CLIENT BRIEFING

REGULATORY HEAT FORCES TOUGH DECISIONS FOR FAMILY OFFICES IN 2012 (PART 2)

By Rosalyn Breedy

Private Wealth Management
Legal Advisers

Regulatory heat forces tough decisions for family offices in 2012 (part 2).

Rosalyn Breedy, of Breedy Henderson Solicitors, continues her survey of the regulatory landscape for family offices and explains why they urgently need to make a decision about whether or not they wish to manage third party money.

In the first of this three-part series, Rosalyn Breedy examined the Dodd-Frank reforms and the AIFMD. Here, in part 2, she outlines the implications of the regulations on family offices and in Part 3, she considers whether private investors will be better protected under the new regime.

Financial meltdown (in a nutshell)

To fully understand the new regulatory environment, it is worth reviewing what has led us to the current situation and revisit the financial crisis.

In a nutshell, several macro-trends collided with an unprecedented level of financial innovation. There was over-reliance on sophisticated mathematical techniques which either didn't work in extreme circumstances or failed to measure adequately the risks associated with the complexity of interconnectedness.

There was also an explosion of world macro-imbalances which had grown over the last 15 years. Basically, oil producing countries, China and Japan and other East Asian emerging economies accumulated large current account surpluses at the time that large current account deficits arose for US, UK, Spain, Ireland and other countries.

This was because the surplus countries had high savings rates or a commitment to a fixed rate of exchange and this drove down the real risk-free rates of interest, encouraging the deficit countries to borrow at dangerous levels and investors to seek new products promising additional yield without ostensibly increasing risk too much.

This demand for yield without risk was met by innovative financial techniques which appeared to be able to originate, package, trade and distribute securitised credit obligations offering investors differing combinations of risk, return and liquidity which seemed more attractive than buying the underlying credit exposures. This was backed by the favourable ratings of credit agencies, which used the problematic risk assessment tools and suffered from conflicts of interest.

This evolution of a securitised credit model was accompanied by remarkable growth in the wholesale financial services sector, an increase in total system leverage and the use of increased off balance sheet accounting for banks resulting in a shadow banking system which was difficult for regulators to follow.

Regulatory development

During the actual financial crisis in 2008 we saw unprecedented levels of co-operation and collaborative actions between governments and regulators.

Then, in 2009, we saw the reviews, such as the Turner report, which indicated that G20 governments and regulators were alive to the global interconnected issues and were working together through global institutions such as the Financial Stability Forum and the Basel Committee of Banking Supervision.

The issues were then taken and implemented into national and regional regulation which all address the same key issues but have differed slightly in detailed implementation.

Family offices need to consider the rules the regulators have brought in as a response to the 2008 crisis, because they directly affect family offices that cannot fit within an exemption to Dodd-Frank or AIFMD.

The rules address 4 key areas, which are expanded upon below:

- Capital adequacy and liquidity;
- Risk management ;
- Consumer protection; and
- Market abuse and financial crime.

Capital adequacy and liquidity

The key regulatory response to 2008 has been to require a higher quantity and quality of capital for banks, investment management firms and insurers and to improve risk coverage and liquidity.

Basel III was introduced by the Basel Committee on Banking Supervision and is aimed at internationally significant banks. Basel III deals specifically with the issues which recently came to light and the key reforms relate to both management of capital and risk. The detail and changes to Basel II are of great interest to banks and have had a real impact on the availability of liquidity in our economies.

In the US, the Collins Amendment to Dodd-Frank provides that US regulators can adopt more onerous capital standards than Basel lll, but not more relaxed ones.

In Europe the application of the EU Capital Requirements Directive lll via AIFMD, is likely to substantively affect EU investment firms and non-EU managers wishing to market alternative investment funds in EU.

Under AIFMD an alternative investment fund manager will now be required to maintain shareholder funds, to maintain professional indemnity insurance or hold additional own funds to cover potential professional negligence liability and to invest own funds into liquid assets or assets readily convertible to cash.

The initial capital requirements start at EUR 125,000 for externally managed AIF and EUR 300,000 for internally managed funds. Managers of portfolios exceeding EUR 250 million must provide an additional amount of own funds corresponding to 0.02% of the excess amount subject to an overall cap of EUR 10 million for initial capital and own funds.

