

# Chief Compliance Officer & Fund Treasurer Summit Report



J.P.Morgan

## Dear Clients and Friends,

J.P. Morgan recently hosted the Fourth Annual Chief Compliance Officer & Fund Treasurer Summit, **Achieving Clarity: New Perspectives in a Changing World**. Despite having to be rescheduled around Superstorm Sandy, the November 29, 2012 conference in Boston proved to be a strong draw. Our J.P. Morgan colleagues were joined by a renowned group of CCOs and Fund Treasurers for a lively series of round table discussions.

**A noteworthy group of industry experts and former SEC professionals also helped us deliver a thought-provoking, yet practical, slate of presentations. These experts included:**

- **Onur Erzan**, a Principal at McKinsey & Company, set the stage by talking about key trends in the asset management industry.
- **Jay Baris**, a Partner at Morrison & Foerster, shared learnings from his role as Chair of the ABA's Task Force on Fund Use of Derivatives and Leverage, offering insight into the progress of rulemaking under Dodd-Frank.
- **Silvestre Fontes**, Director of Financial Services Regulatory at PricewaterhouseCoopers, shared his experiences as SEC Assistant Regional Director, providing perspective on the SEC's stepped up enforcement actions.
- **Milton Miyashiro**, Head of Regulatory and Compliance at Thomson Reuters, contributed to a lively discussion on pricing and valuation in the evolving post-reform environment.
- **John Capone**, Partner at KPMG and a former Chief Accountant of the SEC's Division of Investment Management, contributed his assessment of issues facing Treasurers today.
- **Barry Barbash**, Partner at Wilke Farre and former Director of the SEC's Division of Investment Management, spoke to developments in the regulation of money market funds and involvement of the CFTC in regulating funds. He was joined in this discussion by **Robert Zack**, of Counsel at Dechert and former EVP and General Counsel of OppenheimerFunds.

The big themes? Despite the extraordinary events of the last several years, the asset management industry has proven to be remarkably resilient. Assets under management have returned to their post-crisis high and margins remain high relative to other sectors of the financial services industry. Profitability, however, is coming under pressure as asset management firms struggle

to grow their businesses while keeping up with the increasing demands of regulatory compliance.

Four years after the passage of Dodd-Frank, the pace of regulatory rulemaking remains slow and many key issues have yet to be settled. Meanwhile, the dramatic increase in SEC enforcement actions continues. In the fiscal year that ended in September of 2012, the agency filed 734 enforcement actions, including many in procedural areas that would not have previously been the subject of such vigorous enforcement.

As we move forward into 2013, one of the few certainties is that CCOs and Fund Treasurers will continue to face a diverse and ever-changing series of challenges. At this year's Summit, industry experts provided context for what's happened so far, and some probabilities for what may be coming next. This summary provides some of the highlights. If you have questions regarding any of these topics or would like to learn more, please reach out to your J.P. Morgan Relationship Manager, or Business Development Manager.

We look forward to seeing you at our 2013 summit.

**George O. Martinez**, Executive Director, J.P. Morgan  
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## Presentation: State of the Asset Management Industry and Key Trends

### SPEAKER:

Onur Erzan, Principal  
McKinsey & Company

Having weathered the financial crisis, turmoil in the Eurozone and a host of other shocks to the system, the asset management industry stabilized over the past two years. Global assets under management remained unchanged from 2010 to 2011, at \$48 trillion, while operating profits declined 1.3% to \$44 billion. Industry-wide return on average equity was a healthy 13.5% in 2011, and profits are expected to grow 3% over the next five years.

### The gap between winners and losers grows larger

In North America, industry profitability is becoming increasingly concentrated at a fewer number of asset managers. While the average pre-tax operating margins inched up a point to 28%, the top third achieved 46% margins. The gap in revenues has also increased. The spread between the top quartile and average quartile players has grown from 27% in 2007 to 41% in 2011.

