certain to be the subject of some discussion over the coming months as asset managers and depositaries seek to accommodate the new liability landscape within their structures.

VALUATION

Prior to the AIFMD, responsibility for the valuation procedures of an Irish alternative investment fund (AIF) resided with the AIF's board of directors. Whenever the board of directors of an AIF has elected to act as AIFM under the AIFMD (i.e. a self-managed AIF), the board will retain this responsibility. However, if an external entity is appointed as AIFM, that entity will assume responsibility for this function, representing a change from normal practice in the pre-AIFMD world. The key issues for consideration in relation to valuation provisions under the AIFMD are:

- (i) which entities are permitted to carry out the valuation function;
- (ii) the classification of an external valuation agent;
- (iii) the valuation procedures under the AIFMD; and
- (iv) the liability provisions in relation to the valuation function.

WHO CAN ACT AS VALUER?

The AIFM itself can perform this function on the proviso that the process is functionally separate from its portfolio management and remuneration duties, and that measures are taken to mitigate any potential conflicts of interest.

“The AIFM may appoint an external valuer who cannot sub-delegate this function to anyone else”

Alternatively, the AIFM may appoint an external valuer. Importantly, it is not permitted for this external valuer to sub-delegate this function to anyone else. Additionally, the AIFMD must ensure that the external valuer is professionally recognised, can furnish professional guarantees, and is appointed in compliance with the delegation provisions of the directive. It is worth noting that either one or several external valuation agents can perform the valuation of the AIF's assets.

WHO IS AN EXTERNAL VALUATION AGENT?

The AIFMD clearly distinguishes between the valuation of assets and the calculation of their net asset value (NAV). The European Securities and Markets Authority's (ESMA's) guidance on this topic clarifies things by saying that an administrator who carries out the calculation of the NAV is not considered to be an external valuer as long as he (or it) is merely incorporating values which are obtained from other sources (as opposed to providing the values himself). As such, the administrator does not automatically assume the role of external valuer and the AIFM may retain the valuation function and determine the AIF's pricing policy while also delegating the calculation of the NAV to the administrator.

VALUATION PROCEDURES

The AIFM must ensure that “appropriate procedures” are in place for the proper and independent valuation of assets. Valuation must take place at least annually (although open-ended funds may be required to undergo valuation more frequently, whereas closed-ended funds must carry out a valuation each time the capital of the fund increases or decreases). Additionally, the AIFM will be required to determine the valuation methodologies that will be used for each of the types of asset in which the AIF may invest.

It is important to note that valuation policies and procedures should be reviewed by the AIFM at least annually.

LIABILITY OF THE AIFM

The AIFM's liability towards the AIF and its investors is not affected by the delegation of the valuation function. The external valuer is, however, liable to the AIFM for any losses suffered by the AIFM as a result of its negligence or intentional failure to perform its tasks. This liability standard cannot be waived or amended by contract.

REMUNERATION

In the six months since July 2013, a clearer picture has begun to emerge in respect of two important issues regarding remuneration under AIFMD: (i) whether or not remuneration requirements are applicable to an AIFM's delegates and (ii) the options available to AIFMs and their delegates when they are assessing the extent to which these requirements apply to them and their staff.

“ESMA believes that the remuneration requirements should apply to delegates”

ESMA's guidelines for remuneration, which it published in July 2013, indicate that the authority believes that the remuneration requirements should apply to delegates, as its definition of “Identified Staff” (i.e. those to whom the remuneration rules apply) includes staff at entities to which portfolio or risk management has been delegated. Before ESMA released these guidelines, EU member-states were allowed to opt out of them. It appears that only one country has taken this option.

In terms of assessing the extent to which the remuneration requirements apply, some aspects of the AIFMD rules may be of assistance to AIFMs and their delegates.

Firstly, ESMA's guidelines make it clear that the rules will only apply to staff who have “a material impact on the risk profile of the AIFM or the risk profiles of the AIF they manage”, so that wherever the parameters of a delegation of portfolio or risk management by an AIFM are sufficiently restrictive that a delegate or its staff cannot have such an effect, the remuneration rules will not apply.

Secondly, the “proportionality principle” may enable AIFMs and delegates to decide not to apply the so-called “pay out process” rules, which may require variable remuneration to be paid in units of funds under management, to be deferred for three to five years and to be subject to ‘clawback’ provisions where warranted by subsequent performance. For example, the UK's Financial Conduct Authority (FCA) and the Irish Funds Industry Association, among others, have suggested that anyone who has the job of determining whether it is “proportionate” to apply the remuneration rules should consider assets-under-management thresholds, with AIFMs with assets under management below de minimis levels being presumed exempt. Equally, others think that wherever the management of AIFs represents a small proportion of a delegate's overall business, it may not be proportionate to require the delegate to set up systems and other infrastructure to comply with the remuneration rules.

