AIMA

AIMA JOURNAL

Edition 126 |June 2021| aima.org

Contents

PUBLICATION PLAN 2021

Q3 Edition 127
Deadline for submission 30th July
Publication 20th Sept

Please confirm by the 9th July if you wish to contribute to the Edition 127 of the AIMA Journal.

Q4 Edition 128
Deadline for submission 29th Oct
Publication 30th Nov

Please confirm by the 8th October if you wish to contribute to the Edition 128 of the AIMA Journal.

We might not be able to include any last minute submission.

AIMA JOURNAL EDITORIAL GUIDELINES

Message from AIMA's CEO

Jack Inglis
CEO, AIMA

This edition of the AIMA Journal boasts no fewer than 24 articles, a record high since its launch in 1992.

The topics discussed in these pages cover the full gamut of the hedge fund and private credit industry, from operation and IR challenges and opportunities through to the topical market trends of ESG and digital assets; and everything in between. We also provide in-depth profiles on specific jurisdictions which are enjoying significant interest from alternative investment market participants following regulatory and tax overhauls.

Edition 126 opens with several articles taking on the hot topic of cryptocurrencies with sage observations from legally minded members on some key issues to consider before engaging with the volatile asset class.

We next approach the equally thorny topic of ESG, with insight into how to spot a case of greenwashing.

Contributors also encourage a period of introspection and pose some pertinent questions by which readers can reflect on how to improve their IR functions and operational resiliency, as well as addressing the growing trend of tailored products, specifically side letters and pledge funds.

Turning to private debt, contributors consider how the market segment will fare in a rising interest rate environment, as well as sharing deep dives into business growth in Australia and India.

This journal also covers the unavoidable macro topics of the major markets and shines a spotlight on the current US, UK, EU, and APAC regulatory environments. Readers can explore some of the headline topics of the moment, including the Volcker Rule, Hong Kong and Singapore's open-fund regimes and the EU's SFDR, as well as questions around the reality of the new post-Brexit environment for asset and wealth managers.

Finally, we review the latest developments in technology, such as AI, and the need for greater cybersecurity to protect data, including against the growing threat of ransomware. Contributors also discuss the people behind the screens and how a war is brewing for tech-savvy talent.

My thanks go to all the authors in this edition which have made it one of the most comprehensive market resources of its type to date. As this journal will undoubtedly continue to grow in popularity I encourage all members to secure their place in the next edition imminently. A publication schedule for the rest of 2021 is included at the beginning and at the end of this magazine.

Jack Inglis
CEO, AIMA

Five issues for traditional hedge fund managers to consider when investing in digital assets

Sarah Crabb
Partner
Simmons & Simmons

An increasing number of traditional hedge fund managers are now considering investments in digital assets.

As an entry point to investing in this evolving asset class, many established hedge fund managers are seeking to allocate a small portion of one of their existing fund's portfolios to digital assets rather than launching a bespoke fund product.

Simmons & Simmons hedge funds partner, Sarah Crabb, has been advising managers on specific considerations for funds seeking to include digital assets in their investment universe and sets out her top-five issues to initially consider when seeking exposure to this asset class below.

One: Investment mandate

The first thing to consider is whether the investment objective and investment strategy of the existing fund is broad enough to permit investment in digital assets and whether investing in digital assets would change the overall trading approach of the fund. If an amendment to the investment objective and/or strategy is required in order to invest in digital assets, the relevant procedure for amending the investment objective and/or strategy of that fund will need to be followed which could require investor notification or obtaining investor consent.

An existing fund may already permit investment in derivatives and the view could be taken that employing cryptocurrency derivatives within the portfolio as part of its existing investment strategy is permitted.

For those existing funds where the investment mandate is broad enough to permit investment in digital assets, an amendment to the fund's offering document should be considered in order to include specific risk factors disclosing the particular risks of investments in digital assets, such as price volatility, custody and valuation risks and regulatory and tax uncertainties. It may also be necessary to update the fund's offering document to reflect changes to the fund service providers.

Two: Service providers

If the fund is permitted to invest in digital assets, the next point to consider is service providers such as administrators, auditors, fund directors, banking partners, custodians and depositaries (if applicable). It should not be assumed that the fund's existing service providers will be willing or able to service digital asset strategies. Not all of the traditional hedge fund service providers are willing to service funds investing in digital assets or have the necessary expertise to do so, although some will be minded to service a fund investing in digital assets for a significant and longstanding client.

It is prudent to have at least a basic level of understanding of the digital assets to be traded in order to understand what is needed from individual service providers in respect of those assets and to be able to discuss their offering with them and spot any limitations.

Three: Custody and depositary services

It is common to appoint a new custodian in respect of digital assets. Due to the particular nature of how digital assets are held in 'hot storage' or 'cold storage' and use a private key to move digital assets between wallets — a specialist custody provider is needed who has expertise in this area and has relationships with the major digital asset exchanges. As the space has evolved, there are now a number of alternative custody solutions available.

For those funds managed by a UK alternative investment fund manager and marketed into the EU that are required to appoint a depositary-lite service provider, an analysis should be undertaken as to whether a depositary-lite service provider is required to hold any of the digital assets in custody or to verify their ownership. The conclusion of this analysis will depend on the types of digital assets being held in the portfolio and their classification from a regulatory perspective. Finding a depositary-lite service provider who will undertake these services in respect of digital assets, in particular those that are more difficult to categorise such as stablecoins and security tokens, has been challenging to date. UK alternative investment fund managers should also remember the requirement to submit a material change notification to the UK Financial Conduct Authority if changing or appointing additional service providers to carry out depositary functions.

Four: Exchanges

Another point to consider is the exchanges on which digital assets trade as, unlike traditional asset classes, there is not yet a central marketplace for exchange for digital assets. The available exchanges for digital assets can be of varying quality, some are relatively new and many are unregulated with no listing rules meaning that there may be a higher risk of hacking and failure than when using established, regulated exchanges with a greater level of regulatory oversight, controls and policies.

Bearing the foregoing in mind, as well as certain legal and regulatory requirements to put in place policies, procedures and controls to identify and assess money laundering risks, it would be prudent to carry out appropriate levels of due diligence on the digital asset exchanges to be used. This could include requesting information about the relevant exchange's anti-money laundering policies and procedures, sanctions controls and its ownership structure.

Five: Tax

A final point to consider is whether investing in digital assets will have any impact on the manager's reliance on any tax safe harbours.

Nearly all hedge fund managers operating in the UK do so in reliance on the investment manager exemption (IME). Assuming certain conditions are met, this exemption ensures that UK investment management entities are not subject to a UK tax liability on the profits of their offshore funds. One condition is that the manager must be trading, which is determined by reference to the transactions that the manager is carrying out. The application of the IME is restricted to investment transactions. This exemption is based on a statement of practice first published by HMRC in 2001 when digital assets were not in existence. An unintended consequence is that trading in digital assets does not fit within the types of investment transactions that would mean that the fund is a trading fund. There is therefore some concern that the IME will not apply to UK hedge fund managers in respect of investments in digital assets. This is a 'watch this space' area.

Conversely for funds investing in digital assets via derivatives, such transactions will fall within the IME and this issue falls away.

Final word

There are a number of points to consider when embarking on diversification into digital assets.

Employing cryptocurrency derivatives within a portfolio can be a way to obtain exposure to the upside of digital assets without encountering some of the complexities caused by investing directly in digital assets outlined above.

simmons+simmons

ESG: keeping pace

The importance of navigating the ESG landscape cannot be underestimated. Those that keep up with the pace of change will reap the benefits.

Don't get left behind. Partner with those that will help you integrate ESG into your business strategy, mitigate risks, keep you compliant, and set new investment and workplace policies.

simmons-simmons.com

Haydn Jones
Director, Senior Blockchain Market Specialist, Technology & Investments
PwC
Email Haydn Jones

Central bank digital currencies and Britcoin: Bitcoin's legacy

Forecasting is a tricky business. In fact J.K. Galbraith summed up the challenge quite nicely with the quip that there are two classes of forecasters: those who don't know and those who don't know they don't know. That's almost Rumsfeldian. Nonetheless, forecasting is fun, and we all like a punt. So the ambition of this article is to extend the debate around crypto as an investable asset, and broadening it to highlight the activities of the central banks, and their own activities in the space of digital currencies. And along the way, I'll hopefully attempt to position myself in the first category of Galbraith's forecasters, rather than the second.

First off, let's consider what Bitcoin is and some of the ideas that it has demonstrated as being possible. In doing so, put aside all the emotion around Bitcoin being a scam, a framework for laundering money, and a Ponzi scheme. Let's instead consider what it offers in a purely objective, technical sense.

At its simplest, the Bitcoin technology contains a ledger that records balances associated with units of digital assets that are referred to as Bitcoins. These digital assets can be transferred between the parties that control the balances on the ledger. It's worth re-reading that statement again and taking a moment to contemplate the implications of what's described there; a ledger, which records balances of units of digital assets to which value is ascribed, and those units can be transferred securely from one party to another. What's novel about this, you may ask?

Compared to the traditional, and very separate ledger, payment and store of value frameworks, Bitcoin manages to do something very clever; by combining these three very separate rails, and bringing them together as one; not only is there an efficiency advantage as we don't now need three systems, but because this is all written in code, it opens up a range of possibilities as to how we configure this single ledger, that has payment and store of value capabilities. For example, we can create another class of asset, which we could refer to as a digital security, which looks like a normal security, that can be transferred synchronously with a payment, so perfect delivery verses settlement. Current settlement infrastructure has separate payment and securities settlement rails.

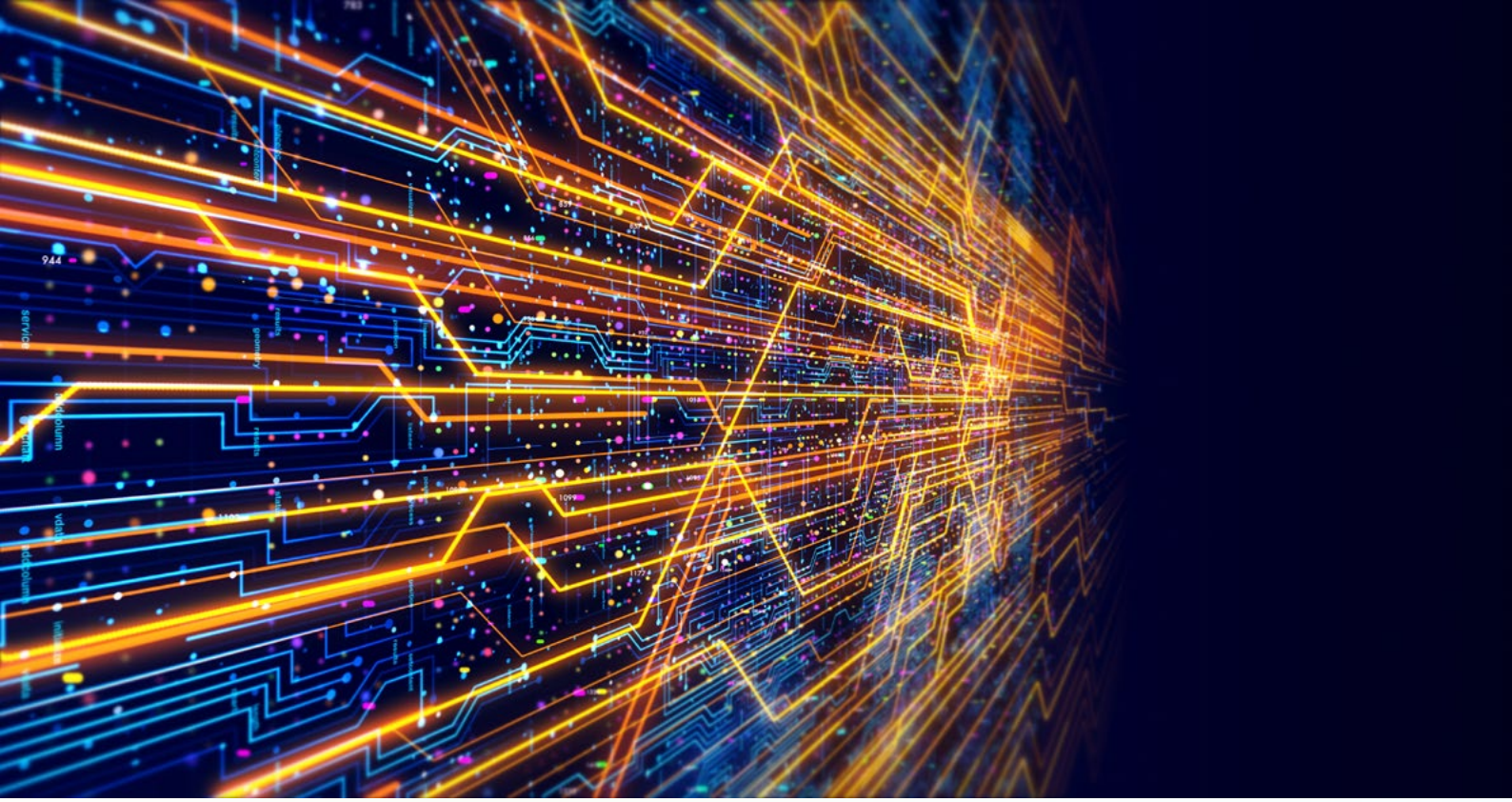
The obvious opportunity here is mitigating counterparty risk and settlement risk. It's worth stating that Bitcoin doesn't generally support securities, and certainly doesn't support bi-directional transactions in the form of 'I send you something if you send me something', but with care, it can be programmed to do so. But the broader question is, would you? The Bitcoin protocol, as clever as it is, supported by some incredibly clever people globally, with its open source code, lacks state support.

That's not to say it wouldn't be supported in the event of failure, but support would not necessarily come from the state; and things do fail warranting support from the central banks. But could the central banks take some of the ideas within Bitcoin and use them for their own purposes, so a central bank issued digital currency. Essentially the same as a Bitcoin, but a 'Britcoin'?

It is almost seven years since the Bank of England published their first paper exploring the implications of Bitcoin, 'Innovations in payment technologies and the emergence of digital currencies' [1] It is an excellent piece of writing and provides a very accessible stepping stone into the topic of cryptocurrencies in a general sense. The authors unpack the history of payment systems, developments in the payments space, and then undertake a critical analysis of Bitcoin as a technology and the way in which it mitigates different types of risk, such as credit or liquidity risk. The elimination of intermediaries within Bitcoin technology is cited as an advantage; instead of having a single point of failure, responsibility for settlement is shared across a distributed network of participants.

The obvious further advantage here is that distributed systems should be more resilient to systemic operational risk because the whole system is not dependent on a centralised third party. The paper then raises the bar somewhat by not only highlighting the opportunities in the context of decentralised payments systems using similar types of technology, but flags the broader potential impact of this type of technology. The majority of financial instruments, such as debt, equity and derivatives exist electronically, so the 'financial system itself is already simply a set of digital records'. The paper elaborates further with the observation that 'This development could allow any type of financial asset, for example shares in a company, to be recorded on a distributed ledger. Distributed ledger technology could also be applied to physical assets where no centralised register exists, such as gold or silver.' This is important stuff - we have a central bank saying we can put the financial system on the same sort of technology that Bitcoin uses.

1 https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2014/innovations-in-payment-technologies-and-the-emergence-of-digital-currencies.pdf



Fast forward to May 2021. Sir Jon Cunliffe's speech [2] The Bank of England's deputy governor financial stability, given to the OMFIF Digital Money Institute again makes fascinating reading. The deputy governor poses the question of whether we need public money? And by public money the deputy governor means money issued by the state to its citizens for everyday use. The speech covers the evolution of money, pointing out that 'It is not only a social convention, it is a very dynamic one. The forms it can take and the uses to which it can be put have varied materially through history and between societies.' The headline observation here is that forms of value exchange change over time; when our ancestors bartered, it was one sheep for ten fish. But sheep and fish are not great as currencies. It was the invention of electronics that gave rise to computers, and the ability to create digital, non-physical records of commercial activity, which is much better than fish / sheep based transactions.

And, as outlined earlier, it was Bitcoin that established the principle of combining those records. The deputy governor then tantalisingly uses the term stable-coin,[3] suggesting that '[he] will look to the future as well as to the present and to the possible entrance of non-bank issuers of private money such as the 'Big Tech' platforms'.

So this is privately-issued money, using stable-coin frameworks. The speech positions the stable-coin concept alongside the prospect of a UK issued central bank digital currency, which the bank is forging ahead with, setting up a taskforce to explore the implications. This is reinventing the digital economy, bit by bit, quite literally.

---

2 https://www.bankofengland.co.uk/speech/2021/may/jon-cunliffe-omfif-digital-monetary-institute-meeting

3 A digital currency backed by a fiat deposit

As investment managers, why does any of this matter? Bitcoin is a profoundly important technology. The Bank of England recognised that seven years ago. The case for investing in digital currencies and the allocation within a portfolio is always a function of risk versus reward, underpinned by some level of fundamental and / or technical analysis. The fact that central banks are exploring how to apply similar types of technology might have interesting bearing on any such decision. And the frameworks for holding these assets are maturing - frameworks for hygiene checks on cryptocurrencies, traded on regulated exchanges, held under safe custody, in a regulated jurisdiction, exist.

But that really is just a glimpse of the future. The advent of central bank digital currencies, a “Britcoin”, will provide the trusted, state operated infrastructure, upon which a new financial ecosystem will be built, allowing for the private issuance of new forms of money and securities, traded on venues which clear and settle 24/7. My Galbraithian forecast is that we will see a Britcoin, and lots of them. They will change securities issuance and settlement forever, but they might not necessarily be called Britcoin.

Do you pass the ESG sniff test?

Will Chignell
Chief Commercial Officer
APEX

As realisation dawns on the private markets that environmental, social and governance (ESG) is here to stay, and is fast becoming a central facet of investing, there comes great excitement, interest and engagement. That's the good news.

Following hot on the heels, of course, rightfully comes scrutiny, accountability, and even cynicism over green- and purpose-washing. These pressures ultimately underline the need to prove the credibility of your ESG approach in a meaningful way.

This is where the road forks. While there are great opportunities to achieve better exits via improved ESG performance, there are also significant risks for those who do not take it seriously and get caught out. Simply put, when it comes to ESG — do you pass the sniff test?

Scratch behind the shiny website graphics and the smoothly written rhetoric, the reality can be paper thin. These surface-level ESG reports may pass for now, but across the entire financial community, the opportunity to show market leading ESG credentials, is driving the scramble to rate, report and drive positive change — with rigour, accuracy and integrity. The reputational risks are now just too high not to.