### Profitable growth is harder to achieve

While the industry as a whole is holding its own, most players are finding it very difficult to achieve sustainable growth. Only one in five U.S. asset managers grew at above the market average since 2002, and most of those relied on M&A. The numbers are more troubling when you look at net flows. Since 2008, more than 100% of growth has come from market performance, with net flows actually contributing a \$400 billion drag on growth. Revenues have rebounded to pre-crisis levels, but profitability is down 16% from 2007.

“While the asset management industry has proven to be remarkably resilient, growth is hard to find.”

### Managers looking farther and wider for growth

Recognizing that broad based growth is difficult to come by, asset managers are looking for growth in new markets. From 2007 to 2011, emerging markets grew at a 6.4% pace, helping offset a slight decline in assets under management in mature markets. By 2011, emerging markets accounted for a 10% share of the world

market, up from 8% in 2001. Net flows, however, varied greatly by market, with Chile, Mexico and India all growing at rates in excess of 25%, while Russia and Korea declined by at least 20%.

### Key trends in the retail market

The fastest growth in the U.S. retail market over the next five years (except defined contribution) is expected in the independent channel. Net flows are expected to show the greatest gains in ETFs, alternatives and multi-asset class funds. Flows into domestic equities are expected to continue their decline, with offsetting increases into international equity funds. Overall, \$1.173 trillion of cumulative net flows are projected from 2012 through 2016.<sup>1</sup>

<sup>1</sup>Source: PricewaterhouseCoopers

### Key trends in the institutional market

Continuing declines in private sector defined benefit plans will put a damper on growth in the institutional market over the next five years. Outsourced insurance is expected to lead the pack with \$319 billion in net new flows, while endowments and foundations will remain relatively stable. By fund type, high yield/global fixed income, hedge funds and multi-asset solutions are expected to see the greatest inflows. Overall, the institutional market is projected to gain \$170 billion in cumulative net flows from 2012 through 2016.

## Panel Discussion: Update on the J.P. Morgan Distributed Operating Model

### MODERATOR:

Daniel Kramer, Managing Director,  
Global Head of Fund Services, J.P. Morgan

### PANELISTS:

Mary-Frances Barry, Vice President,  
Fund Accounting, J.P. Morgan

Harry Dahlman, Vice President,  
Fund Administration, J.P. Morgan

As asset management firms look for ways to become more efficient and increase quality, a distributed operating model makes a lot of sense. As Dan Kramer of J.P. Morgan Fund Services pointed out, “From the Industrial Revolution on, centralizing operations always results in better service and more efficiency.” He noted that the use of multiple global locations also allows firms to use the 24-hour day more effectively and contributes to disaster preparedness. In J.P. Morgan’s experience, the key to success is to properly determine which functions to migrate, where to migrate them, and how to effect a productive transition.

“We’re always looking to improve by capturing what went well in a migration and learning what could go better.”

### Follow the sun to assign appropriate tasks

In determining which functions to migrate, it pays to have the workflow follow the sun around the globe. In essence, domestic night shift work becomes day shift work somewhere else. In the J.P. Morgan model, we look to identify data processing, or other tasks, that can be performed during the U.S. overnight cycle. We also look at any processes that can be performed end-to-end or can be chained together and handed-off from location to location in order to meet client deliverables. In assigning specific tasks to specific locations, we look for how a process can follow this logical progression around the clock.

Of course, we also favor locations where we already have a footprint, and where people with the right skill sets can be hired. Though tasks are distributed, a single governance and control team provides end-to-end support.

### Best practices in migrating a procedure

**Once we have identified a procedure to migrate, we follow a well-defined five-step process:**

1. Define the scope: We carefully document every step of a procedure to create a clear standard before we migrate it. We do it here first, and get it right, before we send it out.

2. Conduct Training: We provide extensive training, including a buddy system where new employees work under the guidance of those with more experience in our “donor” site.
3. Perform a parallel or “model office:” We try to recreate real world conditions to determine the state of our knowledge base and understanding, and adjust training accordingly.
4. Agree to a go-live date: We create clear, objective metrics to determine when an office is ready to go live.
5. Provide ongoing support and oversight: Long after the go-live date, we continue to support, assess and retrain where needed.