Member States may allow managers to provide up to 50% of the additional amount of own funds in the form of a guarantee from a bank or an insurer. Additionally, managers are required to have additional own funds or professional indemnity insurance to cover professional liability risks and this was an issue substantively addressed in recent guidance.

Risk management

One of the key issues regulators have moved quickly to address is to put in place a framework designed to reduce overall systemic risk.

The principal issue they addressed was how to better monitor the leverage and counterparty risk in the system. The tools they have used range from better disclosure and reporting, maximum limits on leverage, and independent valuations.

In September 2010, the European Commission published a legislative proposal for a new framework of supervision of over-the-counter derivatives, central counterparties and trade repositories also known as The European Market Infrastructure Regulation (EMIR).

The objective of the EMIR is to establish a harmonised regime for the regulation of over-the-counter trading of derivatives in the EU and mirrors equivalent provisions in the US under Dodd-Frank. The EU regulation is designed to meet the commitment by G20 leaders in September 2009 that all standardised over-the-counter contracts should be cleared through central clearing counterparties by September 2012 at the latest.

The proposed regime seeks to ensure that all eligible contracts go through centralised clearing, parties to contracts not eligible for centralised clearing use appropriate risk mitigation techniques, govern the establishment of EU central counterparties and improve disclosure and transparency in the derivatives market.

This regulation needs to be looked at in conjunction with the transaction reporting requirements of Markets in Financial Instruments Directive (MIFID II).

Under AIFMD, in addition to the usual audited annual report, managers of alternative investment funds will need to provide investors with minimum pre-investment information from investment strategy and objectives to its liquidity risk management arrangements and leverage levels. Details of liquidity management, risk management arrangements, invested assets, results of stress testing where applicable and information on sources and uses of substantive leverage will be regularly reported to the authorities.

Managers will be required to set a maximum level of leverage for each fund it manages, to limit the extent of its right to reuse collateral and demonstrate the levels set are reasonable and that they comply with them at all times.

Consumer protection

Managers are required to apply due skill, care and diligence to act in the best interests of investors and to identify and seek to avoid conflicts of interest. They are also required to **separate** the functions of risk management from operating units (including portfolio management), implement risk management systems and comply with due diligence standards when investing on behalf of funds.

For each fund it manages (except for unleveraged, closed ended funds) a manager must employ a liquidity management and monitoring system, conduct regular stress tests and ensure that the liquidity profile of a fund matches its redemption policy.

Financial crime and tax avoidance

The Foreign Account Tax Compliance Act is a US law updated by recent US Treasury Notices aimed at foreign financial institutions and other financial intermediaries to prevent tax evasion by US citizens and residents through the use of offshore accounts.

If you are a family office with US assets or clients now known as a 'foreign financial institution' you will have two options: to become a 'participating foreign financial institution and enter into an agreement with the US tax authorities to report on US accounts or to face a 30% withholding tax on dividends and interest payments from US corporations or gross receipts of US property.

Some of you may already be receiving requests for disclosure from fund managers on this point.

What does this mean for family offices?

If you do want to manage third party money then you need to get ready for the new regulatory environment and attend to a number of issues, including:

- new capital requirements;
- separate risk management function;
- risk management which addresses counterparty risk;
- use of leverage
- investor disclosure; and
- increased operating costs.

Inevitably, the costs of running investment vehicles will rise and so family offices need to revisit whether their business plans make sense and to ensure that their vehicles are properly resourced, managed and run,

The main elephant trap for family offices is where their strategy drifts from being a single family office to a multi-family office without planning and realising how the regulatory environment has changed.

If you decide to stay purely as an investor the good news is that your needs are moving more highly up the regulatory agenda. The new UK Financial Conduct authority under the new financial services bill intends to include professional investors within its definition of 'consumer' and accordingly, will seek more to protect your needs. We will be addressing this in more detail in Part 3.

For further information please contact:

Rosalyn Breedy
Breedy Henderson Solicitors
52 Brook Street
London
W1K 5DS

t: +44 (0) 20 7268 2260

www.breedyhenderson.com