The problem is many in the market have taken a wait-and-see attitude. Is ESG a passing fad? Do we need to dedicate specific resources? Is there the quality of personnel and products to manage the pressure from regulators and investors to satisfy ESG requirements?

The majority of alternatives investors now understand that ESG is here to stay, and it is getting serious, but can feel paralysed by the noise and confusion in the market. To cut through this, we have distilled the five **key tests** that should be borne in mind for private companies and their investors when approaching ESG.

Test one:

The listed space has been served for years by data-scraping analysis from publicly available information. That is clearly an inadequate solution for the private markets, with companies providing little to no publicly available information by virtue of being privately held. Therefore, **accurate and reliable ESG analysis requires getting the data first-hand from these companies**.

Test two:

Everyone gets short-changed when making assumptions in the event of data gaps. For example, a common approach is to estimate the carbon footprint of a company, without any of its actual data, based on its size, sector or geography.

Beyond the significant risk of inaccuracy, these approaches leave no option or incentive to change behaviour. The investment manager can only reduce its carbon footprint if it divests from 'dirty' sectors or geographies. The company can only reduce its carbon footprint if it produces less goods or employs less people.

Real, positive change occurs when people use genuine data that drives actual emissions and other ESG metrics. This then enables investors and their companies to implement changes that actually affect the reduction in emissions that the world so sorely needs.

Test three:

ESG data requires verification and validation to ensure accuracy, particularly when self-reported by companies. For investment firms, this requires specialist ESG skills and expertise to sift through hundreds, if not thousands, of data points across a whole portfolio. This is time and resource intensive, so often firms will cut corners by either collecting a much smaller dataset – thus overlooking key issues — or failing to properly scrutinise responses to unpick any errors or misrepresentations.

Fundamentally, any worthwhile ESG analysis must mitigate the 'garbage in, garbage out' principle of data science. If the data input is sub-standard, the reporting output is too. Expert data verification is both essential and cost-effective if you find the right team to do it.

Test four:

Closely related to the above, **independence is becoming indispensable**. No longer is it acceptable for investors and companies to 'mark their own homework'. Wider stakeholders require independent analysis, verification and reporting to ensure that best practice standards are adhered to, and the analysis can be trusted. Using independent providers not only demonstrates that firms are serious about ESG, it also counters accusations of green- and purpose-washing.

Test five:

Last, but certainly not least, it is important to **illustrate growth and value creation over the investment term by quantifying ESG progress**. People are wising-up to the fact that ESG is more than just a nice-looking sustainability policy here or a corporate citizenship initiative there. The downsides to not engaging in a meaningful manner go beyond the obvious, such as reputational damage, as companies are now being sued for misrepresentation.

Stakeholders want to see measurable metrics such as employee diversity, customer complaints and environmental footprint data. Can you measure ESG progress over time? How do you shape up against your sector peers? What is your alignment to the UN Sustainable Development Goals? Are you adhering to the most reputable international standards and regulations? Being able to respond to these questions will get significant traction with stakeholders.

Investors and companies should see these challenges as an opportunity. They can use this data to really understand their ESG impact and consequently implement initiatives that result in true, meaningful improvements. If these parties can demonstrate improved ESG performance, and a quantitatively proven growth trajectory towards ESG leadership, then potential buyers will perceive a more valuable proposition.

In this green rush, beware fool's gold. Take the flashy but inadequate option and as the lights go on, you will be exposed. Engage with ESG meaningfully; set the bar high; be rigorous and accurately rate, report and benchmark. This will underpin and enable measurable ESG improvement over time. Achieve this, and the rewards will be significant, on and off the balance sheet.

APEX

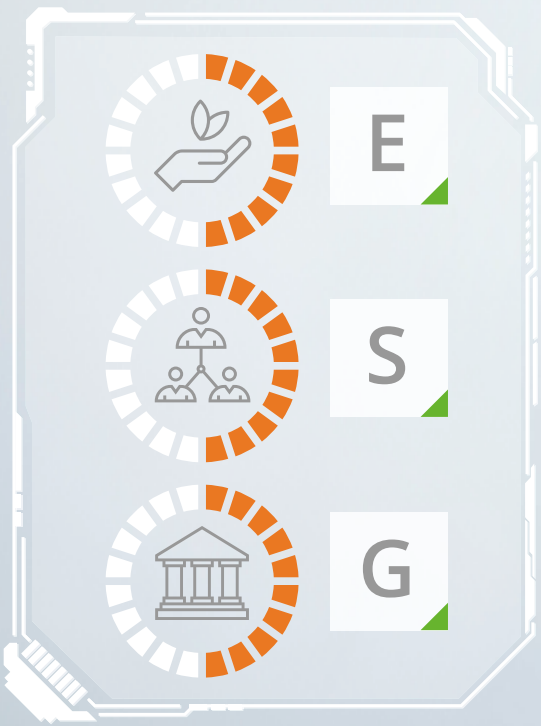
Drive transformation with greater vision

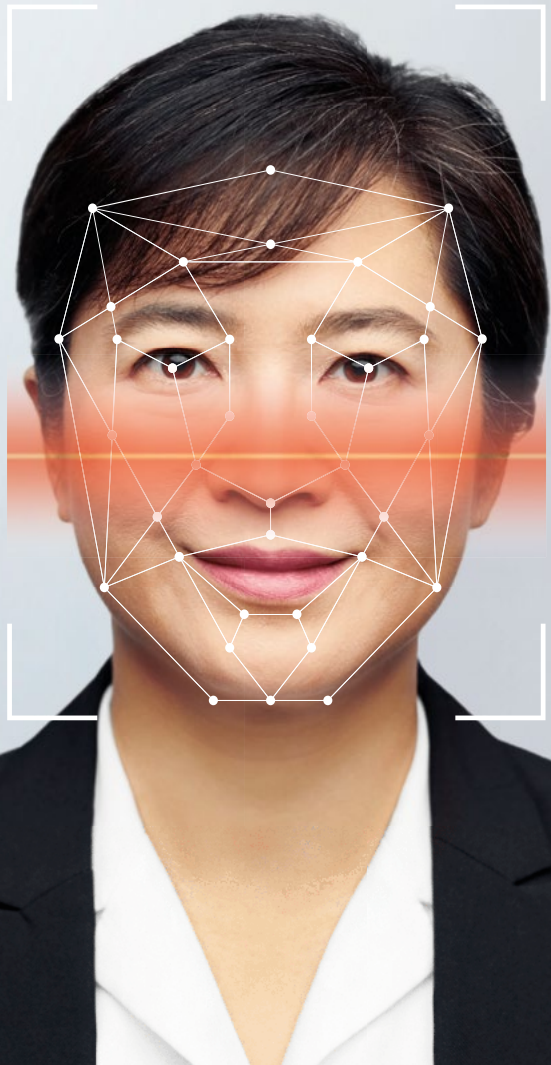
Progress on ESG is no longer a nice to have...
it's a critical requirement.

Purpose is the path to profit,
unlock your ESG insights with Apex Group

Contact us:

enquiries@apex.bm | www.theapexgroup.com





Stronger, smarter, faster: Investor relations moving forward

Andre Boreas
VP, Marketing
DiligenceVault
Email Andre Boreas

"We have a 22% annualised three-year return and 2.1 Sharpe Ratio. I don't understand why we can't win mandates from larger institutional investors."

This is not an uncommon statement from many hedge fund managers. As recently as a few years ago, a compelling risk/return profile was enough to capture an institutional mandate, but those days are long gone as the investor community have raised the bar significantly in terms of what the criteria is to make an allocation.

Asset growth in the industry over the past five years has been steady, but certainly not as explosive as it was from 2010-2015. You can thank the equity bull market and surging interest in private capital for that.

What's it going to take, then, to become the next name-brand hedge fund? And, more importantly, do you even want to? Because servicing $3 billion of institutional assets is quickly becoming very different from even just three years ago. Investor engagement,both in fundraising and servicing,will be as much of a driver of a firm's success as its risk/return profile. Investor relations will need to be a key advocate for that, and therefore a driver of change and adoption to a new world, as limited partners (LPs) become more sophisticated. Investor relations (IR) will need to adapt to a new operating model as many of the larger managers have already done.

It's worth noting that raising assets is, of course, only part of the story — keeping those investors and having them allocate additional capital is also a huge undertaking, particularly in having to address the reporting and information needs of investors. You can always hire more IR people, but that becomes quite expensive, and with the fee pressure managers are facing, hiring more people isn't going to help margins. Technology, though, can be an extremely useful tool for fund managers to scale their business, including the investor relations function. While most attention for new technology normally goes to the investment team and back office, there are evolving solutions to help IR meet the information needs of institutional investors.

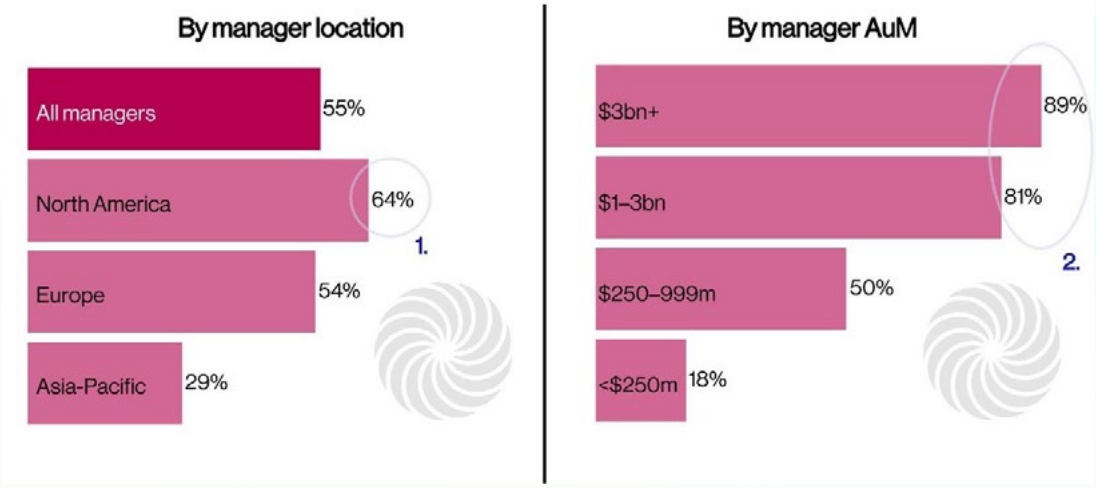
Fundraising

The phenomenon where the bulk of allocator capital going to the largest managers is not a new trend. This has been going on for years and almost becomes a self-fulfilling prophecy as the larger get larger, with the vast majority of managers fighting over what's left. The good news for the hedge fund industry is that early 2021 has seen a renewed interest from investors as managers have been able to take advantage of market dislocations from 2020 along with concerns from sky-high valuations in both the public and private equity markets. For many managers not in the multi-billion dollar club, though, the question becomes — do you even want to try to attract institutional assets?

Some managers might not want to, given the effort, time, and investment it takes to compete effectively in the institutional space. For those that do, the question is 1) what's it going to take to get there, and 2) how do you communicate to the market that you are 'institutional ready' once you've made the necessary investments in the firm? Third-party marketers and prime brokers can certainly help in capital raising (marketing material, introductions,) but after you've posted the top quartile risk-adjusted returns to get you a meeting, do you have the right people, processes and systems in place for an investment consultant, sovereign wealth fund or public pension plan to feel comfortable in making an allocation?

It should also be noted that larger managers that already have institutional capital and have passed an operational due diligence (DD) cannot rest on their heels. The bar for what constitutes best practices across a manager's operations is always being raised. Disruptions last year from the pandemic proved to be an important litmus test for the industry. Allocators took notice as operational DD processes went virtual. The challenge for smaller and mid-sized managers is the larger set of operational unknowns that are perceived by investors (rightly or wrongly) and the drag that had last year on raising capital.

Exhibit 3.2: Proportion of managers to have passed an online operational due diligence (ODD) process in 2020 *Source: HFM Insights*



Ultimately, the criteria for winning mandates is always changing. Managers would do well to think about how they want to be perceived in the market, how they build investor affinity, and their points of differentiation versus peers and competitors. Are you known for your risk management? Environmental, social and governance (ESG) capabilities? Diverse team? Are you transparent and communication friendly? Do you have a niche investment strategy that can act as a diversifier to an investor's existing alternative investment programme? How the IR team is positioned to effectively engage in the investment community with the right message, knowledge and tools behind them can make-or-break the capital raising path forward.

At the same time, hedge fund managers will need to look to offer new vehicles and products that will have the ability to address specific gaps in investor goals (ESG, liquidity, risk/return, diversification, yield, etc). As investors look for more specialised outcomes from certain mandates, managers will need to respond to request for proposals (RFPs) and DD questionnaires (DDQs)s that are outside of what they typically are prepared for. Two specific examples of this that have been gaining significant traction in the hedge fund industry include private capital and ESG-specific offerings. For managers that are diversifying their product offerings, private equity or private debt funds are a compelling way to diversify the asset base while capturing potentially higher fee revenue streams. ESG, for its part, can no longer be ignored as a criteria from institutions, particularly European investors. There is no getting around the fact that what initially took root in the long-only and private markets is finding its way to the hedge fund industry. LPs are expanding their definition of fiduciary beyond risk/return to societal/impact. Managers will need to respond.

In either case, investors are sure to change how they perform due diligence (both investment-wise and operationally) to take into account any specialised mandates that extend from a managers' core offering. Managers will need to be prepared to address the diligence requirements of investors should these (or other) types of strategies be offered.

Investor experience

The model for how IR teams of all sizes interact, communicate and service their investors is quickly moving beyond the monthly one-pager and quarterly phone call. One thing IR teams can rely on, is the fact that any increase in volatility or a downturn in the markets will inevitably lead to an increase in information requests from investors. COVID-19 is, of course, the most recent example of this. How hedge fund managers respond during periods of stress can be a watershed moment in their relationship with their investors. Proactive versus reactive investor communications is of paramount importance in maintaining goodwill with investors.

Performance will always be the driving factor for investors to redeem (outside of running afoul of regulators, of course). However, how the firm's

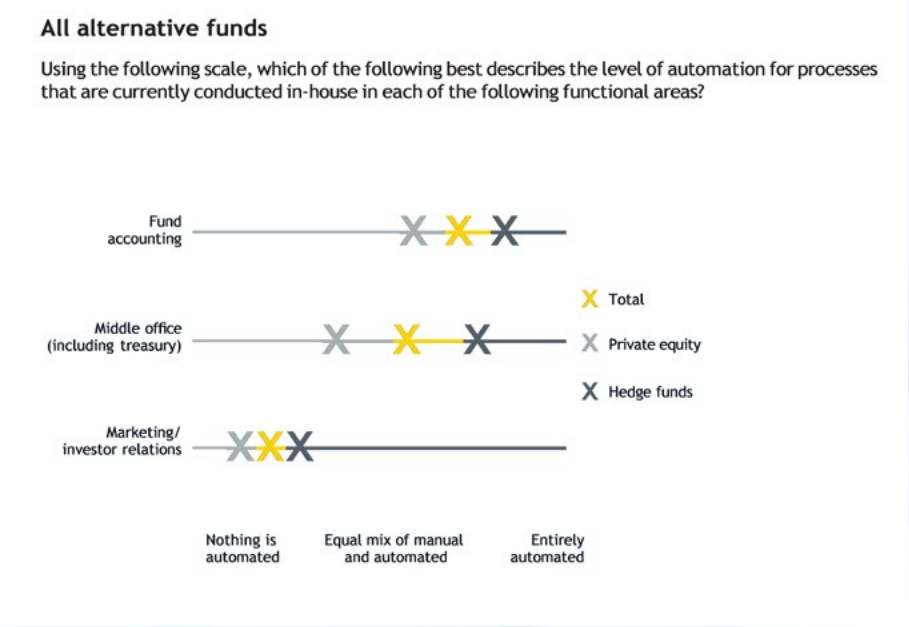
operations evolve over time will always be a continual point of evaluation to institutional investors. The evolution of ODD means fund managers, regardless of performance, will always be under scrutiny. How a manager responds to such scrutiny and how changes in the operational performance of the firm, both positive and negative, evolve can carry significant consequences in the manager-investor relationship.

The fund managers who win the communication game will have a leg up on competitors. The IR team's 'tech stack' will be a key contributor to said wins. In fact, technology can be a great equaliser when competing against larger firms when utilised correctly.

Technology

The data management, reporting and communication technology needs of the IR team are often an afterthought in relation to a manager's firm-wide tech stack. While the software and systems used can be broad (email, video conferencing, spreadsheets, presentations, databases, workflow tools, onboarding platforms, diligence platforms, shared drives or intranets), it is often the challenges around information management and collaboration that creates the biggest obstacles in communicating to both prospective and current investors. Developing a 'single source of truth' between your marketing materials, third-party databases, DDQs and RFPs and regulatory filings can go a long way to offering your prospects and investors a modern, timely and goodwill-friendly experience.

The hedge fund/investor communication dynamic is changing constantly. LPs are upping their own tech game, particularly around how they consume data and information from their managers, service providers and other data sources. The PDF as the primary tool to pass both quantitative and qualitative information from manager to investor is quickly becoming outdated. The next generation of brand-name hedge funds will emphasise a hyper-focus on delivering solutions, interactions and experiences to the institutional investor community, and will look to scale their firms by leveraging the right technology in doing so.



Source: EY

Operational resilience: Practical steps for building an operationally resilient firm

Jon Szehofner
Partner
GD Financial Markets
Email Jon Szehofner

Joshua Clarke
Junior Consultant
GD Financial Markets
Email Joshua Clarke

On 29 March 2021, the Bank of England (BoE), Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) — collectively the 'supervisory authorities' — published their policy and supervisory statements aimed at strengthening the UK financial system's ability to withstand impact from operational disruption.

The focus of this paper is not a detailed decomposition of the supervisory statements, other than to remark that there are few unexpected changes to the anticipated approach set out during the consultation process (although there will be some devil in the detail as the industry grapples with implementation).

The focus is instead to provide you; FCA regulated hedge fund managers, alternative credit managers and funds of funds, with a clear roadmap of the activities that you will now need to navigate in order to meet the FCA requirements. It is important to note firms need to take a proportionate approach in line with their size and type of services they offer to consumers.

Operational resilience requires firms to adopt a mindset of disruption being inevitable. The assumption is that business disruption and failures will occur, and as a result there is an ongoing need to assess the firm's ability to **respond, recover** and **take proactive action** to ensure that its important business services remain resilient.