### Important tips and cautions:

- Standardize a procedure before you migrate it to keep post-migration adjustments to a minimum.
- Don’t move processes piecemeal. Move entire process, so employees have context.
- Set up a mentoring program where new employees work with current professionals.
- Business continuity planning should be a key component of your migration strategy.
- Don’t expect perfection, but learn from your mistakes.

## Panel Discussion: Practical Aspects of Derivatives Usage and Collateral Management

### MODERATOR:

Michael Mykytiw, Executive Director,  
Product Management, J.P. Morgan

### PANELISTS:

Jay Baris, Partner, Morrison & Foerster,  
Chair of the ABA's Task Force on Fund Use  
of Derivatives & Leverage

Clay Daly, Vice President, Derivatives  
Collateral Management, J.P. Morgan

Well over a year after the SEC concept release on the use of derivatives, scant progress has been made towards concrete rulemaking. We see little reason to expect substantive changes in the coming year as a divided SEC grapples with complex issues. With Chairman Shapiro's resignation, the SEC is now split, with two Democratic and two Republican commissioners. In our opinion, her departure is not likely to accelerate pace, nor change the ultimate direction of policy. Dissension among commissioners, in fact, is more likely to lead to gridlock. There may be attempts, however, to regulate through interpretation of existing rules rather than establishment of new ones.

### Slow progress in new rulemaking

The SEC policy statement, issued in August of 2011, essentially reiterated issues that had long been identified by the financial community. While little is certain, and less imminent, some issues are likely to be addressed by the regulators:

- The measurement of derivatives for the purpose of concentration and diversification will most likely require participants to look at the reference asset in a trade, not just who issued it.
- Some rulemaking defining a SWAP.
- Perhaps, but not likely, new rules concerning segregation-of-assets, perhaps those limiting the use of Controlled Foreign Corporations.

“We have two very different schemes trying to regulate industries that have essentially merged, and it's not working.”

### The potential impact on collateral management

SEC and CFTC rulings on issues impacting Collateral Management have progressed slowly and the outlook continues to be uncertain. For the time being, we are focusing on the few specific developments that will clearly take place:

- **Greater complexity**  
Under Dodd-Frank regulations, it's expected that approximately two-thirds to three-quarters of the current bilateral trade volume will shift to centralized clearing. For a

significant period of time, many market participants will have to manage collateral across both bilateral and cleared trades, a bifurcated model that will add considerable complexity.

- **Higher initial margin**

Initial margin will increase for both cleared and uncleared trades. Under some proposed rules, these margin amounts for uncleared trades may reach punitive levels. There has also been some discussion that rehypothecation rights may not be allowed. If so, \$8 trillion of collateral will be drained from the system.

- **A growing need for collateral transformation**

While there has been some talk of expanding eligibility criteria, it is clear that there will be an increased demand for higher grade collateral in the post-reform trading environment. This will create a widespread need for collateral transformation. Netting capabilities may help ease the pressure, as Central Clearing Parties will look to offer cross-margining capabilities for products they clear (IRS swaps and Treasury futures, for example).

With that as a backdrop, clients are urged to focus early and seek solutions before the regulations go into effect in 2013.

## Panel Discussion: Chief Compliance Officers Roundtable

### MODERATOR:

George Martinez, Executive Director,  
J.P. Morgan

### PANELISTS:

Silvestre Fontes, Director Financial  
Services Regulatory, PwC, former SEC  
Assistant Regional Director

Russ Lemley, CCO, American Funds

Donna Rogers, CCO, Foreside

Michael Whitaker, CCO, Fidelity Funds

“We may have seen the future,  
and it looks a lot like 2011 and  
2012.”

The SEC underwent unprecedented structural changes from 2008 to 2010, the impact of which is now particularly noticeable on the enforcement front. Over the past two years, the SEC set a new record for total actions brought: 735 in fiscal year 2011 and 734 in 2012. These included:

- 147 enforcement actions against investment advisers and investment companies in 2012, one more than 2011's record number.
- Insider trading cases increased with 58 actions filed in 2012, one more than last year's total of 57 actions.