“ESMA might be thinking of publishing a Q&A document, which could confirm some commonly-held views”

The FCA is due to publish guidance about this shortly and its points are expected to be broadly in line with proposals outlined in its previous consultation. ESMA is also understood to be thinking of publishing a question-and-answer document, which could provide welcome ‘certainty’ by confirming some commonly-held views. These include those outlined above and others on subjects such as the timing of the application of the rules; other remuneration regimes (e.g. CRD and MiFID) which may be deemed to be equivalent to AIFMD; and the possibility that variable remuneration might be paid in units of entities other than the funds under management themselves, wherever that is not possible or practical.

THE EFFECT OF THE AIFMD ON PRIVATE EQUITY MANAGERS

Because the AIFMD defines the phrase ‘alternative investment fund’ so broadly, previously unregulated private equity fund managers may

now find themselves falling into its regulatory clutches, with all the resultant problems and benefits that that may bring. We have seen a marked increase in the number of private equity fund managers who are considering Ireland as a domicile because the directive contains a 'marketing passport'. In this regard, the Irish AIF vehicle offers the characteristics and flexibility of the typical private equity fund product, while being authorised and regulated by the Central Bank and offering the AIFMD-compliant standard which investors are increasingly likely to seek. The financial services industry is also collaborating with the Irish government to make amendments to the existing investment limited partnership legislation. The idea is to make this structure more attractive as an option for private equity managers.

The next six months will certainly be an interesting time as far as the asset management industry is concerned, as a host of regulatory developments follow in the wake of the directive. In addition, it is expected that the next months will also see the introduction in Ireland of the Irish Collective Asset-management Vehicle (the "ICAV"), a new corporate fund vehicle tailored for the needs of asset managers, which should prove to be a popular alternative to the existing Irish fund vehicle range for both UCITS and AIFs. Since 2008, assets under management in Irish AIFs have experienced 120% growth. Ireland is certainly well-placed to build on its existing position as the domicile of choice for the establishment of AIFs. ■

CAYMAN'S RECENT FUND GOVERNANCE SORP

The Cayman Islands Monetary Authority's recently-published statement of guidance on matters of fund governance has taken effect and applies to all funds regulated under the terms of the Mutual Funds Law. Neal Lomax of Mourant Ozannes tell us how.

The statement establishes key principles of good governance which must be observed by funds which CIMA regulates. Many funds will not be phased by the requirements of the statement for their governance models will exceed the standards which the statement demands, though others may find the statement challenging and should seek to improve their governance standards accordingly.

The statement is neither rigid nor prescriptive (and not exhaustive either). Instead, it sets out key principles to be interpreted and applied in the specific context of each fund, taking into account factors such as the fund's structure, complexity and size. It aims its requirements at the 'governing body' of a fund (i.e. its governing mind and will and the body responsible for overseeing and supervising the activities and affairs of the fund) as well as at its 'operators' (i.e. the members who, together, comprise the fund's governing body).

BEYOND FIDUCIARY DUTIES: A REGULATORY OVERLAY

It is clear from the statement that CIMA seeks to ensure that fund governance not only becomes a focus beyond common law fiduciary duties but also that it is contextually relevant. CIMA also wishes to say who bears responsibility for governance and concedes that its supervisory glare falls upon a broad community (hence the different treatment in the statement of the fund's operators from its governing body) which must have regard to broader principles than those established as rules of common law or guidelines established in *Weaving Macro Fixed Income Fund Limited (in liquidation) v Stefan Peterson and Hans Ekstrom (2011)*.

The oversight principle. The requirement of the statement for effective supervision and oversight of a fund's activities and affairs by its governing body is entirely consistent with the general requirements of supervision imposed by common law (and highlighted in the *Weaving* judgment as being absent in the case of the *Weaving* fund). In many ways this is at the heart of the statement and underpins the other principles which it establishes, and includes a requirement that the governing body of a fund should meet at least twice per year or more frequently if the circumstances of the fund require it to do so in order to fulfil its responsibilities effectively.

The documents principle. The statement highlights the need for funds to ensure that they provide investors with accurate and sufficient disclosure of matters such as the fund's investment strategy, relevant conflicts of interests and descriptions of the equity interests being offered to investors. In large measure these replicate the requirements of the *Mutual Funds Law*, though the statement goes further in requiring that internal documents are maintained which record fully, accurately and clearly the proceedings at meetings of the fund's governing body.

The communication principle. The statement notes that communication between the operators of a fund and its service-providers (as well as between funds and CIMA) should contain reports about compliance with the rules of the fund as well as with applicable law and regulation and should also allow investors to see this information whenever disclosure to them is appropriate.