Characteristics of an operationally resilient firm are one in which:

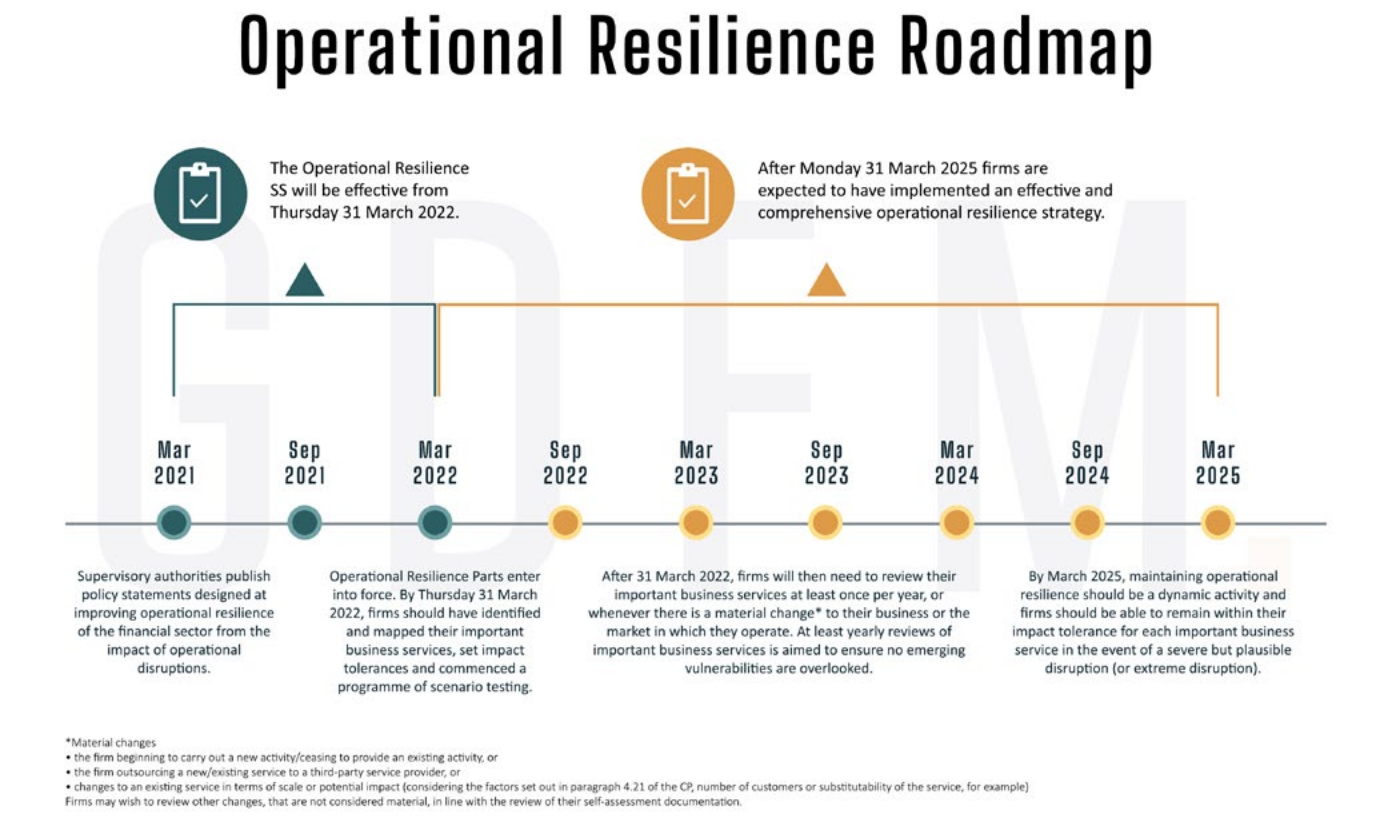
Prioritises the things that matter: by understanding the services it delivers to an external end user or participant and determining which are the most important.

Sets clear standards for operational resilience: by defining the maximum level of disruption to an important business service that can occur before intolerable harm manifests.

Invests to build resilience: by testing its ability to remain within its impact tolerances and identifying where vulnerabilities need to be addressed.

When identifying and prioritising those services – *business services* – which are most important, the FCA propose that firms should examine the impact of their disruption. Testing the firm's ability to remain resilient against an appropriate and proportionate set of plausible disruption scenarios should enable boards and senior management to make prioritisation and investment decisions.

Now that the long-anticipated regulatory policy and supervisory statements have been published, we explore the key activities UK regulated firms should be fully focused on.



1. Setup the change programme for success

Resilience is not a new topic. However, taking a business service-led approach to resilience will be new for many firms and necessitate a change in how they think about their business architecture and the outcomes they deliver to their consumers.

Firms need to develop an operational resilience strategy and framework which utilises existing capabilities and is approved by the board with SMF 24 accountability where applicable; aimed at removing organisational silos, promoting cross-functional responsibility and a culture of resilience practices within the fabric of the firm.

2. Identify and prioritise business services

Fundamental to the supervisory authorities' objectives for operational resilience is the approach and methodology taken to identify important business services that are specific and proportionate to the firms' own context and then monitored on an ongoing basis.

The supervisory authorities have deliberately steered away from providing a prescribed taxonomy, but instead offer four key considerations for when identifying and prioritising business services:

- Harm to customers and markets
- Harm to financial stability
- Harm to firm safety and soundness
- Service substitutability

By now firms should have started this process to identify and prioritise business services to a sufficiently granular level so that an impact tolerance can be applied and tested. The FCA's guidance for what constitutes an important business services includes:

Important business service means a service provided by a firm, or by another person on behalf of the firm, to one or more clients of the firm which, if disrupted, could: (1) cause intolerable levels of harm to any one or more of the firm's clients; or (2) pose a risk to the soundness, stability or resilience of the UK financial system or the orderly operation of the financial markets.

3. Build and maintain the dependency map for each important business service

To understand the possible threats to resilience, firms are required to capture the key resources and dependencies which contribute to the provision of each important business service. This should include facilities, people, processes, systems, data and third parties at an appropriate level of detail.

Mapping needs to be maintained close to real time and reflect any changes to how important business services are delivered. Mapping is designed to highlight vulnerabilities in how important business services are delivered such as single points of failure, concentration risk and limited substitutability of resources. Many firms have taken a 'customer value stream approach' to mapping which requires a detailed focus on the stage within the important business service which if disrupted would cause intolerable harm rather than simply an inconvenience. This approach enables the firm to focus resources on the activities which really matter from a resilience perspective.

4. Set impact tolerances and scenario test

Firms are required to assess how disruption may impact end users of the business service and propose corresponding impact tolerance i.e. the amount of disruption that can be tolerated before intolerable harm manifests. Firms are required to develop a methodology for setting impact tolerance statements for each important business service, using time/duration-based metrics, covering the objectives of the FCA (consumer harm and market integrity). Where firms are providing a service to another firm who holds the direct relationship with the end consumer, the impact tolerance of both relationships should be considered and should be supportive of their collective aim of serving the end consumer.

Scenario testing then assesses the firm's ability to manage service delivery within impact tolerances across a range of plausible disruption scenarios. In carrying out scenario testing, the firm must identify an appropriate and proportionate range of adverse circumstances, severity and duration relevant to its business and risk profile. The firms testing strategy should consider disruption scenarios occurring simultaneously (multi-incident) and also multiple business services being impacted concurrently.

5. Assign owners within the organisation who are responsible for the end-to-end resilience of each important business service

Firms will need to identify appropriate owners for each important business service who are responsible for the following:

- Hold an end-to-end understanding of and provide oversight over the processes, people, technology, data, third parties and facilities relevant to the business service
- Set appropriate impact tolerance statements for the business service and establish governance to periodically review and update this
- Test the service performance against the set of impact tolerances and establish a process to do so annually
- Identify all stakeholders required to support the business service and establish a RACI and supporting SLAs with internal and external service providers
- Establish a forum to discuss the effectiveness of the control environment as well as strategic and operational risks and issues which relate to the business service. The owner should be able to prioritise and fund remediation activities as and when required

- Define and implement appropriate management information across the end-to-end business service

- Develop and embed a plan to maintain the service during times of disruption by developing and leveraging response and recovery plans and embedding effective crisis communications both internally and externally

6. Define the operating model and invest appropriately to enhance and maintain resilience

The firm should develop and embed a set of capabilities to deliver operational resilience on an ongoing basis, leveraging, supplementing and enhancing existing resilience capabilities and risk management frameworks where appropriate. The operating model should enable the firm to prioritise the things that matter; prioritise those activities that, if disrupted, would be detrimental to customers or the firm's safety and soundness.

Firms should embed ongoing resilience procedures to monitor the resilience profile. This includes incident management procedures, communication plans and training. Investment should be made available to enhance the control framework where required.

7. Self-assessment

Lastly, a key feature of the operating model and a responsibility of the business service owner is the requirement to produce an annual self-assessment which should be made available to the regulators when required. The self-assessment should focus on:

- Ongoing evaluation of business services identification methodology

- Review of the approach to prioritising important business services

- Ongoing evaluation of impact tolerances

- Review of the firm's approach to mapping important business services

- Ongoing evaluation of testing scenarios

- Business as usual governance of operational resilience

- Implementation of resilience procedures and ongoing review of procedures (including RACI)

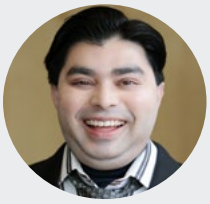
- Training delivered to impacted people and teams in line with newly embedded resilience procedures and any future changes

- Investment and remediation to close out vulnerabilities identified that threaten the firm's ability to deliver its important business services

Firms should apply the principle of proportionality to the assessment based on their scale and risk profile. The assessment should be reviewed and approved by the firm's board or equivalent management body regularly.

The regulatory policy set out a clear timeline which includes an initial implementation period to 31 March 2022, followed by a period of 'reasonable time' to demonstrate that firms can remain within their impact tolerances for important business services in severe but plausible scenarios.

Hedge fund managers should reevaluate their approach to side letter management amidst increased scrutiny



Vivek Pingili
Director
ACA Group
Email Vivek Pingili

Andrew Poole
Director
ACA Group
Email Andrew Poole

Introduction

The global hedge fund industry has seen a significant increase in both the volume and complexity of side letters over the past decade. Before the global financial crisis of the late 2000s, many hedge fund managers ran over-subscribed funds. At the same time, investors typically had a limited ability to negotiate investment terms (including via side letters).

However, even established hedge fund managers are finding that they are now the ones with limited control, over both the length and complexity of side letters as well as the frequency with which they need to negotiate them with investors.

Despite the evolving environment around side letters, many hedge fund managers have not updated their operational processes in response. As a result, some managers are finding an increasing number of instances of side letter non-compliance (albeit of an inadvertent nature), a situation that has been exacerbated by increased scrutiny from both investors and regulators. For example, some investors' operational due diligence processes are increasingly requiring evidence of side letter compliance, including periodic certifications, as well as prompt notification of any compliance failures.

Regulators are turning their attention to side letters as well. For example, the US Securities and Exchange Commission has increasingly focused on side letter compliance during their examinations of hedge fund managers, resulting in multiple regulatory sanctions of both a private and public nature. In instances where deficiencies have been found, managers have often been required to present an action plan to the regulator designed to enhance their operational compliance processes to reduce the risk of repeat failures.

Practice-oriented solutions and strategies

In the current regulatory and business environment, the need to update approaches to side letter compliance has never been higher. This article discusses some practical solutions and strategies, including the use of emerging technology, to help hedge fund managers effectively monitor and manage their side letter compliance obligations.

Creating side letters - thoughtful negotiations & planning

The first step in making the side letter management process more manageable is to reduce (or eliminate) variations in side letter terms on identical or similar topics as much as possible. A good starting point is to standardise

side letter language (for example, via a side letter template and/or electronic database that is periodically updated). Based upon previously negotiated topics of the type a manager typically expects its investors to request in the future, this will ensure increased consistency in terms from side letter to side letter as well as from fund to fund. This in turn reduces the operational burden on a manager of keeping track of subtle and/or significant variations in terms (an area where non-compliance is frequent).

While some investors may push for highly customised side letter terms (including their own versions of such terms), most investors are comfortable with the hedge fund manager's standard language on a particular provision when it is not uniquely relevant to such investors.

When receiving a side letter request (particularly of a type not agreed to in the past), it is critical to get buy-in from appropriate persons at the firm to ensure that satisfying the request is feasible (both conceptually as well as on the terms being requested). Some parties at a firm may negotiate side letter terms only to discover later that there are major obstacles to complying with the negotiated provisions. To address this challenge, fund managers are increasingly establishing side letter committees to ensure that their firms are making the correct collective decisions on when to give into investors' side letter requests and when to push back entirely or compromise.

Finally, there is significant room for streamlining the burdens around administering most-favoured nations (MFN) clauses at many hedge fund managers. Historically, these clauses were provided only to a small sub-set of investors receiving side letters – typically the largest and/or most strategic investors. However, in the face of decreasing negotiation leverage over the past few years, some managers have agreed to provide MFN provisions to almost any investor who asks for one, which has significantly increased the administrative burdens and non-compliance risks associated with managing MFN elections made by investors.

Managers should actively seek to limit the impact of MFN elections (both upfront and thereafter) on their operational teams by seeking effective ways to limit the scope of provisions an investor receiving an MFN provision may be entitled to. For example, size-based MFNs and limiting the universe of provisions that an investor can elect via an MFN can significantly help streamline MFN election processes. To eliminate the risk of investors with MFNs electing (and receiving) provisions outside the scope of their MFNs, managers should consider proactively providing investors with only the database of provisions they may elect from.

This could, of course, sit awkwardly with the requirements of the European Alternative Investment Fund Managers Directive (AIFMD) if engaging with European Economic Area (EEA) domiciled investors. AIFMD requires the manager to disclose not only its ability to offer alternative arrangements to investors, but also a description of those arrangements and the types of investors eligible to receive them.

Effective processes for monitoring, meeting, and testing side letter obligations

Once side letters have been negotiated, the next step is to determine how to best create effective processes to monitor, meet, and forensically test for compliance with both recurring and non-recurring side letter obligations.

Historically, fund managers have tried to get their arms around side letter provisions by having their external or internal legal counsel prepare charts or matrices summarising the provisions that impose operational obligations. These tools typically track noteworthy variations in similar side letter provisions from one investor to another. While the manual nature of utilising such tools may have worked in the past, managers are finding that these older approaches are less effective in ensuring compliance with side letter obligations as they have become increasingly voluminous. We have seen an increasing number of managers who rely on outdated tools fail to comply with side letter provisions and/or fail to demonstrate such compliance in a readily accessible manner. As such, managers should consider using more effective and modern tools such as technology-based solutions to better manage side letter obligations.

Given the varying nature of side letter terms, it is rarely the case that one person within a firm can effectively monitor and manage side letter obligations. As such, it is imperative that

managers assign responsibilities in this area to appropriate individuals in the firm. For example, financial and tax reporting-related obligations should be assigned to one or more members of a manager's finance team (perhaps in coordination with the manager's investor relations team). Similarly, obligations relating to investment-related matters, such as providing formal investment updates or offering co-investment rights, should be delegated to one or more investment team members. There is also a critical need to monitor in real time the tasks assigned to various responsible parties to ensure these are being completed in a timely manner.

Further, while recurring obligations, such as delivering periodic reports of a certain type, may be easier to monitor and manage, fund managers need to think harder about how to effectively handle non-recurring side letter obligations that are triggered in specific instances (e.g., preferential liquidity rights or co-investment rights relating to illiquid investments, including side-pocketed investments).

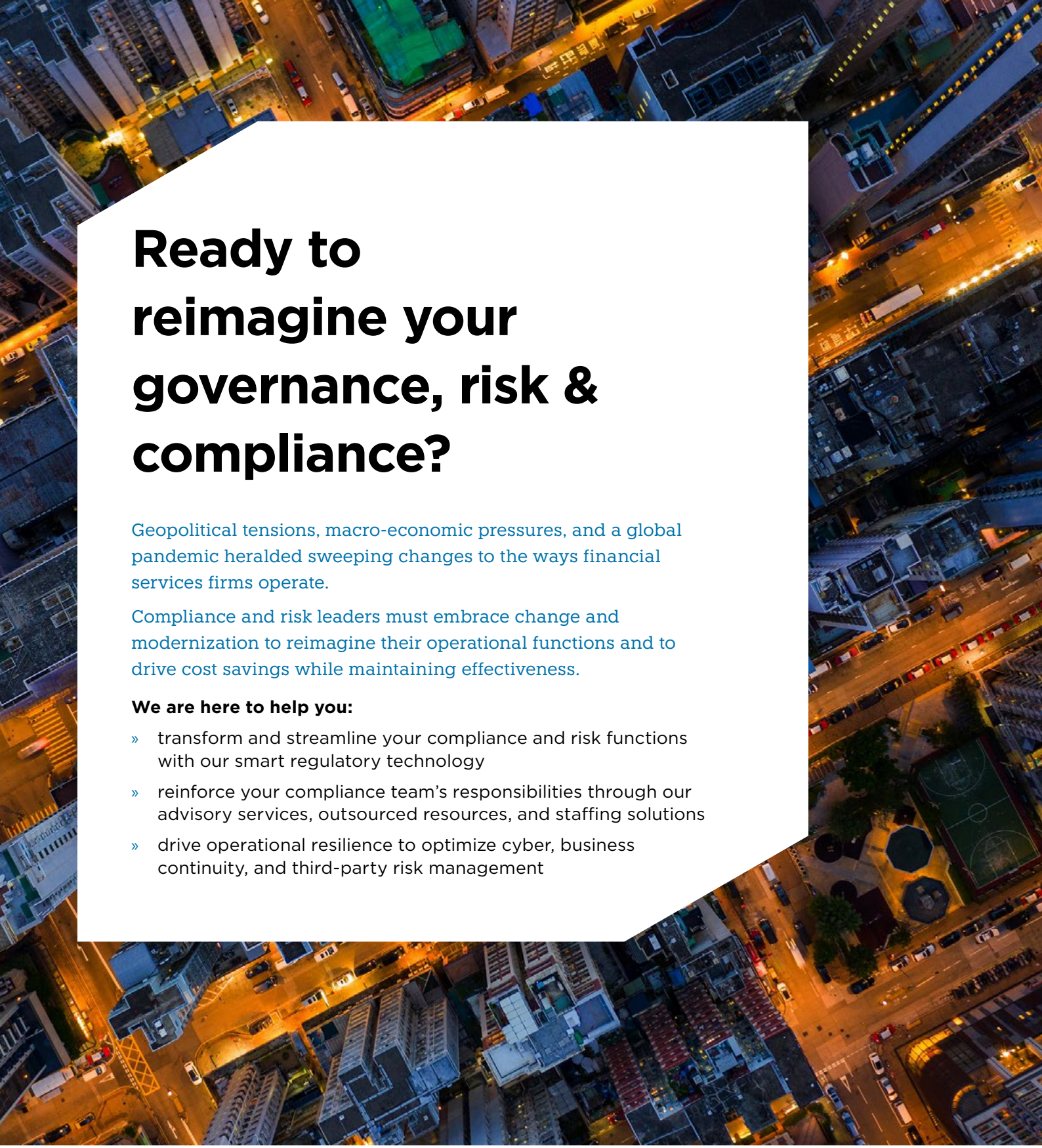
Finally, few managers currently undertake formal forensic testing of side letter obligations in any organised manner (if at all) and even fewer maintain written documentation related to testing efforts. With increased pressure from regulators and investors to enhance such testing processes, it is critical that firms re-think their approach and consider newer solutions, such as technology-based tools.