### The top concerns of CCOs

Against this backdrop of exceptionally aggressive enforcement policies and broader regulatory uncertainty, our panel of Chief Compliance Officers at leading asset management firms discussed their top concerns:

- **Risk management**  
CCOs stress the need to look at a broader spectrum of risks, and to elevate the importance of risk management so that it permeates the culture of the institution. Enterprise Risk Management now needs to be addressed at the board level.
- **NFA/CFTC registration**  
Exemptions on requirements to register as a CPO are expected to become far more limited, so CCOs need to conduct fund-by-fund analyses to determine which managers may need to register. While the final rules are not yet clear, it's important to understand the potential impact that new limits may have on operations.
- **Intermediaries**  
More stringent efforts are being made to ensure that third-party vendors are complying with their new regulatory responsibilities. CCOs are increasingly looking at the actions of outside vendors.
- **Disclosure**  
Disclosure statements are receiving closer scrutiny. While it's still very important to weed out misleading statements, it's also now important to demonstrate that the correct procedures are being followed.
- **Valuation**  
It's increasingly important to understand not only where a valuation is coming from, but also how it is derived. All vendors should be closely examined for the precise methodologies they use to make their valuation decisions.
- **Data privacy**  
There was a time when firms could mail out a privacy statement and be done with it. Asset management firms now need to demonstrate the layers of controls they have put in place to protect data.
- **Use of contractors vis-à-vis company policies**  
CCOs need to evaluate which duties have been assigned to each outside vendor and how the vendor's policies fit within the firm's overall program.
- **Regulatory rulemaking and aggressive enforcement**  
It's very difficult to maintain compliance with such an uncertain regulatory outlook, and highly aggressive enforcement raises the stakes. CCOs on the panel were concerned with the ability to keep up with the pace of regulatory changes and new requirements.
- **Staffing**  
The demands on CCOs and compliance departments have increased faster than staffing budgets, putting added pressure on CCOs.

The CCO panel stressed that their traditional roles have broadened to encompass an enterprise-wide approach. From the CEO on down, every employee of an asset management firm needs to be aware of their compliance duties, and be diligent in meeting them.

## Panel Discussion: Pricing & Valuation

### MODERATOR:

Peter Donatio, Executive Director,  
Product Management, J.P. Morgan

### PANELISTS:

Richard Bezanson, Vice President,  
Fund Accounting, J.P. Morgan

Unmesh Bhide, Managing Director,  
J.P. Morgan

Milton Miyashiro, Head of Regulatory  
Compliance, Thomson Reuters

Efforts to produce accurate, defensible valuations have become simultaneously more difficult, more important and more closely scrutinized. As a result, asset management firms now face a wide-ranging set of substantial new challenges.

### The Euro crisis

Adding a new layer of complexity, the Euro crisis requires evaluators to look harder at the underlying credit, not just the sovereign risks. At J.P. Morgan, we have looked at the potential impact the day after if Greece exited the Euro, and completed systems tests to make sure we could go back to Drachma over a single weekend. We have also conducted analyses for clients so they understand their exposures.

These exposures have generally been relatively small in Greece, but could become a major concern if Italy and/or Spain were to exit the Euro.

### Transparency in pricing

There is now a far greater need to understand, and be able to demonstrate to regulators, exactly what goes into pricing decisions. Regulators want to see what tools and methodologies are being used, as well as look into transaction data. Auditors are asking for a “snapshot in time” so they can see how many quotes were used, and how reliable they were.

### Availability of historical pricing data

Firms need to be aware of who is responsible for warehousing data, and understand which records are being held by which vendors. New online tools are available to access historical data, price challenges, transactions, and otherwise ease this burden.

### Due diligence meetings

Most firms are having more meetings covering a broader range of valuation issues in greater depth. Questionnaires are becoming increasingly robust, and now routinely include questions about controls and contingency planning. There is a new emphasis on verifying that the methodologies being described are actually followed on a day-to-day basis.

### Third party pricing information

When working with outside vendors who provide cash flow models, it's important to understand their controls so there is no disruption when models are changed. Firms should conduct routine data checks for quality assurance.

“Ultimately, you are trying to determine an accurate price that reflects what you would get in the market.”