The risk management principle. The statement requires a fund's risks to be appropriately managed and mitigated and discussed at the (at least) biannual meetings of the fund's governing body.

THE ENFORCEMENT DILEMMA

The statement may be a double-edged sword for CIMA; much as it encourages good governance among fund operators and governing bodies, investors are bound to expect that compliance with it will be policed and shortcomings dealt with. Whether CIMA will in fact do this remains to be seen; for the time being, it lacks a specific statutory right of enforcement in the event of failure by fund operators and governing bodies to adhere to the terms of the statement. However, any conclusions which CIMA reaches about bad behaviour will colour the way it exercise its of its statutory power of substitution where fund operators fall short of what CIMA considers to be fit and proper. ■

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CHINESE OLIGARCHS AND THEIR LOOT - THE NEXT WAVE OF ILLICIT MONEY-FLOWS

Money-laundering reporting officers and compliance officers in Hong Kong, the British Virgin Islands and other international financial centres might find it prudent to double-check accounts associated with close relatives of mainland Chinese politicians. Chris Hamblin of Compliance Matters probes the problem.

One of the reasons for the need for renewed vigilance is a new Chinese law, passed quietly last year and now in force, which requires mainland high-net-worth individuals to declare details of any offshore accounts they may hold. Offshore banks that do not ask for evidence that their Chinese HNW customers have signed on the dotted line might find themselves on the receiving end of a FATCA-style enquiry from the Chinese government at some point in the future. FATCA, the US *Foreign Account Tax Compliance Act*, comes into force in July, although there is talk of yet another extension. Everybody else – including China – is queuing up to copy it as we move towards a world where the extraterritorial powers of states overlap in both taxation and regulation.

TAX DISCLOSURES: THE NEW RULES

The Vistra website lists three main amendments to China's tax disclosure law, which dates from 1995 and has the catchy title of "Measure for the reporting of statistics on international receipts and payments." These are found in circular 642 and are as follows.

* Everyone who is resident in China is now required to report his or her "foreign financial assets and liabilities," a completely undefined phrase that has bemused the experts, to the government along with all cross-border transactions. Nobody knows when the Chinese government is going to clarify the definition of this term; some residents are doubtless hoping that they will not have to wait until their own trials for all to be revealed, especially as the penalty for high corruption is death and only the very well-connected seem to have their sentences commuted.

* The new rules have forced the reporting requirements on a wider community of people. These now include: individuals who reside in China for a calendar year or more; Chinese passport-holders who have been absent from China for less than a calendar year; businesses that are incorporated in China; people not resident in China who nonetheless "perform economic transactions within the People's Republic of China," which might or might not include people doing deals on emails that go through China; and the representative offices or branches of foreign institutions such as private banks.

"Western governments have an execrable record of protecting sensitive data"

* The amendments state that people who work in all departments of the Chinese government are now obliged to respect the confidentiality of the information that they draw from these sources. This is likely to be of no worth whatever, as (a) Chinese officials do not have a good law-abiding track-record, as witnessed by the

blizzards of senior officials who launder their money in the US and go to live there themselves, and (b) Western governments have an execrable record of protecting sensitive data, with Her Majesty's Revenue & Customs probably coming top of the list of data-losers, data-abusers and issuers of spurious data-related propaganda. The data confidentiality rules also apply to bank staff who come across the data – a more hopeful proposition except in the case of indigent Chinese banks, where 'due diligence' is patchy.

"All departments of the Chinese government are now obliged to respect the confidentiality of account information"

The sheer opacity of the one-party state system obscures the reasons for China's new laws at the best of times. Commentators are assuming that these new rules are aimed at stemming the tidal wave of money offshore that is routinely stolen from the Chinese government. Much of this money is accompanied by the very 'politically exposed persons' who have sequestered it. Officials from the state banks and other government departments have a long history of moving to the US and surrounding themselves with unexplained wealth. In 2011 a 67-page report from China's central bank – one among many on the subject – looked at where corrupt officials were going and how they moved their money out of the country. One favourite route was to squirrel cash away with the help of loved ones emigrating abroad through the use of fake documents.

"The focus of Chinese PEP money seems to have floated south from the US to the Caribbean"

IN THE SHADOW OF FATCA

Another explanation for the new law might, however, be more prosaic; China's top-level leadership has long been on the warpath against corrupt PEPs and is now reeling from the sheer aggressiveness of FATCA. The government might merely be plumping for a means of retaliation against FATCA that also happens to be in line with one of its favourite projects, namely the anti-corruption drive. At any event, compliance officers and MLROs ought to become more vigilant for these schemes while noting that the focus of Chinese PEP money seems to have floated south from the opaque incorporations of Delaware, Wyoming and Nebraska towards the banks and international business companies (IBCs) of the BVI. ■