Effectively leveraging newly-eemerging technology solutions

The business case for adopting technology to address the challenges with side letter compliance and mitigate risk through automation and workflows has never been stronger. While software in the past may not have been tailored to the needs of hedge fund managers for side letter management, the latest side letter management technology solutions offer compellingly efficient tools to bridge the gap across the hedge fund industry in virtually all of the areas covered in this article.

An effective side letter management software tool should include, at a minimum, provide the functionality to: (i) track side letter obligations and assign responsible parties to monitor, manage, and document within the tool compliance with such provisions (thereby making forensic testing of such compliance far more efficient than would otherwise be the case); (ii) link periodically recurring provisions (e.g., quarterly reporting obligations owed to a specific investor) as well as provisions without a specific frequency (e.g., co-investment or liquidity rights) to calendared activities to create, monitor and back-test compliance with workflows; (iii) to automatically scan in fully signed documents and parse their provisions into thematic categories (e.g., MFNs, reporting rights, etc.) as well as pull out key information like counterparties, commitment size, and more (in an effort to better streamline MFN election processes; and (iv) search for all variations of a particular type of provision granted to multiple parties across all side letters in the database (which can be leveraged to reduce compliance risks and burdens associated with offering to investors unnecessarily varying or inconsistent terms around similar provisions).

When it comes to effective monitoring and management of side letter compliance obligations, it's ever more important that firms review their operational processes and consider embracing regulatory technology to help reduce the risk of errors and stay on the right side of the regulators.



Ready to reimagine your governance, risk & compliance?

Geopolitical tensions, macro-economic pressures, and a global pandemic heralded sweeping changes to the ways financial services firms operate.

Compliance and risk leaders must embrace change and modernization to reimagine their operational functions and to drive cost savings while maintaining effectiveness.

We are here to help you:

- transform and streamline your compliance and risk functions with our smart regulatory technology
- reinforce your compliance team's responsibilities through our advisory services, outsourced resources, and staffing solutions
- drive operational resilience to optimize cyber, business continuity, and third-party risk management

Speak to our dedicated GRC specialists to learn more about our wide range of solutions designed to help you protect and grow your business.

www.acaglobal.com

info@acaglobal.com

U.S. +1 212.951.1030 | UK +44 (0) 20 7042 0500

ACA™

Pledge fund: An *à la carte* investment programme

Jean-Christian Six
Partner - Funds & Asset Management
Allen & Overy, Luxembourg

Miao Wang
Counsel - Fund & Asset Management
Allen & Overy, Luxembourg

1. What is a pledge fund?

A pledge fund is a type of pooled fund that enables each of its investors to decide, at its discretion, whether or not to participate in each investment opportunity. The commercial and governance terms of the fund must therefore be adapted in light of this investment-by-investment election arrangement. This article intends to discuss key commercial and governance terms that a fund manager should have in mind when setting up a pledge fund.

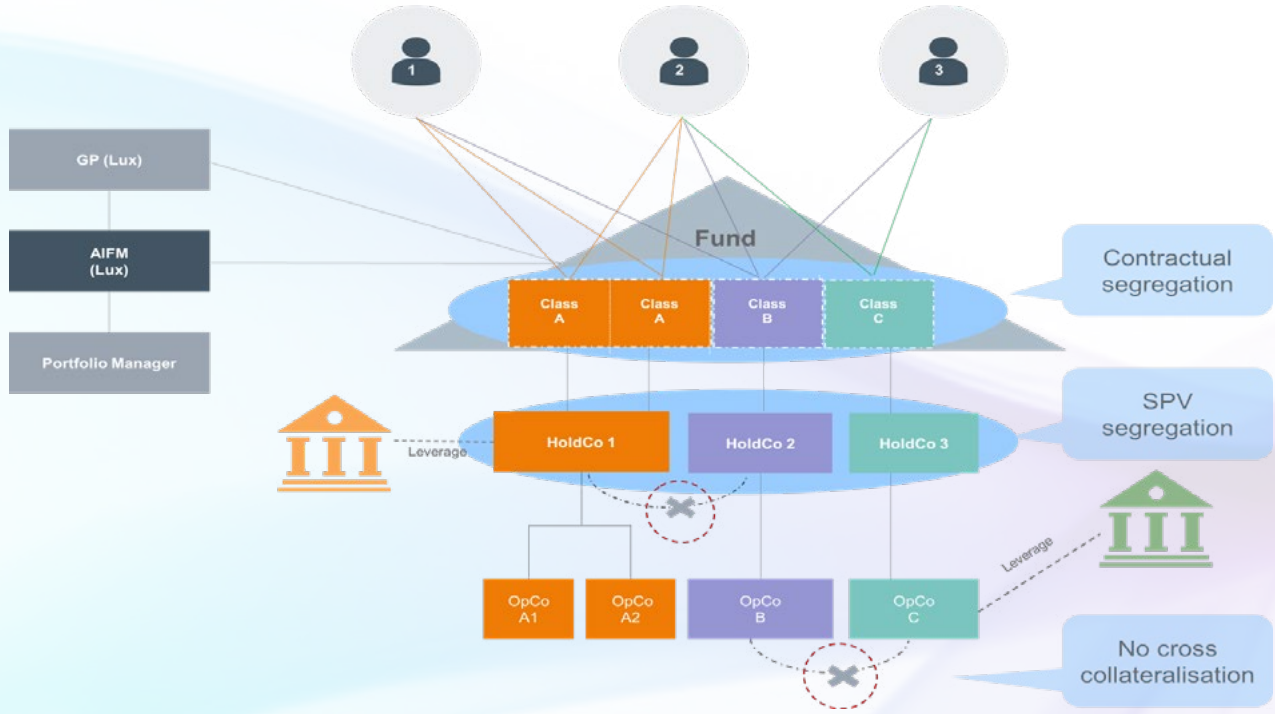
2. Segregation of liability

An important question when structuring a pledge fund is how to segregate liabilities among the fund's investments, so that an investor which does not participate in one particular investment has no financial exposure to it.

A pledge fund structure can be set up in the form of a limited partnership (e.g. a Luxembourg special limited partnership) where the participation of each investor is represented either by unitised partnership interests or by a partnership account.

In such a setup, there are three mechanisms that collectively ensure the segregation of liabilities.

Please see below a chart for reference:

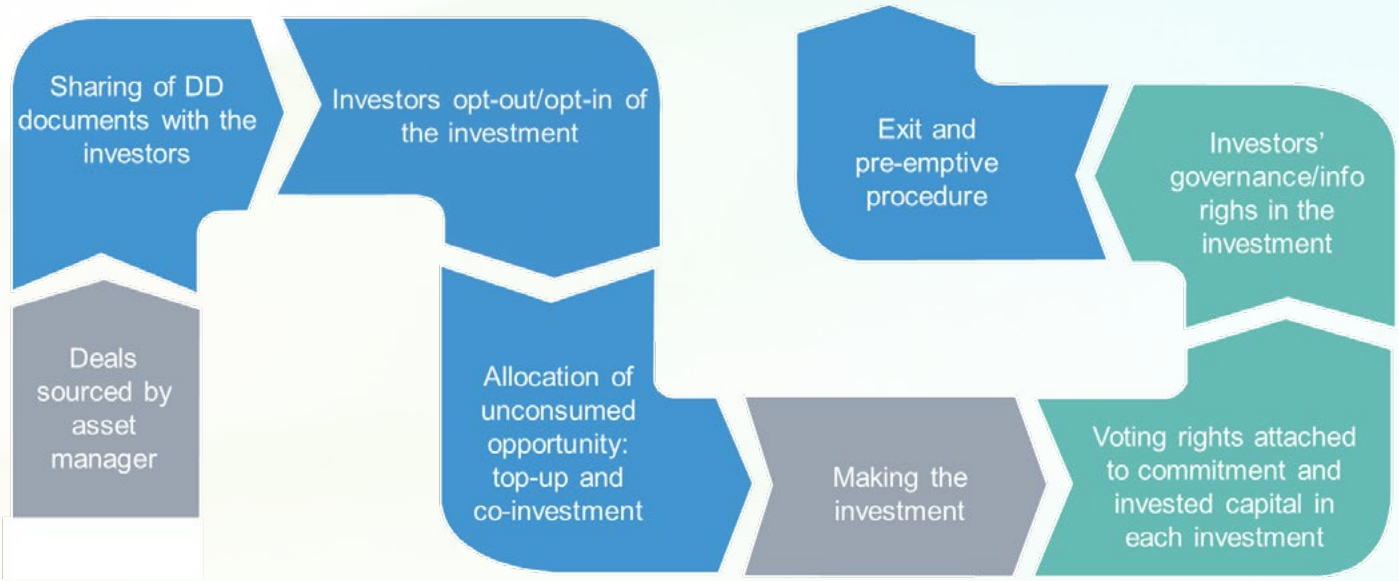


a At the fund level, the constitutive documents provide contractual segregation of assets and liabilities between various pools of assets. This can be achieved for instance by issuing different classes of tracking interests/ shares, each class providing exposure to one underlying special purpose vehicle (each an SPV). Investors holding one class of interests/shares have no financial exposure to the assets and liabilities allocated to other classes. Contrary to the statutory segregation of assets and liabilities of sub-funds in a Luxembourg umbrella vehicle, the segregation here is purely contractual under the fund's constitutive documents. When dealing with a third-party (e.g. a lender) in respect of a specific pool, the recourse of the relevant counterparty must be contractually limited. In practice, it may be preferable to incur leverage at a lower level in the structure (i.e. SPV level) to avoid any cross-contamination risk (such as cross-collateral among investments).

b At SPV level, a separate SPV (owned by the fund) is set up to hold each investment to reinforce the segregation. To reduce set up and operating costs and to facilitate investment management, several investments may be regrouped under the same SPV, as long as all investors participating in the relevant investments remain the same and invest in the same investment proportion and share the same leverage exposure.

3. Investment process and governance

As compared to a typical blind-pool fund, the investment and divestment process of a pledge fund must be adjusted to allow for the review of each investment opportunity by investors. The process is illustrated in the following graph:



a **Investment allocation**
The fund manager presents each investment opportunity to all investors, usually pro rata to their commitments in the pledge fund. Each investor individually will then decide whether it wishes to participate in such an opportunity. This can be achieved either by way of an opt-in or opt-out mechanism. In the former case, investors do not participate in an investment unless they positively confirm their participation within a certain period of time. In the latter case, investors participate in each investment unless they inform the fund manager that they do not want to participate within a certain period of time. If one or more investors decide not to participate in an investment opportunity, their pro rata portion of such investment can (depending on the terms of the fund documents) either be re-allocated among the participating investors on a proportionate basis as top-up investment and/or be offered to co-investors (i.e. existing investors or third parties) as co-investment, until such an investment opportunity is fully allocated.

b **Investment information and voting right**
In order to be in a position to exercise their opt-in or opt-out rights, investors in a pledge fund will usually have access to due diligence materials and other relevant information relating to potential investments.
In addition, investors may ask for specific consultation/consent right for certain investment governance matters. Unlike matters relating to the fund's operation as a whole where classic voting proportion (e.g. pro rata to investors' commitments) applies, with respect to investments-related matters, only participating investors would have voting rights (pro rata to their capital contribution in relation to the relevant investment).

The fund manager must therefore seek to strike the right balance between efficient management of the investments on one hand, and investors' information sharing and governance on the other hand.

c **Exit: right of first refusal**
During the exit phase, the fund manager may provide a right of first refusal enabling investors participating in an investment to purchase the relevant asset from the fund. The right of first refusal can be exercised via a bidding process and/or on a base price determined pursuant to an agreed valuation method.

4. Adapted economic terms

To match the 'cherry-picking' arrangement in a pledge fund, certain economic terms of the fund must be adjusted compared to a typical blind-pool fund.

a **Equalisation**
In a traditional PE-style closed-ended fund, subsequent investors must pay contributions to the fund to equalise all investments made before their admission as if they had been admitted to the fund at the first closing. In a pledge fund, subsequent investors do not necessarily equalise all existing investments. Instead, the equalisation on an existing investment may be subject to the consent of both subsequent investors (who must elect to participate in such investments) and existing investors participating in such investment (who must agree with the dilution of their participation in such investments). This may involve discussions on the valuation of existing investments.

b **Distribution and return of distributions**
Unlike the 'fund as a whole' or 'investment-by-investment' waterfall commonly used in traditional PE-style funds, pledge funds usually provide for an "investor-by-investor" waterfall, which is based on each investor's capital contributions and returns:

i. Investment proceeds and income generated from one investment will first be apportioned among the participating investors based on their capital contribution proportion in such investment.

ii. The amount apportioned to each such investor then runs through its own waterfall:

- First, distributions are made to such investor in repayment of its aggregate capital contribution to the fund (i.e. on a fund as a whole basis) or in repayment of such investor's capital contribution in relation to its relevant realised investment (i.e. on a deal-by-deal basis);
- Thereafter, the preferred return, catch-up and carry interest with respect to such investor are calculated accordingly.

Limited partners giveback and general partner clawback obligations are calculated on an investor-by-investor basis by taking into account of all investments made by such investor throughout the life of the pledge fund.

5. Flexible use of pledge fund

Pledge funds offer multiple advantages. From the investors' standpoint, they provide more control over the deployment of their capital and allow them to build a closer relationship with their fund manager and fellow investors. This may be of interest for instance to investors that wish to gain experience with investing in a certain asset class. From the fund managers' perspective, pledge funds may potentially facilitate their fundraising in certain circumstances (e.g. for a first time fund manager or for targeting a new investor base). If, however, some investors prefer adopting a more passive approach to their investment, this can be addressed by setting up a 'traditional' fund, in which investors do not have the right to review and elect in investment opportunities, to invest alongside the pledge fund.

The technology that has been developed for the structuring of pledge funds can also be used as a simple and cost efficient solution to implement co-investment vehicles, enabling fund managers to offer opportunities to all co-investors in one and the same platform, instead of setting up a separate co-investment vehicle for each co-investor or investment.

Connecting the dots to achieve 'operational resilience'

Priya Mehta
Partner
Buzzacott
Email Priya Mehta

'Operational resilience' has become the new buzzword recently, especially in context to the new ways of running a business following the pandemic. After the recent upheaval in 'normal' working practices, the UK's Financial Conduct Authority (FCA) have issued numerous surveys, guidance documents and specific consultations to reinforce its position and expectations.

One clear expectation for regulated businesses is the ability to demonstrate 'operational resilience' by ensuring that there is a robust **'operational risk management (ORM) framework'** in place.

In this article we explore the **'Goldilocks Rule'** relating to operational resilience, taking into account the challenges that the investment management industry typically faces. We also look into how incorporating resilience in the day-to-day operations can become beneficial rather than being an additional burden.

What does this mean in practice?

To understand the scope of operational resilience, let's first look at the definition of an ORM framework.

An ORM framework is a comprehensive, proactive process that is used to identify, assess, manage, monitor and report on the significant strategic, business and process-level risks related to the achievement of the investment manager's objectives, which are inherent in the business strategy and operations. This obliges investment managers to implement robust processes which help them not only to identify risks but also enable control and mitigation. The objective of the framework should be to create and protect value, leading to improvement in performance and innovation.

The ORM framework should function as the centrepiece of the firm's business and all other policies and procedures should feed into the framework. This should be linked to the governance and culture of the organisation such that all staff and management take responsibility for the day-to-day adherence to the ORM framework.

Dissecting this into two key elements – 'identification of risks' and 'governance'

Identification of risks

First and foremost is a check on whether all applicable risks have been correctly identified, qualified and quantified. The most significant ones which typically every business faces irrespective of size and structure are:

- Counterparty risk
- Business conduct risk
- Reputational risk
- Technology, IT and cyber security risk
- Internal and external fraud risk
- Legal, regulatory and compliance risk
- Financial risk

Each of the above could be broken down into greater detail to include many more risk areas. Once the relevant risks have been identified, it is critical to take a step back and analyse what these risks mean to your business; this is the most important aspect and perhaps the most challenging job. Also, linking this analysis to business continuity and disaster recovery plan is key.

Governance
Perhaps a recurring theme, 'governance' is something that everyone understands yet it is rarely documented properly. Governance is a top-down, principles-based articulation that unites the understanding of risk management with the strategy to deal with those risks. Good governance should focus on and enable proactive risk management processes rather than reactive ones. An effective governing body which could be a combination of various senior management personnel with appropriate decision-making powers should have primary responsibility for risk oversight in the light of an established risk appetite. Key outcomes and the desired culture should then be cascaded downwards from the governing body.

'Skin in the game' is the term used by the FCA to set out their expectations from the senior management of the business who are required to ensure that the firm can function in an orderly way and that their incentives align with the best interests of their clients or the wider financial markets. It is about demonstrating that the senior management have their own interests aligned with the business which makes them personally accountable and responsible.

Documentation, documentation and documentation

Shifting the discussion from the somewhat dictatorial and onerous obligations to some reasonable actions, let us ascertain how to get the right balance between what is expected vis-à-vis what is practical. The purpose of reinforcing 'documentation' in this context is to demonstrate a clear route to an effective 'operational risk framework' which evidences the strength of a firms' processes and procedures, as well as identifying any potential weaknesses. That may mean a checklist approach for some or periodic health checks for others to ensure all the nuts and bolts are tightened regularly and a detailed report is fed back to the senior management or governing body. Most importantly, having a structure that works for the size of your business is vital.

It is not possible to talk about documentation without mentioning the requirements of the **'Internal Capital Adequacy and Risk Assessment' (ICARA) process** being introduced by the 'Investment Firm Prudential Regime' coming into effect on 1 January 2022.