### Using secondary pricing sources for OTC derivatives

OTC derivatives are now being priced in a manner similar to fixed income assets. Instead of just using an outside vendor to verify a price, participants are going to two independent sources. As volatility in the markets continues to be a challenge, it will remain difficult to be certain that a bond or derivative is being looked at in a consistent way. Secondary sourcing allows parties in a trade to validate that they are looking at the same thing.



## Panel Discussion: Regulatory Developments

### MODERATOR:

George Martinez, Executive Director,  
J.P. Morgan

### PANELISTS:

Barry Barbash, Partner, Wilkie Farr,  
former Director SEC's Division of  
Investment Management

Roberts Zack, Of Counsel, Dechert,  
former EVP and General Counsel  
OppenheimerFunds

### The potential impact of money market fund regulations

There is significant disagreement within the asset management industry and the regulatory community as to whether money market funds require additional controls. Many in the industry believe that the government has not made the case that money market funds need more regulation. Regulators have expressed concerns that the money market funds may be susceptible to runs, and have asked that certain measures be explored. At the urging of Treasury Secretary Timothy Geithner, the Financial Stability Oversight Council recently asked the SEC consider three options:

- Floating NAVs
- Maintain a capital buffer and minimum balance at risk
- Require an NAV buffer and other measures

So what could happen? The FSOC will hold hearings. If they adopt final recommendations and send them to the SEC, the SEC would have to adopt them, or explain why they would not adopt them, within 90 days. The FSOC must then report to Congress on what happened. If the SEC declines to take action, the Federal Reserve could place one of more funds, or sponsors, under their supervision by designating them a SIFI. They could also exercise authority over bank holding companies and limit use of funding provided by money market funds, or subject sponsors to stress tests.

### Increases in asset-management-related enforcement cases

About 100 enforcement cases have been brought or settled by SEC in the asset management area in the past year, an extremely high number by historical standards. SEC observers consider many

of these actions to be “message” cases, matters that the SEC would have allowed asset managers to solve internally in past years. Recent cases include:

- “Process” cases, where the SEC found that funds gave them misleading information or impeded their investigation
- Cases where records weren't properly kept
- Cases where stated processes were not followed
- Best executions cases

While SEC enforcement cases are not law, CCOs are well advised to look at them as precedential, and adjust processes accordingly. We expect the SEC aggressive attitudes toward enforcement to persist.

“On money market funds issue, neither the industry nor the SEC wants other regulatory agencies to get involved, but it is difficult to predict whether restraint will be exercised.”

## Panel Discussion: Fund Treasurer Roundtable

### MODERATOR:

Mark Fischer, Executive Director,  
Fund Administration, J.P. Morgan

### PANELISTS:

John Capone, Partner, KPMG

Thomas Disbrow, Fund Treasurer, UBS

Joy Dowd, Fund Treasurer,  
J.P. Morgan Funds

Aaron Masek, Fund Treasurer,  
AQR Capital Management

Markets and instruments have become increasingly complex, and funds are operating under far greater regulatory scrutiny.

### Valuation issues and the PCAOB

Both the SEC and the Public Company Accounting Oversight Board (PCAOB) are now demanding far greater transparency to understand methodologies of vendors and brokers. There is a new emphasis on making disclosures easier to understand, and they are evaluating fair value leveling decisions with a far more skeptical eye. The PCAOB has long held management responsible for valuations, including leveling decisions, and the SEC is now following suit. Fund managers are now required to do what the PCAOB has made auditors do for years: show “relevance and reliability” and prove they have a good price.

As a result many funds now include securities priced by models and matrices in Level 3, and look for exceptions that can be upgraded to Level 2. Even securities with exchange-traded prices can be considered Level 3 if the price is stale. Previously these would have predominantly been considered Level 2 securities.

“There is a huge cost being generated by all the new regulations.”