Deviating slightly from the ORM framework, it is worth noting the following key objectives of ICARA process and document:

- Identification, monitoring and mitigation of harms to the business
- Business model planning and forecasting; recovery and wind-down planning
- Assessing the adequacy of financial resources (own funds and liquidity)

Under the IFPR, all investment firms are required to carry out the ICARA process initially and to conduct a review at least every 12 months.

A typical ICARA document for an investment manager would be expected to include the following:

- An explanation of the activities that the firm carries out, with a focus on the most material activities
- An explanation of why the ICARA is fit for purpose. Or, where this isn't the case, an explanation of the deficiencies identified, the steps taken to remedy them, and who is responsible for implementing any remedies
- An analysis of the effectiveness of the firm's risk management processes during the period covered by the review
- A summary of the material harms the firm has identified and any steps taken to mitigate them
- An overview of the business model and an assessment of capital and liquidity planning

- An explanation of how the firm is complying with the 'Overall Financial Adequacy Rule'. This should include a clear break-down at the review date of available own funds, available liquid assets, and the applicable threshold requirements
- A summary of stress testing and reverse stress testing it has carried out
- An overview of wind-down planning, including any key assumptions or qualifications

Thus, an ICARA document would be expected to capture a complete examination of the qualitative and quantitative approach to risk assessment.
Circling back to 'operational resilience'
The FCA recently issued its policy statement on 'Building operational resilience' setting out rules and guidance on the new requirements, aimed at strengthening operational resilience by defining the maximum tolerable disruption and identifying any vulnerabilities.

Although the first set of action points to be implemented by 31 March 2022 are addressed to banks, building societies, Prudential Regulated Authority (PRA)-designated investment firms, insurers, Recognised Investment Exchanges, enhanced scope SMCR firms, and entities authorised and registered under the Payment Services Regulations 2017 and Electronic Money Regulations 2011; the FCA will look at extending the scope to all investment firms and will be consulting on this separately in the near future. The policy statement will bring into force a granular level of mapping the important business areas to associated risks with the intention of carving out 'impact tolerances'. This in turn will aid firms to conduct more focussed and practical scenario testing.

Conclusion

Although it is vital that all regulated businesses become mindful of all the legislative and regulatory requirements that seemingly overlap with each other, it is also crucial to combine various regulatory expectations to bolster effective controls and build efficiencies. Whilst the 'letter of the law' must be followed, firms should take a holistic view on these requirements which aim for the same goals.

References:

1. **FCA's FG 20/1 – Our framework: assessing adequate financial resources**
2. **FCA's PS 21/3 – Building operational resilience**
3. **FCA's CP 21/7 – A new UK prudential regime for MiFID investment firms**
4. **AIMA's guide to sound practices for operational risk management**

Buzzacott

The smart alternative.

Are you ready for **IFPR**? Don't worry. **We are**.

The new IFPR regulations will be introduced in January 2022.

Act now to ensure you aren't caught out.

Contact us for the latest on the proposals, how they could impact you and what needs to be put in place before it's too late.

Priya Mehta
Partner
T 020 7556 1372
E mehtap@buzzacott.co.uk
buzzacott.co.uk

The virtues of private debt in a rising rate environment

Gordon Henderson
Managing Director
Espresso Capital

While interest rates have stayed at historically low levels for more than a decade, over the past few months they've experienced some upward pressure. And while that means that bonds have fallen since their price is inversely related to yields, it's worth pointing out that private debt hasn't lost value in the same way. That's because credit risk plays a larger role in determining the value of private debt than it does in many traditional bonds. Plus, private debt is extended for shorter terms.

This means that many private debt instruments have comparatively low durations — a measure of how sensitive their prices are to changes in interest rates. By looking at bonds and private debt in terms of duration, we can see exactly why private debt might suffer less in a rising interest rate environment.

What determines a bond's interest rate?

The interest rate borrowers pay on bonds is made up of two parts: the risk-free rate and credit risk. Let's look at each in turn.

If lenders can be certain of repayment, their only concern will be the purchasing power of the money that they get back in the future. And, they will price their loans at a level that at least preserves that purchasing power. The risk-free rate is fundamentally a reflection of inflation expectations.

In many countries, including the US and Canada, yields on government bonds are used as a proxy for the risk-free rate. The likelihood of the US government defaulting on its obligations, for example, is so small that it can normally be completely discounted. In practice, there are other factors that influence government bond prices, but the predominant driver is inflation expectations.

Some borrowers also have to consider credit risk — the possibility that a loan won't be repaid on the agreed terms. To allow for this possibility, risky borrowers have to pay higher interest rates than safe ones. This concept can also be extended to account for timing. While an overnight loan is probably quite safe, a lot can go wrong over longer periods of time. Longer loans are therefore riskier than shorter ones, and all else being equal, will have higher interest rates.

Why do bond prices and interest rates move in opposite directions?

Although some bonds are sold with 0% coupons, most feature regular interest payments or coupons. By convention, many bonds are priced with a face-value — the amount that will ultimately be repaid — of US$1,000. A bond with a 5% coupon will therefore pay US$50 per year in interest.

If interest rates rise by half a percentage point, investors can get US$55 for every US$1,000 they invest in a new but otherwise identical instrument. However, for investors to earn the same percentage return on the first bond as they can on an equivalent note issued at the higher rate, the price of the first bond has to drop to US$909.

At that level, the US$50 that it pays out per year represents a 5.5% yield to investors, the same as they could earn on the new bond. Of course, the same math also applies in reverse. If interest rates fall, the prices of existing bonds will rise to balance out the yields between equivalent instruments.

What is duration?

Mathematically, duration is the weighted average of the present value of a bond's remaining cash flows (i.e., the interest payments that will be made in the future and the repayment of principal). Intuitively, bonds in which the bulk of the value is returned far in the future — those with low coupons or long maturities — will be more sensitive to changes in the discount rate than those which return more value to the holder in the short term (either because there are high coupon payments or because the bond will mature soon).

Time and coupon rates are therefore the two key inputs for duration calculations. Duration is positively correlated with maturity. The longer until a bond is scheduled to be repaid, the higher its duration will be. And all else being equal, duration is inversely related to yield. Low coupons drive high durations and vice versa.

Why is duration important?

Investors use duration to calculate the sensitivity of bond prices to a given change in interest rates. This allows them to compare bonds with different coupons and different maturities, and to understand how a bond portfolio will perform under different interest rate scenarios.
A bond (or portfolio) with low duration will be relatively insensitive to interest rate changes. Conversely, high duration bonds will respond more dramatically to a change in the interest rate.

Of course, duration isn't intrinsically good or bad. Investors' inflation and interest rate expectations will determine whether they want higher or lower duration. Although there are nuances, in general, investors will look for high duration bonds if they believe that interest rates will fall, and lower duration bonds if they think interest rates are likely to rise.

How does duration affect private debt?

Duration is principally influenced by a bond's interest rate and maturity. Private debt includes a multitude of instruments, but many of them carry high interest rates. This is often because private debt users present some challenge to traditional lenders' credit criteria, and as a result, require flexibility from their lender that they pay for through higher interest.

In fact, the yields on private debt are often orders of magnitude higher than those on other instruments and income categories. This reduces their duration significantly.

Ignoring the details of the math, one can intuitively grasp this logic by thinking again about how the risk-free rate and credit risk add up to a bond's interest rate. Simply put, the risk free rate — the component of price that reflects inflation expectations — is a much larger percentage of the interest in most bonds than it is in private debt. A change of 0.1% is much more impactful to a bond with a 2% yield than it is on a loan paying 20%.

Second, duration is affected by maturity, which is also very relevant in the context of private debt. Many private debt facilities are extended on a short-term basis, which lowers their theoretical duration. But they are often repaid early because the cost of carrying that debt is high, meaning that businesses typically look to refinance them as soon as possible. This means that actual maturity (and duration) is even lower than the theoretical cases, making private debt less sensitive still.

While stated maturity is usually quite short, in practice it tends to be even shorter, which again lessens duration and lowers the sensitivity of private debt to interest rate changes.

Private debt will outperform in a rising rate environment

Bond prices move in the opposite direction to yields, and their sensitivity to changes in the yield environment is governed by the size of their coupon payments and the time until they mature. The lower the yield on a bond and the longer the time until maturity, the more sensitive a bond will be to interest rate moves.

The same math applies to private debt, but the realities of that market make changes in the level of interest rates much less relevant to the value of a particular loan. Specifically, the high interest rates charged on many forms of private debt, and the comparatively short periods for which loans are outstanding, lessen those instruments' sensitivity to changes in interest rates.

President Biden has set out the most expansionary fiscal policy roadmap in many years, and the Federal Reserve has signaled that it is willing to accommodate overshoots in inflation in the short term. Many other governments around the world have borrowed significantly to blunt the economic impact of COVID-19, and historically high government borrowing has often led to increased interest rates.

Many forecasters have predicted higher rates at different times over the past decade, and these calls have been wrong. However, the market is now starting to seriously consider the possibility of inflation, and with it, the potential for interest rates to rise. If they do, private debt, with its combination of higher starting yields and shorter maturities, will likely fare better than many traditional fixed income instruments.

When you invest with Espresso, you invest with confidence.

Espresso Capital provides secured, low leverage loans to fast-growing technology companies (venture debt), many of which supply mission-critical or core business solutions to their customers.

Our investment goals of capital preservation, monthly income distributions, and superior risk-adjusted returns have been proven over an 11-year operating history.

We'd welcome the opportunity to tell you why venture debt is an excellent form of alternative fixed income, particularly in a rising interest rate environment, while giving investors greater diversification in their portfolios.

espresso

Toronto | Chicago | San Francisco | Los Angeles | Montreal | **www.espressocapital.com**

The Australian middle market direct lending opportunity

Mick Wright-Smith
Founding Partner
Epsilon Direct Lending

Joe Millward
Founding Partner
Epsilon Direct Lending

Paul Nagy
Founding Partner
Epsilon Direct Lending

Investors have been able to access private credit markets for some time. However, middle market direct lending – a specific subset of private credit – has largely been the sole domain of traditional bank lenders, with investors having limited access to this market segment.

It has only really started to emerge in Australia in recent years as bank lenders have reduced lending activities to middle market companies, due to regulatory, capital and cost pressures. New alternative lenders have been established to address borrower demand and provide investors access to the opportunity.

This evolution in the Australian corporate loan market, particularly with middle market companies seeking growth and event-driven financing to undertake acquisitions, leveraged buyouts and fund other capital investments, provides for a deeply underserved market, offering compelling lending opportunities.

What is middle market direct lending?

Direct lenders provide loans to performing middle market companies (companies with annual revenue of AU$25-500 million) that are originated, structured and managed directly with the borrower. The loans are typically senior, floating rate loans (meaning the interest rate moves pursuant to a benchmark) that are evaluated and secured based on the ongoing, forecast cash flow and enterprise value of the borrower. Loans are typically provided by one lender (bilateral), or a small 'club' of lenders, and are held to maturity (three to five year terms).

The strategy excludes real estate loans. Australian-based direct lenders targetting established, profitable companies with a predominantly senior loan focus where the loan purpose is to support growth, will typically target mid-to-high single-digit net returns to investors across cycles.

What is driving investor interest in middle market direct lending?

Attractive, defensive, and regular cash income

Middle market direct lending can provide investors with predicable, recurring income from upfront borrower fees (or establishment fees) and cash interest payments (typically paid quarterly) which are enshrined by contractual undertakings between the borrower and lender for the entirety of the term of the loan. The strategy is seen as a defensive asset class as investors can benefit from rising interest rate markets given that loans are typically based on floating rate terms, and have some protection in declining interest rate markets as most direct lenders will have a floor on base rates.

Quality substitute or complement for traditional fixed income investments

Middle market direct lending can be a source of additional yield without assuming significantly more risk. In an environment that is dominated by very low (and in some instances, even negative) interest rates and inflated asset prices with generally compressed risk premiums, middle market direct lending can provide investors with access to a regular source of AUD cash income typically paid on a quarterly basis that can compensate for some additional liquidity and credit risk when compared to investment grade fixed income.

Diversification into investment opportunities typically unavailable to most investors

Private credit can be an attractive asset class for investors seeking targetted exposure to various strategies, sectors or investment opportunities, each delivering differentiated risk-adjusted returns. Investors have the scope to build out private credit portfolios in the same way they would in other asset classes such as equities, whereby, depending on an investor's risk profile, a portfolio can be structured to provide higher or lower expected returns based on a higher or lower risk profile of the underlying strategy being allocated to.

Middle market direct lending is an unsaturated private credit strategy that has only recently emerged in the evolving Australian corporate loan market. The strategy aims to deliver investors the opportunity to further diversify their portfolios into investment opportunities that they typically cannot access themselves.

Low correlation to other private credit, public market and fixed income investments

Given that middle market loans are individually structured and documented with idiosyncratic terms and conditions, investment returns, and risks are highly transaction-specific rather than market related, and this therefore provides a different risk profile to other private credit investments, public market investments and traditional fixed income investments.

Unlike real estate and special situations strategies, direct lenders typically focus on non-cyclical industries, lessening the impact on investors overall private credit allocations during a downturn.

The addition of a middle market direct lending strategy to a portfolio can be complementary, and not necessarily seen as a replacement for existing private credit allocations.

Low volatility of returns

The key risk faced by investors allocating to a direct lending strategy is credit risk. Credit risk is typically expressed using two key data points – probability of default and loss given default. S&P has tracked both statistics for this strategy in offshore markets over a broad time horizon, allowing observers to make a reasonable assessment of the potential cost of credit risk when allocating to this strategy (unlike small and medium-sized enterprise (SME), special situations or real estate lending). Over the past 30 years, the expected loss for an average middle market senior secured loan is around 0.5% p.a. based on an average default rate of around 2% p.a. and a 77% recovery rate for middle market senior secured leveraged loans.

In the current low interest rate environment, defaults are not typically triggered by a borrower's inability to pay interest as it falls due. It is commonplace for other structural loan protections to trigger a default well ahead of any failure to pay interest. Furthermore, the Australian regulatory and legal framework provides a high level of lender protection, which when coupled with heavily negotiated loan documentation, provides a broad range of remedies for lenders to manage non-performing loans. The combination of low rates and very low expected credit losses further illustrates the defensiveness of the strategy.

How do investors access these lending opportunities?

Historically, accessing Australian corporate loan investments was difficult to achieve and limited in strategy selection. This has predominantly been due to Australian banks' dominance in providing approximately 90% of all loans to these borrowers. However, as has also occurred offshore post-Global Financial Crisis, market share is shifting to non-banks on a permanent

basis, and this has created the opportunity for investors to step in and profit from supplying capital to underserved market segments such as middle market direct lending.

For institutional investors, the mainstay of the domestic corporate loan market has been largely limited to i) real estate lending and ii) participating in the broadly syndicated loan markets where lending opportunities are arranged, structured and sold-down by commercial and investment banks. Some larger institutional investors have direct access to these markets in their own right, while others invest with professional managers to build a diversified portfolio. Elsewhere, some investors have indirect exposure to corporate private credit via allocating to professional managers that provide multi-credit strategies (mix of corporate, real estate, infrastructure, asset-backed securities (ABS), etc).

What has largely eluded investors to date, is access to direct or bilateral corporate lending opportunities that provides investors with the potential for high returns and greater influence over loan structure, terms and conditions. This is no longer the case, with newly-established specialist managers offering investors access to the strategy.

The material in this article is general information only and does not consider any individual's investment objectives.

EPSILON
DIRECT
LENDING

Our specialism means we truly understand our market and focus on it with all of the attention it requires and deserves.

WE ARE SPECIALISTS
Our focus is solely on lending to support the growth of middle market companies.

WE ARE DIRECT LENDERS
We directly originate, structure and manage private market loans.

Epsilon Direct Lending is an Australian based private credit asset management firm, providing bespoke financing to performing, Australian and New Zealand middle market companies that are looking to expand and grow.

Visit epsilondl.com.au for more information about the Australian middle market direct lending opportunity.

Distressed investing in India: Coming of age

Hemant Daga
Chief Executive Officer
Edelweiss Asset Management

Investment in stressed/distressed assets in India have come of age over the past five years. The Insolvency and Bankruptcy code (IBC), introduced in 2016, has matured as a regulatory framework for resolving creditor situations. Banks and financial institutions are looking to sell non-performing assets at attractive discounts to investors to release capital. At the same time, stressed companies are looking to raise capital from funds like ours for last mile funding for projects or for a settlement with banks. The need of the hour is long-term patient capital to restructure or resolve these assets. We believe that investors and asset managers with a deep understanding of local regulations and expertise in asset turnaround will stand to immensely gain from this opportunity.

Distressed debt in India — an addressable market opportunity of US$25bn – US$30bn

Until 2012, India was posting robust growth and corporates were setting up new capacity. Banks also grew their loan books at a fast pace. However, in the years after that, a combination of delays in project approvals, cost overruns, unrelated diversifications by corporates and a decline in commodity prices led to a sharp rise in the quantum of stressed loans in the banking system. The COVID-19 pandemic has only exacerbated this stress. The banking sector non-performing assets (NPAs) in India are currently estimated at over 10% of assets i.e. ~US$135 billion.

Non-bank finance companies (NBFCs) in India — especially those focused on wholesale credit — have also been impacted by rising corporate stress –mostly in sectors like real estate. NPAs for non-banks in India are currently estimated at ~7% of assets i.e. ~US$25 billion. Thus, overall stressed assets in the Indian financial system are estimated to be upwards of $160 billion, providing a large market opportunity for investors.

A further dissection of this investment opportunity based on the turnaround potential of underlying companies provides us with an addressable investment opportunity of US$25 billion – US$30 billion. While most of this stress amongst lenders is with respect to corporate debt, the pandemic has resulted in an increase rise in retail NPAs in

India. Retail NPAs in India are expected to double to over 4% in 2021 from 2% in 2018. This can provide additional opportunities for distressed debt investors.

Regulatory framework for stressed assets resolution is favourable

The introduction of IBC has been the most holistic and impactful insolvency resolution mechanism in India to date. The IBC provided a time-bound framework for resolution of creditor situations in India. The recovery rate after the implementation of the IBC has improved significantly to ~42.5% from ~26.5% achieved through earlier creditor recovery mechanisms. The resolution time for the cases has also improved post the implementation from four to six years earlier to one to two years. More importantly, with the ownership of large companies changing hands through the IBC process, it has led to a change in the credit culture in India, as Indian promoters (sponsors) are now concerned of losing control of their companies.

The government, the central bank and the judiciary in India have also been very proactive in ironing out issues with respect to the insolvency code and making it more effective. This was best brought out through the barring of Indian sponsors from acquiring their own companies during the resolution process. Also, a landmark judgement by the Supreme Court on the Essar Steel resolution upheld the primacy of secured financial creditors.

To further improve the effectiveness of the resolution process, India has proposed a **Pre-packaged Insolvency Resolution Process (PIRP)** for micro, small and medium enterprises (MSMEs). This process aims to retain the basic structure of the IBC and allow creditors and debtors to work on an informal plan without the involvement of a court or a tribunal. The ultimate aim of the PIRP is to be the primary resolution process going forward thus improving its efficiency.

In an endeavour to clean the balance sheets and provide liquidity to public sector banks (PSBs), the finance ministry in the Union Budget 2021, proposed the **creation of a 'bad bank'.** The bad bank is expected to take over the existing stressed loans from PSBs and dispose them off to potential investors. As the bad bank is expected to be a warehouse of stressed assets for all public sector banks, it would help to speed up the process of

decision making and provide timely resolution of stressed debt. This mechanism would also make it easier for investors to acquire a controlling stake in the debt of a company.

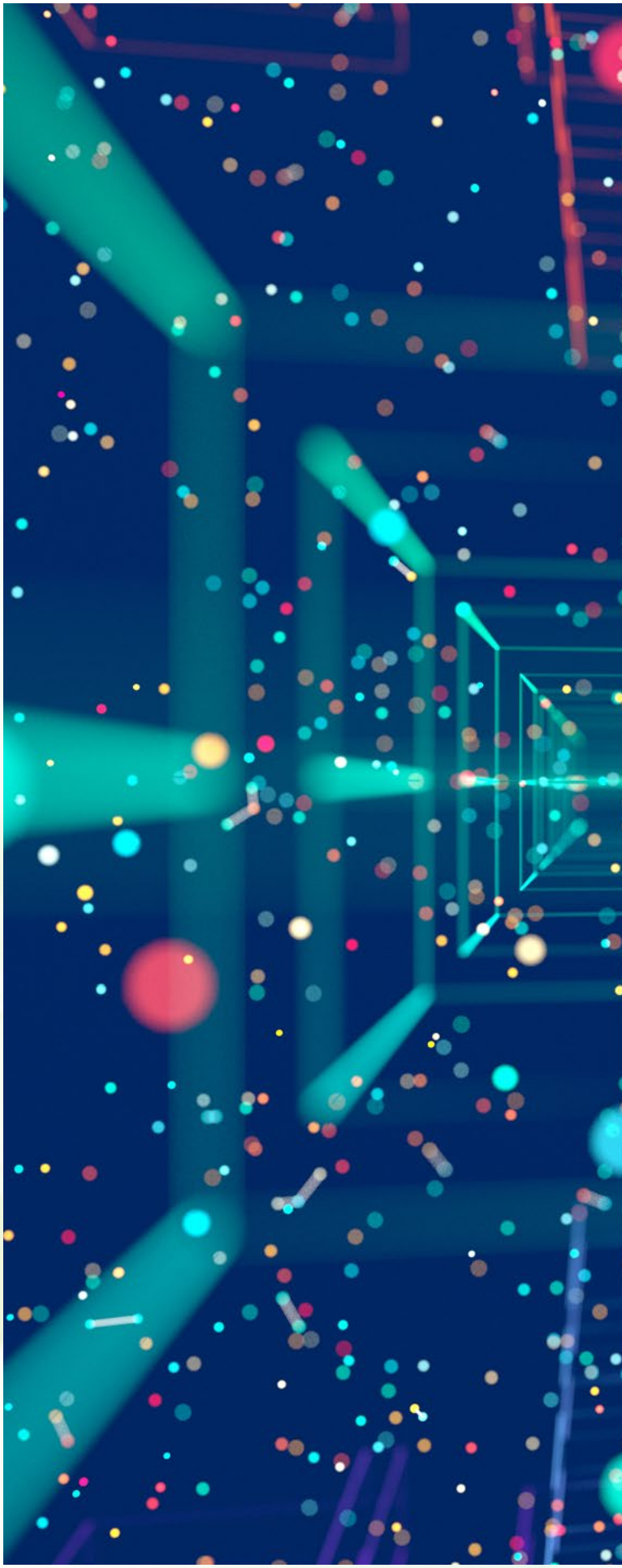
As of July 2020, the securities regulator in India also permitted **trading in defaulted debt securities**. This would help in creating a market for distressed bonds similar to the market for distressed loans which currently exists in India. Trading in such distressed bonds may enable investors to find a time bound exit without undergoing long drawn restructuring negotiations with the issuers or resorting to court proceedings.

Strong demand for capital from banks and corporates

Banks in India have preferred to sell stressed loans given the strict provisioning norms applicable for these institutions in India. In addition, the banks also need to raise capital to meet their Basel III requirements. As per our estimates, India's public sector banks (constituting ~60% of bank loans) require an additional ~US$5.9 billion of capital to meet tier I capital requirements under Basel III norms by 2022.

NBFCs in India have been facing a tight liquidity environment post the default of IL&FS – an infrastructure holding company in India, in 2018. This has recently led to an increasing interest from non-banks to sell their corporate loan portfolios. We have seen some interesting transaction structures evolve in this space over the past one year. The investors providing such liquidity invest through a senior tranche supported by a junior tranche into which the selling NBFC invests. Such structures provide very attractive risk adjusted returns to investors.

Banks and financial institutions in India are not willing to lend to companies that have been classified as NPAs, as such lending is subject to additional provisioning requirements. Thus, we have seen stressed companies approach investors like us to raise priority funding for working capital requirements or for last mile financing of projects. Such borrowing has a priority on cash flows over the senior lenders. Further, with Indian sponsors concerned of losing control over their companies in an IBC resolution process, there is an increasing demand from companies to raise primary financing for a one-time settlement with banks prior to the



company being taken to IBC. Also, we continue to see strong strategic interest in companies resolved through the IBC process in sectors such as steel, cement, and power. Acquiring a controlling/equity stake in companies through conversion of debt into equity can potentially provide a large upside to investors who are investing in this strategy.

Long term patient capital with expertise — the need of the hour

We have seen that investment in stressed situations requires long term patient capital as it typically takes at least three to six years for a turnaround or resolution. The key differentiator however, to capitalise on this opportunity is the availability of on-the-ground talent, an in-depth understanding of the Indian legal and regulatory landscape and specialised skillsets required for an operational turnaround of such assets. For investors having access to these right skillsets, investing in stressed assets through a combination of debt buyouts, primary or priority financing to corporates, or by a buyout/takeover of the company can be highly rewarding experience in our view.

Thus, the stage is set for investors with patient capital looking to invest in India stressed assets space — the opportunity set is large, the regulatory framework has evolved, and the risk return profile is highly attractive.

Simon Hopwood
Group Partner, Jersey
Maples Group

Tim Morgan
Partner, Jersey
Maples Group

Developments in Jersey structuring and governance

Growing use of Jersey private funds and recent best practice

Jersey private funds (JPFs) continue to be a key product in the jurisdiction's fund offering. Recent figures from the Jersey Financial Services Commission (JFSC) show that the number of JPFs grew by almost 100 in 2020 reaching 403, asserting their continuing appeal to investors. It is also worth noting that JPFs are increasingly being used for open-ended, as well as closed-ended structures.

One key feature of the JPF regime is the requirement to have a Jersey-based regulated designated service provider (DSP) with substance. In most cases the DSP also acts as the fund administrator, although this may not always be the case and will depend on the asset class and strategy. A DSP has certain specific duties in relation to a JPF, having responsibility for:

- Ensuring eligibility criteria are met
- Carrying out all necessary due diligence in relation to a JPF and its sponsor
- Complying with Jersey's anti-money laundering (AML)/CFT requirements
- Notifying to the JFSC any material changes or events and, if audited, any qualified audits
- Submitting an annual JPF compliance return

This reliance on the DSP enables an increased speed to market for a JPF, on the basis that the DSP is responsible for carrying out most of the due diligence process.

On 29 March 2021, the JFSC issued the results of its thematic review of DSPs to ensure compliance of JPFs with the JPF Guide and the DSPs' responsibilities regarding compliance with Jersey AML/CFT requirements.

The JFSC cites the following as examples of best practice:

- Tabling an annual compliance checklist for consideration by the JPF's board before the DSP files the JPF return
- Adopting a compliance monitory plan carrying out formal business risk assessments;
- Conducting a full DSP review of policies and procedures to ensure all JPF Guide and AML/CFT requirements are considered
- Ensuring the administration agreement between DSP and JPF clearly details all responsibilities
- Ensuring the JPF's board minutes cover compliance reports, record the appointment of a MLRO and a MLCO and consider the DSP's performance

- Maintaining records to demonstrate training of board members and the DSP's directors and staff concerning the JPF Guide and the AML/CFT Handbook

As a result of the thematic review, further updates to the JPF Guide are anticipated which are likely to increase the operationalisation of key processes.

Governance, substance and extension to self-managed funds and partnerships

COVID-19 accelerated certain trends, and one fundamental trend is the rise of governance and substance as a core element of running a fund management operation in Jersey.
Driven in part by the remote fundraising environment of the past year, investors are asking more questions of managers, while lawyers and service providers are spending increasing amounts of time on due diligence questionnaires and operational governance assessments.

Economic substance regimes have increasingly been seen as a key element in demonstrating governance.

Jersey's Economic Substance Law regime (the ES Law), first implemented in 2019, provides that if a Jersey company is both tax resident and performs a 'relevant activity' in Jersey, then it must also demonstrate that it has substance in Jersey by (i) being 'directed and managed' in Jersey, (ii) having adequate people, premises and expenditure in Jersey, and; (iii) conducting core income generating activities in Jersey.

The ES Law provides that 'fund management business' is a relevant activity and includes core income generating activities such as taking decisions on the holding and selling of investments, calculating risk and reserves, taking decisions on currency or interest fluctuations and hedging positions, and reporting to investors and regulators. 'Fund management business' is, however, defined so that responsibility falls on the functionary acting as the manager of the fund, rather than on the fund itself.

This approach focuses on the entity carrying out the effective management, whether a key functionary to unincorporated vehicles (such as Jersey limited partnerships and Jersey unit trusts) or the fund manager, acting for funds which outsource management to a third-party manager, who would fall within the scope of the ES Law and, therefore, are required to satisfy the 'economic substance' criteria.

The existing ES Law has not previously applied to corporate funds themselves, however on 10 February 2021, the Government of Jersey adopted amended legislation to clarify the way in which the ES Law will apply, with effect from 1 January 2021, to self-managed corporate funds, where no separate manager is appointed, which will now be required to comply with the 'economic substance' requirements.

Going forward, and in keeping with other Jersey fund structures, these self-managed funds will need to provide supporting evidence to show how they satisfy these requirements in their annual tax return. The test for whether a self-managed fund is performing a 'relevant activity' will relate to the fund management activities that it performs and is intended to mirror the requirements applied to other companies performing fund management business.
Although self-managed funds will be within the scope of the ES Law, they will not be required to satisfy the 'directed and managed' test in recognition of Jersey's funds regulatory regime, which already requires regulatory substance on the island. Consequently, a self-managed fund will not satisfy the economic substance test if it fails to comply with the relevant regulatory regime.

Revenue Jersey has also clarified that it would expect the 'taking of decisions on the holding and selling of investments' should always be carried out by the self-managed fund itself, evidenced through frequent and robust consideration by the fund board. While the self-managed fund will be assessed against the same core activities for fund management business as a third-party manager, Revenue Jersey has acknowledged that the self-managed fund will not in practice receive a separate income stream arising from fund management activities.

Substance for partnerships

The Government of Jersey has also confirmed its intention to extend the economic substance legislation to partnerships performing a 'relevant activity' around the 1st July 2021, to fulfil a commitment to the EU Code of Conduct Group for Business Taxation. Notably, partnerships that are funds are expected to remain entirely out of scope.

The expectation is that a new economic substance test for relevant partnerships (excluding funds) will follow the approach for companies as closely as possible. However, Revenue Jersey recognises the challenge of applying an economic substance test to partnerships as there is no international concept of tax residence for partnerships. In addition, when compared to companies, there is a much greater variety of governance and management arrangements found in partnerships which makes it challenging to construct a single test suitable for general application.

Limited partnership law

Jersey's existing limited partnership law (LP Law) is undergoing a review by an industry working group, in conjunction with Jersey's government and the JFSC, with a view to agreeing enhancements to the LP Law to augment the limited partnership's attractiveness, flexibility and usability, to ensure it remains the vehicle of choice for funds and investment vehicles.

The headline changes proposed include, in summary:

- Extending the entities, which may act as general partners (GPs)
- Making, wherever possible, the LP Law, subject to limited partnership agreement (LPA), to allow more flexibility for GPs and investors to agree their own terms, particularly concerning access to partnership records, GPs' and limited partners' (LPs) rights and obligations, return and clawback of LPs' contributions and third-party rights
- Expanding the safe harbour provisions to enhance the limited liability protection afforded to LPs
- Enhancing the winding-up and dissolution provisions

An empowering provision to allow for the introduction of cellular limited partnerships by regulationsIt is anticipated that the proposed amendments to the LP Law will be lodged with, and approved by, the States Assembly before the end of 2021.

ESG developments

In response to international reforms in relation to environmental, social and governance (ESG), the JFSC has carried out two consultations on proposals to enhance disclosure and governance requirements for investment funds committing to sustainable investments.

The proposals to enhance various codes of practice and the Jersey Private Fund Guide to ensure that investments are not inappropriately labelled as sustainable, also known as 'greenwashing'. The proposals aim to increase clarity around sustainable investments, enhance consumer protection and contribute towards the goal of meeting international standards. Clarifications are anticipated which will require funds with environmental, sustainable or socially responsible investments to put policies and procedures in place to support the credentials of the fund's investments.

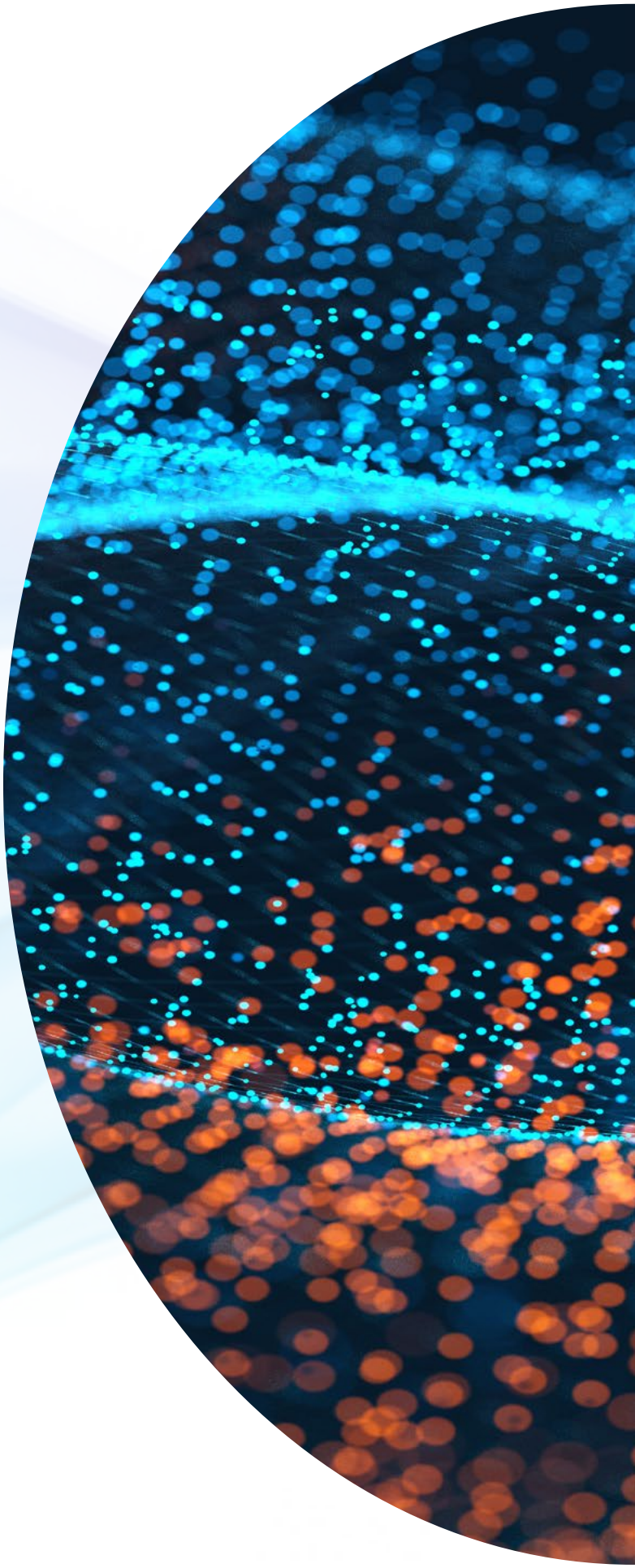
The requirements include:

- Issuing a public statement (such as a prospectus) in respect of sustainable investments
- Implementing an investment management process to (i) verify and document the ESG elements in the due diligence process by way of recognised taxonomy and; (ii) carry out an annual review to ensure the continued compliance
- Adopting appropriate corporate governance and organisational measures to monitor the investment management process, including access to resources with appropriate skills and experience and implementing appropriate reporting lines.

The requirements are anticipated to be contained in relevant Codes of Practice and guides issued by the JFSC and will potentially affect and impose new obligations on Jersey funds, as well as foreign funds with Jersey service providers, which commit to ESG investing; and regulated investment managers advising funds with ESG investment strategies.

At the same time, the EU's Sustainable Finance Disclosure Regulation (SFDR), requires pre-contractual and periodic disclosures at an 'entity' and 'product' level which will, include Jersey firms which are non-EU AIFMs within the meaning of the Alternative Investment Fund Managers Directive. The exact extent to which SFDR will apply to non-EU AIFMs remains subject to clarification requested by the European Supervisory Authorities with the European Commission. It is anticipated that further guidance will be issued in due course.

This article is intended to provide only general information for the clients and professional contacts of the legal services division of the Maples Group. It does not purport to be comprehensive or to render legal advice.



Volcker Rule 2.0 is here to stay: Congress refuses to exercise rights under CRA

Anthony R.G Nolan
Partner
K&L Gates

C. Todd Gibson
Partner
K&L Gates

Rebecca H. Laird
Of Counsel
K&L Gates

Yuki Sako
Counsel
K&L Gates

It is now widely understood that the set of amendments to the Volcker Rule covered fund provisions that became effective in October 2020 (together with the amendments to proprietary trading provisions that took effect in January 2020, 'Volcker Rule 2.0')[1] are no longer subject to being overturned by the US Congress (the Congress) pursuant to the Congressional Review Act (the CRA).[2] The timing of the approval and the effectiveness of Volcker Rule 2.0 gave rise to apprehension that the new Congress acting in a principled or partisan way could exercise its authority under the CRA to undo the amendments; however, such concerns are no longer relevant.