### ASC 740 (formerly FIN 48)

There is considerable confusion in fund treasurer circles concerning Rule ASC 740, the accounting for uncertainty of tax positions and potential liabilities. With requirements to “self-assess” capital gains taxes in certain countries, it is difficult to calculate what the potential liability may be. The application of U.S. treaty benefits varies by country, fund structure and type. So, an in-depth analysis, country by country, is required to determine what taxes are owed to which countries. Even when they are accurately assessed, market practices often make paying liabilities difficult. In certain cases, funds may actually have to book a liability that is basically impossible to pay. There may also be broader global impact on firms if a fund books a liability, as it will raise questions with the taxing authorities regarding other funds in the fund family.

### CFTC harmonization issues

With some fundamental difference between the National Futures Association (NFA) and the SEC, Fund Treasurers must cope with a series of regulatory harmonization issues that are still in flux. For example:

- The NFA and SEC have different requirements concerning pre-effective advertisements, performance data and hypothetical performance data.
- Rule 2-35 Disclosure Document includes a broader range of disclosures, has different filing requirements and must be delivered to prospective clients prior to signing of agreements. (Pools excluded under Rule 4.5 will not be required to comply until rules are finalized.)
- Rule 4.22 Reporting to Pool Participants defines what statements and reports must be distributed to each pool participant, and when.
- Form CPO-PQR must be filed with the NFA and has varying requirements depending on the size of CPO. This will be a huge drain on resources, as much of the filing has to be done manually.



## Panel Discussion: Policies and Procedures: Development and Monitoring Effectiveness

### MODERATOR:

**Susan Morrison, Esq.,** Vice President,  
Regulatory Services, J.P. Morgan

### PANELISTS:

**Charles Buckley,** Vice President,  
Treasury and Compliance, J.P. Morgan

**Charles Daly, Esq.,** Vice President,  
Regulatory Services, J.P. Morgan

**Giovanna Galbiati,** Vice President,  
Fund Accounting Manager, J.P. Morgan

**Rick Millard,** Vice President,  
Financial Reporting, J.P. Morgan

**Julie Piatelli,** Vice President,  
Fund Administration, J.P. Morgan

Rule 38a-1 of the Investment Company Act requires mutual funds to adopt and implement policies and procedures designed to prevent violation of Federal securities laws. J.P. Morgan's CCO Compliance Solutions is our approach to meeting our Rule 38a-1 responsibilities. Our approach integrates both internal and external controls.

### How we develop and implement new procedures

The need to create a new procedure may be created by a new service offering, a system enhancement, or a change in either the market or regulatory environment. Regardless of why we are initiating a new procedure, we strive to take a systematized approach to its development, with tight controls to define, document, and implement the procedure and train people in its use. We encourage an open debate with all internal stakeholders to gain consensus before we standardize operating procedures. We then develop a checklist to codify those standards, a useful tool for both training and ongoing operations.

“ We try to have enough clarity in the process so that people who don't do what we do every day can easily understand the procedure.”

To see how procedures will affect a client, we self-test across all lines of business before we go live. This includes operations control management (“OCM”) testing; an internal audit; and controlled self-assessment. After release, we re-test all critical and non-critical procedures at least once a year, looking to identify lapses in adherence and gaps in the workflow. We also step back and assess whether or not the procedure is effectively mitigating the risk it was designed to address.

Our process oversight includes daily health checks following what we call a “FAST” approach:

- **Focus:** are we compliant?
- **Action:** are corrections needed?
- **Status:** have we resolved identified issues?
- **Teamwork:** are we working together effectively?

# Final Thoughts



Four years after the financial crisis, we remain in a truly uncertain regulatory and market climate. It's more difficult than ever to remain compliant, and the stakes for falling short have never been higher.

We hope this Summit helped you in achieving a bit more clarity and provided you some new perspectives in a changing world.

We appreciate the efforts of all the experts who took time out of their busy post-Sandy schedules to help all of us get up to speed on some of the most pressing issues facing our industry. We are delighted that those who attended rated the 2012 CCO and Fund Treasurer Summit our best conference yet. Fully 100% of those who responded to the client feedback survey reported that they would be "extremely likely" to attend again in 2013.

We look forward to hosting our Fifth Annual Chief Compliance Officer & Fund Treasurer Summit in the Fall of 2013 and hope you will join us.

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