What Is CRA Review?

Under the CRA, the Congress may reverse certain agency actions retroactively and prohibit an agency from reissuing a new rule that is substantially the same by a joint resolution of disapproval, subject to presidential veto, within 60 session days after the later date of the Congress's receipt, or publication in the Federal Register, of an agency rule.[3] The CRA provides the Congress with a powerful tool to conduct oversight of agency actions, in particular, during a 'lookback' period following the inauguration of a new president, because when the Congress adjourns within 60 session days, a review period under the CRA will reset in its entirety in the next session of the Congress, giving the new Congress a full period to disapprove a rule.
Now, we are well into the 117th Congress, and the reset review period for the covered fund portion of Volcker Rule 2.0 under the CRA appears to have passed, which leaves these amendments intact.

How did CRA affect Volcker Rule 2.0 implementation?

By way of background, Volcker Rule 2.0 was designed to address some concerns raised by industry professionals in the original Volcker Rule and provide clarity and remove undue compliance burdens on banking entities and participants in markets such as imposing unnecessary costs or reducing access to capital and liquidity. With respect to the 'covered fund' portion of Volcker Rule 2.0, proposed in February 2020 and adopted in July 2020, it became effective in October 2020 shortly before the elections that led to a new presidential administration and a knife-edge Democratic majority in the Congress.[4]

1 84 Fed. Reg. 61974 (Nov. 14, 2019).

2 5 U.S.C. §801.

3 See U.S. Congressional Research Service, The Congressional Review Act (CRA): Frequently Asked Questions (Jan. 2020), p. 13.

4 See 85 Fed. Reg. 46422 (July 31, 2020).

Volcker Rule 2.0 expanded the exclusion from the scope of the definition of "covered fund" to include certain specific types of funds such as credit funds, venture capital funds, family wealth management vehicles, and customer facilitation vehicles. It also provided additional flexibility in existing covered fund exclusions, such as by expanding permissible loan securitisations to include non-loan assets and by easing the requirements for foreign public funds.

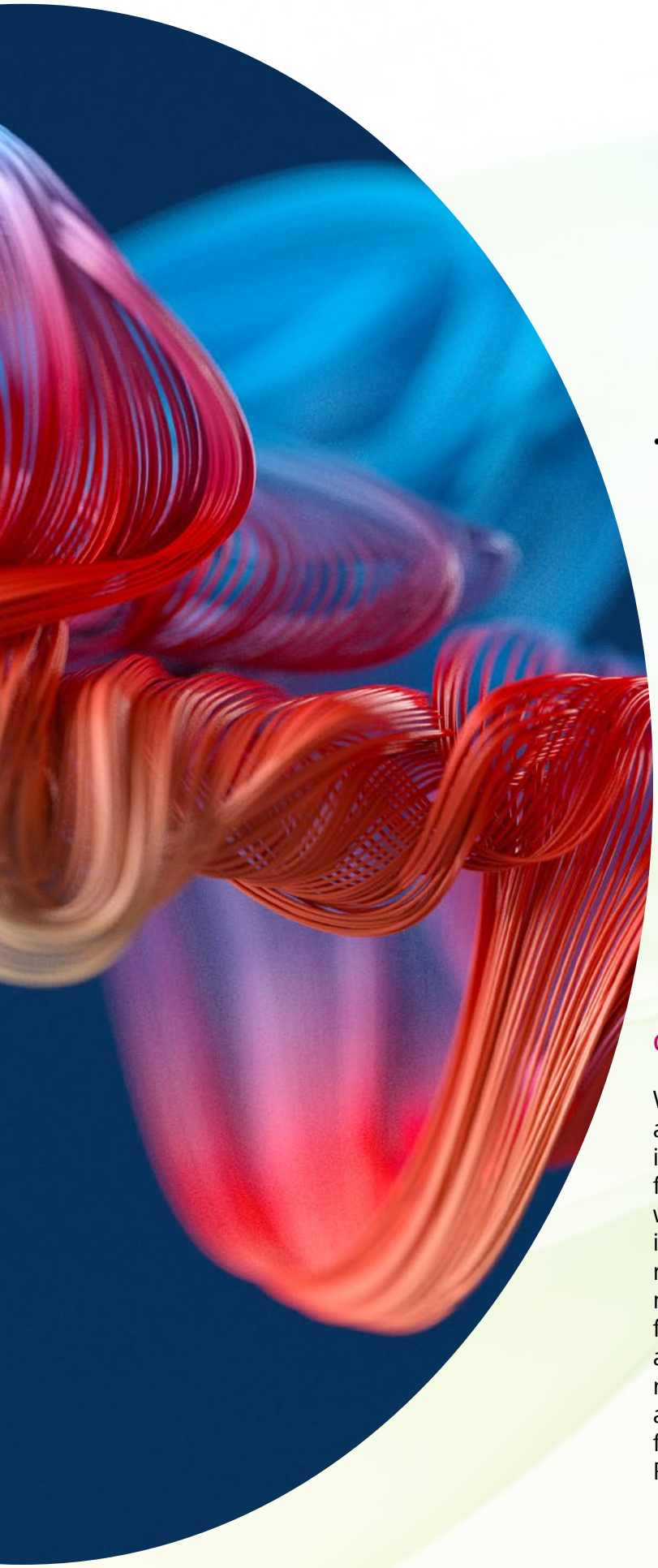
Volcker Rule 2.0 has been largely welcomed by the investment management industry because it provides additional investment opportunities to enhance customer-oriented asset management services. However, as described above, because of the timing of the approval and the effectiveness of Volcker Rule 2.0, concern was raised that the new Congress could exercise its CRA authority to undo these changes. This concern balanced the enthusiasm for the relaxation of the covered fund regime introduced by Volcker Rule 2.0 changes. As a consequence, some investment management firms appear to have decided to wait for the CRA review period to end before structuring their funds to take advantage of the benefits of Volcker Rule 2.0.

Second Look at Volcker Rule 2.0

With the Damocles' sword of CRA review no longer hanging over Volcker Rule 2.0, it is worth taking a second look at key features of the amendments. Principal among these are the following:

- New exclusions from the covered fund definition
    - Credit fund: A qualifying credit fund is a fund that invests in loans, debt instruments, other related or incidental assets (including equity securities, options, and warrants received on customary terms in connection with the fund's investing in loans or debt instruments), and interest rate or foreign exchange derivatives related to loans, debt instruments, or other assets. The fund is subject to a prohibition on proprietary trading, issuing asset-backed securities, or engaging in certain transactions with a sponsoring or investment adviser banking entity (known as 'Super 23A'), and the banking entity may not guarantee the fund's performance.
    - Venture capital fund: A qualifying venture capital fund is an issuer that represents to investors that it pursues a venture capital strategy and meets other requirements to qualify the "venture capital fund" definition in the Securities and Exchange Commission rule.[5] The fund is subject to prohibitions similar to credit funds.
    - Family wealth management vehicle: A qualifying family wealth management vehicle is a trust in which all the grantors are family customers, or a non-trust entity, a majority of the interests of which are held by family customers and up to five closely related persons (although up to 0.5% of the outstanding ownership interest may be held by a banking entity). Family wealth management vehicles are intended to allow banking entities to provide traditional banking and asset management services for family customers.
    - Customer facilitation vehicle (fund of one): This exclusion allows a banking entity to provide services to a customer through a special purpose vehicle similar to the way it may provide services directly.
- Additional flexibilities to existing exclusions
    - Loan securitisation: Volcker Rule 2.0 expanded the scope of permissible loan securitisations to permit asset-backed issuers to hold up to 5% of their assets in assets other than loans, however, such assets must be held in debt securities (other than convertible debt securities and asset-backed securities). Securities that are servicing assets are not counted toward the 5% limit. This allows a bond bucket for collateralised loan obligations in order to increase their diversification and enable collateral managers to respond flexibly to changing market

5 17 C.F.R. § 275.203(l)-1.



conditions.

- Foreign public fund: Volcker Rule 2.0 ditched requirements that are inconsistent with the market practices so that foreign registered funds are generally found to be within the exclusion consistent with the original intention of the rule to treat them as similar to U.S. registered investment companies.

- Public welfare investment fund: The scope of qualifying welfare investment funds is expanded to include, e.g. qualified opportunity funds.

- Permitted activities of qualifying foreign excluded funds: One unintended consequence of the covered fund rule as originally adopted was that an investment fund that is organised and offered outside of the United States could still become subject to Volcker Rule's prohibitions on proprietary trading and other restrictions. Volcker Rule 2.0 expressly provides exemptions for activities of qualifying foreign excluded funds that are organised, offered, and sold outside the United States as part of a bona fide asset management business where the fund is not operated so as to evade the Volcker Rule. Thus, a foreign banking entity may acquire, retain or sponsor a qualifying foreign excluded fund by relying on the so-called 'SOTUS' exemption (permitted covered fund activities and investments outside the United States).

Conclusion

With the expiration of the CRA review period, a cloud of uncertainty over the alternative investment management industry has lifted and floated away. Now, instead of worrying about whether Volcker Rule 2.0 is a valid regulation, investment managers are free to structure new and existing funds to conform to the new exclusions or take advantage of the new flexibility in existing exclusions. It will also permit alternative investment managers to focus with renewed intensity on some of the points of ambiguity in the Volcker Rule 2.0 that may be a fruitful source of interpretive guidance through FAQs or otherwise.

K&L GATES

INVESTED IN OUR CLIENTS

We are proud to be a sponsoring partner of AIMA. Our Asset Management and Investment Funds practice has 50 years of experience in the financial services industry and comprises more than 100 lawyers in Asia, Australia, Europe, the Middle East, North America, and South America. The practice covers many disciplines that require a deep bench of knowledge and experience. No matter the size or location of your company, our lawyers provide seamless advice across jurisdictions so you can focus on growing your business.

K&L Gates LLP. Global counsel across five continents.
Learn more at klgates.com.

Scrutiny due for undue charges

Mark Browne
Partner
Clerkin Lynch LLP
Email Mark Browne

The fund management industry has become increasingly cost sensitive in recent years. While much of this has been driven by competitive pressures, the power of significant allocator investors and investor appetitive for index products, other factors including investor education and regulatory oversight, or related concerns have also been factors. The latter seems poised to assume central stage as the European Securities and Markets Authority (ESMA), the European super-regulator, has identified costs as one of its priority areas of focus for 2021 and it is currently orchestrating a pan-EU action by local regulatory authorities to focus on "undue" costs.

Background

ESMA published its first annual statistical report on costs and performance for retail products in early 2019.[1] This highlighted the significant impact of fees on performance, particularly for retail fund products. This prompted ESMA to undertake a survey among National Competent Authorities across the EU (NCAs), the local regulators in each Member State of the EU (Member State), on approaches to the supervision of cost-related provisions, noting that the legislation underpinning both UCITS and alternative investment funds contain relevant legislative provisions.

The results revealed diverse interpretations of the concept of "undue costs" between NCAs as well as related supervisory procedures. ESMA identified this as creating potential for regulatory arbitrage and deficiencies in appropriate investor protection across the EU and accordingly determined that there was a need for a common framework for NCAs to use to consider issues pertaining to fund costs as well as related supervision and enforcement.

The ESMA briefing was issued under Article 29(2) of the ESMA Regulation which enables ESMA to develop new practical instruments to assist in driving convergence among Member States in June 2020.[2] ESMA subsequently cited costs and fees charged by fund managers as one of the two supervisory priorities to be addressed for 2021 under their discretion to identify key market risks impacting Member States.[3]

The reason for selecting this topic as a focus for priority attention is cited to be its key role in investor protection since unfair or disproportionate costs and fees can cause significant investor detriment. Regulatory arbitrage is also a concern as it negatively impacts the competitive landscape.

1 Available at: esma50-165-731-asr-performance_and_costs_of_retail_investments_products_in_the_eu.pdf (europa.eu)

2 "Supervisory Briefing on the Supervision of costs in UCITs and AIFs" 4 June 2020 ESMA34-39-1042

3 See Press Release: "ESMA Identifies Costs and Performance Data Quality as New Union Strategic Supervisory Priorities", 13 November 2020

As a result ESMA announced[4] it was launching a "common supervisory action" (CSA) with the NCAs early in 2021 to assess the compliance of supervised entities with the cost-related provisions in the UCITS framework and in particular the obligation to ensure funds were not paying undue charges.

Legal basis

A key driver behind EMSA's actions in this regard has been the fact that the existing product level financial services legislation, being the UCITS Directive and Alternative Investment Fund Managers Directive (**AIFMD**), already address the fundamental issues identified.

For example, Article 22(4) of Commission Directive 2010/43/EU (UCITS Level 2 Directive) provides that Member States shall require management companies to act in such a way as to prevent undue costs being charged to the UCITS and its Unitholders. The ESMA Briefing further notes that Article 14(1)(a) and (b) of Directive 2009/65/EC (the UCITS Level I Directive) provides for Member States to draw up rules of conduct to ensure management companies (a) act honestly and fairly in conducting its business activities in the best interests of the UCITS it manages and the integrity of the market; (b) acts with due skill, care and diligence in the best interests of the UCITS it manages and the integrity of the market.

Similarly, in relation to the AIFMD, Article 17(2) of Commission Delegated Regulation (EU) No 231/2013 (AIFMD Level 2 Regulation) provides that AIFMs shall ensure that the AIFs they manage or the investors in these AIFs are not charged undue costs.

Furthermore Article 12(1) of Directive 2011/61/EU (AIFMD Level 1) provides that Member States shall ensure that, at all times, AIFMs (a) act honestly, with due skill, care and diligence and fairly in conducting their activities; (b) act in the best interests of the AIFs or the investors of the AIFs they manage and the integrity of the market (c) treat all AIF investors fairly.

The ESMA Briefing is non-binding on NSAs but seeks to assist them by setting out a common framework for their consideration and principles to be applied when conducting supervisory authority in the context of assessing fund costs, which as noted above are already subject to existing legal requirements. This framework can be used to assist in determining if specific costs ought to be considered "undue" for the purposes of applicable legislation in the context of specific funds. This is particularly useful given that the term is not defined in such legislation.

Analysis and Indicators

The ESMA Briefing clarifies that the primary principle to be applied in considering the notion of undue costs is that these should be assessed against what should be considered in the best interests of the fund or its unitholders.

Accordingly, the costs charged should: (a) be consistent with the investment objective of a fund and not prevent it from achieving this objective, particularly where those costs are paid to third party service providers to the fund, and (b) be clearly identifiable and quantifiable.

To facilitate effective supervision that undue costs are not being charged, management companies are to be expected to develop and periodically review a structured pricing process addressing key elements:

a Whether costs are linked to a service necessary for the fund to operate in line with its investment objective or ordinary activity:

b Whether such costs are proportionate to market standards and the types of services provided (interestingly legal costs are specifically mentioned in this regard);

4 See Press Release "ESMA launches a Common Supervisory Action with NCAs on the Supervision of Costs and Fees of UCITS", 6 January 2021

c Whether the fee structure is consistent with the characteristics of the fund;

d The sustainability of costs;

e Whether costs ensure equal treatment of investors (except where specifically permitted);

j The absence of duplication of costs;

g The application and disclosure of fee caps;

h Compliance of performance fees with applicable guidance and rules as well as disclosures;

i The disclosure of all costs; and

j The reliability of the data.

Clearly therefore the question as to whether fees are "undue" will be entirely fund specific and needs to be assessed on the merits of individual cases. It is also evident that the response to any analysis of this question with respect to any given fund could change over time.

Supervisory actions

NCAs are now expected to incorporate a review of compliance with the relevant requirements at different stages — including not only during the fund authorisation process, but during periodic inspections, upon approval of material changes, thematic reviews and when undertaking an assessment of investor complaints.

Key aspects of the focus of the review should include disclosure and transparency relating to fees and ensuring that fees are aimed at remunerating services incurred by the fund without impairing compliance with the duty to act in the best interests of investors. Primary aspects of the latter include the development of a pricing policy that sets out responsibility for reviewing costs charged and preventing negative impacts due to conflicts of interest.

Where undue costs are identified it is to be expected that remedial action may include investor compensation, reduction of fees, review of disclosures and public disclosures of the identification of poor practices, including in the press to act as a deterrent.

Current position

Throughout 2021, NCAs are sharing knowledge and experiences co-ordinated through ESMA to ensure EU supervisory convergence regarding cost-related issues as part of the CSA. This is being undertaken on the basis of the common methodology developed by ESMA. Certain NCAs have announced measures they are undertaking as part of this CSA, e.g. the CSSF in Luxembourg[5] and given that this CSA is one of two stated ESMA priorities for 2021, it is to be expected that significant progress will be achieved and applied on a general basis across UCITS over the course of this year.

5 Launch of the ESMA Common Supervisory Action on the supervision of costs and fees of UCITS – CSSF

Other relevant initiatives

As mentioned at the outset of this article, regulatory pressures on costs have been evident for some time in the funds' context. Performance fees in particular have already been a focus at the EU level.[6] However, there have also been examples of actions being undertaken at the Member State level by NSAs such as the Central Bank of Ireland[7] or the "value for money" focus of the Financial Conduct Authority in the UK. Many US managers will also be familiar with the provisions under Section 36(B) of the 1940 Act to ensure excessive fees are not paid to investment managers.

Recommendations

Given the current status of the CSA, it is to be recommended that management companies and fund boards ensure that an analysis is undertaken using the framework set out in the ESMA Briefing and steps are taken to address any potential deficiencies. It is clearly preferable to take the initiative in identifying and tackling any issues in this regard rather than waiting until an NSA such as the Central Bank or CSSF undertakes such analysis and potentially commences action on foot of this, which could potentially include not only instructions to pay investor compensation but also public censure.

6 See for example "Guidelines on performance fees in UCITS and certain types of AIFs " esma_34-39-968_final_report_guidelines_on_performance_fees.pdf (europa.eu)

7 See for example: Central Bank to launch fund fee probe (irishtimes.com)

The way forward: How firms can meet their SFDR obligations with less disruption

Steve Barnes
CTO
AQMetrics

The environmental, social and governance (ESG) revolution in Europe reached a pivotal moment earlier this year as the Sustainable Finance Disclosure Regulation (SFDR) regime finally went live on 10 March 2021. Years in the making, the sweeping new rules involve disclosure requirements at firm and fund levels (for UCITS and alternative investment funds), and hope to prevent greenwashing within the ESG fund industry.

So far, SFDR has required funds and products to have been categorised (non-green, light green or dark green), firm-wide sustainability considerations have been deliberated, and disclosures and marketing materials have all been updated to reflect the SFDR disclosure.

But, for firms with light and dark green funds (up to 21% of all funds across Europe, according to Morningstar research[1]), the hard work has just begun; they now have only a few short months before the EU Taxonomy goes live on 1 January 2022. This will soon require ESG firms to assess how aligned their investments are with the sustainability activities within the Taxonomy.

This presents challenges and opportunities, with the European Fund and Asset Management Association (EFAMA) recently calling for a transitional period and a one-year delay to the deadline.[2]

Another consideration for market participants is that the level-two 2 rules haven't been finalised (although the draft rules have been published), and ESG ratings are not yet as consistent as credit ratings or other ratings houses.

As many commentators have noted, successful ESG data sourcing and aggregation remains the key task for any successful SFDR implementation, with firms now looking at ways to optimise data management to make sure that their funds are aligned with the SFDR and EU Taxonomy.

Given this, AQMetrics examines the data challenges that firms in Europe currently face, and explores how technology platforms can provide an end-to-end solution, not only for data management, but also for ESG impact assessment, monitoring and reporting.

Sourcing ESG Data

For light and dark green funds, the SFDR requires these firms to measure — against the Taxonomy — the ESG implications of every asset in the portfolio. Individual investments must be ranked according to their alignment, and an overall alignment score will also be given to the portfolio.

It's worth noting that this challenge will become somewhat easier in 2022, when large companies (over 500 employees) subject to the EU Non Financial Reporting Directive (NFRD) must provide Taxonomy-aligned non-financial disclosures. Even

1 Sara Silano, 'Finding ESG Funds Just Got Easier', 6 April 2021, available at: https://www.morningstar.co.uk/uk/news/211061/finding-esg-funds-just-got-easier.aspx

2 EFAMA, 'EFAMA replies to ESA's consultation on taxonomy-related sustainability disclosures in SFDR, 18 May 2021, available: https://www.efama.org/index.php/newsroom/news/efama-replies-esa-s-consultation-taxonomy-related-sustainability-disclosures-sfdr

then, though, the disclosures will only apply to bigger 'blue chip' companies, and won't include smaller or overseas companies, providing scant relief for ESG funds invested in smaller or niche investments.

So, what should firms do?

The first option is to try and source, manage and aggregate all of the data in-house. Because of the difficulty in assessing the ESG characteristics of every asset and underlying asset in the portfolio, firms will likely rely on ESG data providers to obtain as much relevant data as possible.

Many of these providers have spent the past year or so revamping their products to make sure that their data reflects the EU Taxonomy and SFDR obligations. That's the good news.

In addition, there is some important progress being made in this area, with ESG ratings likely to become more harmonised in the future. Earlier this year, for instance, the European Securities and Markets Authority (ESMA) called for legislative action on ESG ratings and assessments,[3] in a move that should eventually pave the way for more scrutiny and harmonisation.

But until this happens, firms preparing for the level-two rules now will still have to ensure their asset data is weighted, scored and aggregated across the portfolio.

Once all this is done, firms will be better positioned to start running ESG rules and commencing sustainability reporting once the reference period ends on 31 December 2021.

Solving SFDR: the platform approach

For those firms that don't want to - or can't - manage and analyse ESG data sets in-house, a platform that applies best practices to data aggregation, ESG rules and sustainability reporting can help meet this emerging regulation.

In fact, leading regulatory technology firms and other market participants are launching purpose built SFDR solutions to provide their clients with reporting-ready ESG data sets. Many platforms will source and licence multiple ESG data sets, eliminating the need for firms to integrate directly with one or more ESG data vendors. .

An SFDR-ready platform should be able to easily analyse and classify vast swathes of data (including unstructured text) to derive the scope of ESG impacts, and weight and compare them in such a way that can easily calculate an overall Taxonomy alignment score for an investment.

Once the ESG score is calculated by the platform, pre-built sustainability rules are executed on a scheduled basis. Any changes to the portfolio are continuously assessed for the ESG impact and risk. Sustainability rules aligned with SFDR taxonomies can be further supplemented with rules built by the firms themselves.

This combination of regulatory-driven rules and firm or investor ESG rules gives a level of ESG risk and impact assessment over and beyond the basic regulatory requirement.

Compliance processes, meanwhile, can be enhanced for SFDR with an AI-enabled workflow encompassing alert management, what-if scenario analysis and stress testing.

The workflow should track trends and detect patterns over time, providing insights back to the firm and its investors on how the ESG score of the portfolio is evolving over time.

The SFDR reporting framework should include real-time dashboards containing investment rankings, concentration risk and benchmark trend analysis. Structured reports can be generated and disseminated to the board and directly to the firm's investors.

A single platform will also enable firms to track exactly how ESG data was sourced, weighted and aggregated — an important requirement under SFDR. With full data traceability, firms can rest assured that they're fully aligned with the Taxonomy and meeting the level-two rules under the SFDR.

3 ESMA, 'ESMA Calls for Legislative Action on ESG Ratings and Assessment Tools,' 29 January 2021, available at: https://www.esma.europa.eu/press-news/esma-news/esma-calls-legislative-action-esg-ratings-and-assessment-tools

Finally, a single platform should give firms greater flexibility and improved operational resilience, while future proofing their sustainability reporting. Since certain aspects of SFDR are still to be finalised, a platform built to handle regulatory change can adapt as the finalised regulations emerge and mature over the coming months.

Now is the time for firms to focus on getting their platform strategy right. Having confirmed what products are in and out of scope when it comes to the EU Taxonomy, it's time to consider the overall data management and how the taxonomy alignment, ESG risk impact scoring and sustainability reporting will integrate within the firm's compliance framework.

Finding a platform with proven methodologies for regulatory monitoring, oversight and control might just be the way forward.

Your SFDR Platform

The AQMetrics purpose-built platform has the deep ESG data necessary for risk assessing and reporting on your portfolio's sustainability.

Our platform allows firms the flexibility to leverage pre-built SFDR rules or even create your own sustainability rules.

To find out more about the AQMetrics platform, get in touch via **sales@aqmetrics.com**

aqmetrics.com

AQMETRICS

Leveraging data and AI for innovation in asset management

Carl Barrelet
Head of Data Science
KPMG in Canada

The importance of utilising data and AI models for the better screening and monitoring of investments and risks has grown steadily across the asset management industry in recent years. It is fair to say, though, that through the COVID-19 pandemic, its significance has never been higher. The unprecedented levels of volatility and unpredictability that the outbreak introduced into the investment landscape means the ability to predict and manage risks, especially on the downside, has become more critical than ever.

Those asset managers that have a dynamic handle on risks and a more sophisticated view of the impacts of the pandemic on both portfolios and individual stocks will have a significant advantage over their peers. We have already seen a growth in interest in 'COVID datasets' from alternative data vendors for example, offering information on previously largely ignored data such as patient numbers and hospital admissions in cities and regions, as well as real-time foot traffic in cities around the world as an indicator of economic activity.

To a large extent, advanced data and AI tools used to be concentrated in the hands of a limited group – top tier funds and hedge funds with deep pockets – but as data has become more accessible across organisations, and as more powerful models have become available for investors, it's now much more feasible for other players to create and run live data models.

It is a trend that has become increasingly pronounced across the sector – and one that we can expect to continue to grow strongly, especially as firms navigate what will most likely prove to be a gradual and stop-start recovery period through this year.

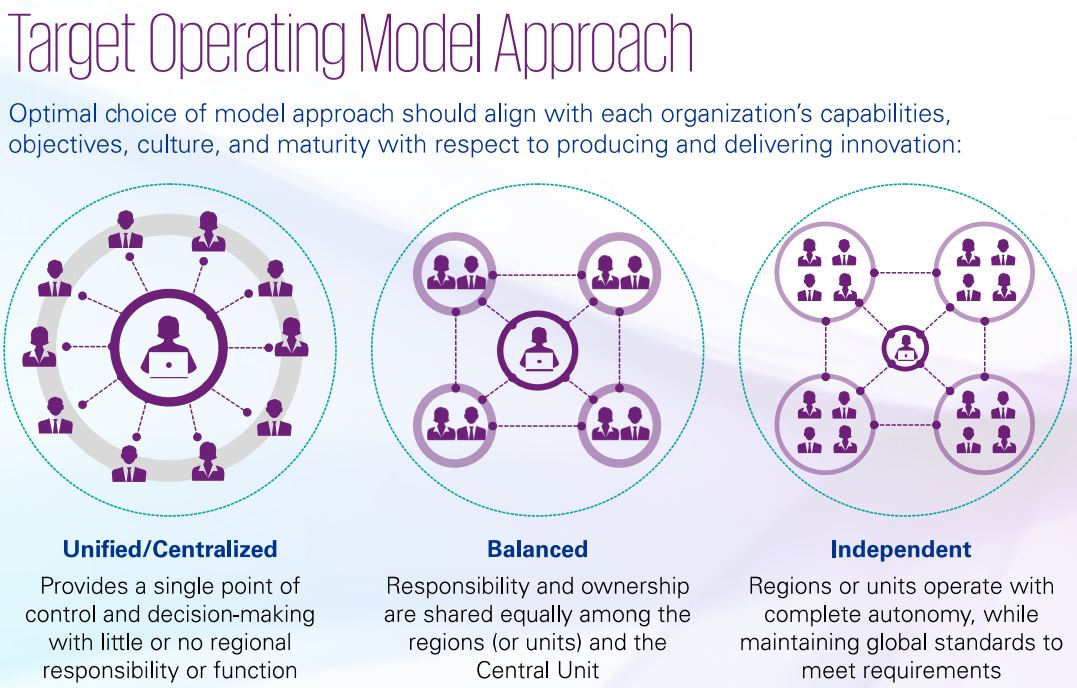
Getting the operating model on target

But what are the factors for success? It's critically important that asset managers devise the right target operating model (TOM) for their data approach. There is no single operating model that works for all firms – it's a case of aligning the approach with the organisation's capabilities, objectives, culture and maturity with respect to producing and delivering innovation.

It is also the case that different parts of a firm may be more in tune already with data and AI than others. The systematic trading side, for example, are often advanced already in leveraging aspects of artificial intelligence (AI) and machine learning (ML), while other parts of an organisation remain more relationship than data-driven, closer to the traditional private equity or venture capital model. It will also vary from portfolio manager to portfolio manager – some will be enthusiastic while others may be skeptical, so taking account of the receptiveness of individual portfolio managers is important.

Operating models for data and innovation can range widely from highly centralised (all data scientists co-located in one team, separate from the rest of the business) right through to decentralised and independent (data scientists integrated directly into teams across the organisation). The truth is that the most successful models are likely to be somewhere in between – a hybrid approach. The danger of a very centralised approach is that the data team is too removed from the portfolio managers who are making investment decisions on the ground; while a highly decentralised model can mean duplication of effort and inefficiency.

The choice of operating model will have implications for aligning with operational functions such as data management, technology architecture and resources, and data & model governance. It's also key to appreciate that an organisation's operating model is likely to evolve over time. It may look quite different in year three, for example, to how it looked in year one. Most likely, it will start off relatively centralised and then move further to the right over time.



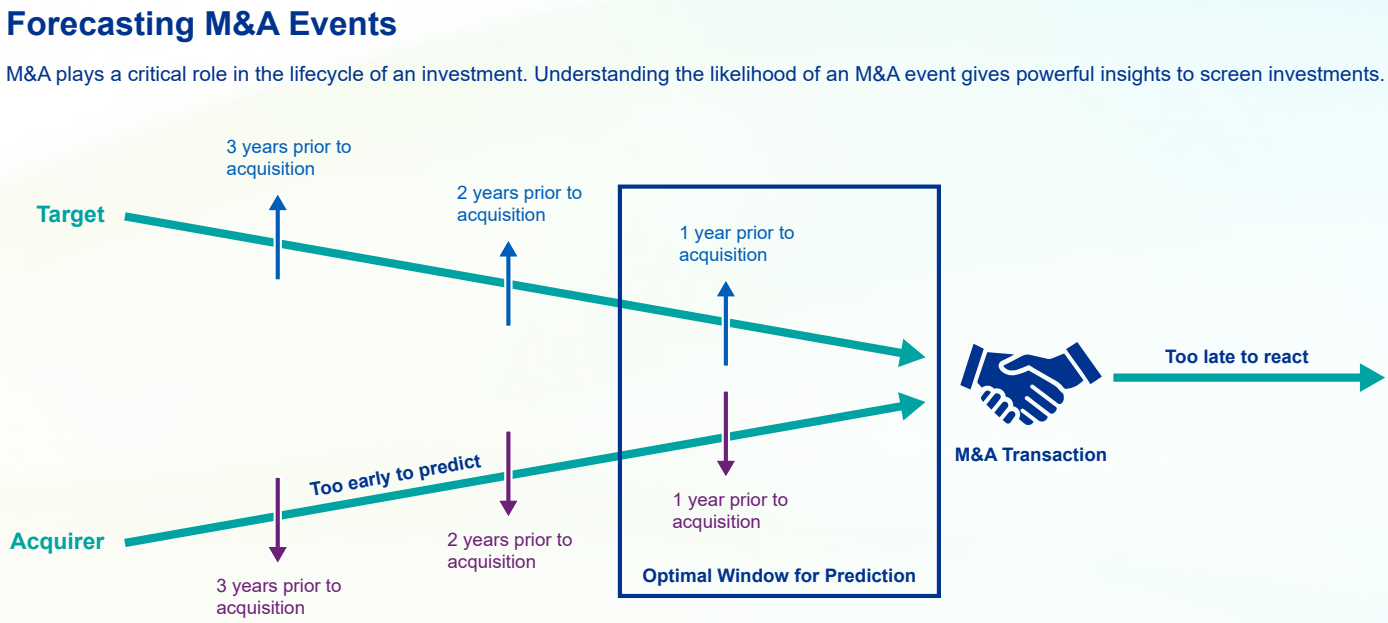
Getting your TOM right is an essential first step to properly leveraging data and AI across the enterprise. It's vital that you get the right people round the table (or, the virtual table) to have a full and considered discussion, and recognise that it will be a journey not a one-off transformation. The ultimate goal must be to reach the position where emerging technologies enable the organisation to use data not as cost to be managed but as a profit center – creating alpha generation from AI insights.

Implementing AI tools for real results

But how should an asset manager utilise these high-potential tools? Again, there are various possible models. A portfolio manager may simply read a report that has been generated through the application of data and AI and then make decisions accordingly; equally, a data signal may feed directly into an algo-trading model itself. Models may be developed in-house, or they may be taken from a provider. Or there may be a hybrid approach – working together to develop and enhance a model that can then be applied across a portfolio. Today's models are becoming increasingly sophisticated, making use of a range of technologies such as AI, ML and natural language processing (NLP). They don't stand still either – nowadays, there is not only ML and NLP but advanced variants such as computer vision, language models and reinforcement learning Data-driven solutions are commonly used across three main areas. Some are for **screening investments and forecasting merger and acquisition (M&A) events** ahead of time. M&A plays a critical role in the lifecycle of an investment – understanding the likelihood of an M&A event gives powerful insights to screen investments.

Firms are able to identify and rank companies according to the likelihood of their becoming a target and optimise their investment approach as a result – allowing them to take advantage of the model's prediction scores before it becomes too late to react. Other tools help to monitor investments and forecast default risks ahead of them coming to pass. Early prediction of default can empower investors to make well-informed and timely decisions. For example, a default predictor developed at KPMG Lighthouse ingests about 20 million data points spanning the previous 10 years, covering all public companies across North America. The model can be reviewed, validated and tuned across hundreds of iterations to achieve optimal performance. The output also includes explanatory detail.

Another important use case is leveraging natural language processing to consistently read the news generated globally by the news provider to pick up potential risk and reputational issues – data and AI techniques provide a powerful tool. Common risk areas include ethics violations, fraudulent activities, safety issues and external factors such as acquisitions or associations with third parties. Particularly where social media is involved, reputation-altering events can arise and take hold extremely quickly



so having a real-time monitoring dashboard powered by advanced technologies could help to significantly reduce the financial or social impact of adverse experiences and events.
It is important to remember, however, that these tools are intended to augment human judgment, not replace it. They provide insights that would otherwise be difficult (or impossible) for a human being to capture – but ultimately, it remains with the portfolio manager to make final decisions. Used in the right way, though, they can provide invaluable assistance that make a PM's job easier, faster and much more data-driven: they take old-fashioned investment manager intuition into new, data-driven grounded realms.

The battle for skills and people

Another key factor for success is a difficult one to crack: obtaining the right talent to build the models. To leverage data and AI, firms need a new breed of people. Whereas in the past, intakes used to be based around attracting individuals with a heavy focus on advanced financial or accountancy skills now firms are just as likely to want to bring in people who can code in Python or other advanced programming languages. This is a significant shift. The need for the 'old' skills has certainly not disappeared, but the requirement for new technology-based skills has rapidly shot up the agenda. Competition is high and the big tech giants tend to have the upper hand. They can afford to pay big salaries and have the cache and reputation for cutting-edge innovation that naturally attracts the people (often Millennials) with the highly specialised skills needed.

However, the investment industry also holds significant attractions so firms should certainly not lose heart. With such strong correlations between investment strategy and data, many highly talented software engineers, machine learning engineers and data scientists could find a fulfilling and rewarding career at a progressive asset manager. Remember also that it doesn't come down to getting that one, perfect person: it's about assembling a team with complementary skills across it. Working with external organisations can also be a route to success. 2020 was a huge test for many in the industry; 2021 continues to be challenging, given the uncertainties over the pace and breadth of economic stabilisation and recovery. Whatever the future brings, embedding effective models for data-driven innovation will be a key determinant in asset managers' performance.

New Reality for Asset Management. Getting fit for the future

Inspiring leaders in the asset management industry are guiding their organizations through significant change at a rapid pace. From sharpening focus on high opportunity areas and adapting to new ways of working, to implementing innovative technology and integrating ESG into investment decision making — KPMG professionals have the passion and expertise to help you make decisions about your business. We can make better decisions together to thrive in the new reality.

KPMG Asset Management practice
home.kpmg/newrealityofAM

KPMG

Five steps to modernising information security in a post-Pandemic world

Timothy Kropp
Global Chief Information Security Officer
SS&C Technologies
Email Timothy Kropp

Traditional Information Security programs at well-established organisations had a tough time keeping up with the rate and volume of changes that resulted from the COVID-19 pandemic. The days of the four-walled security operations centers (SOCs), locked doors, with staff members comfortably inside, went away. The new security paradigm is a peer-to-peer, agile, collaborative model. In this new model, organisations need steps to guide them on their journey to change.

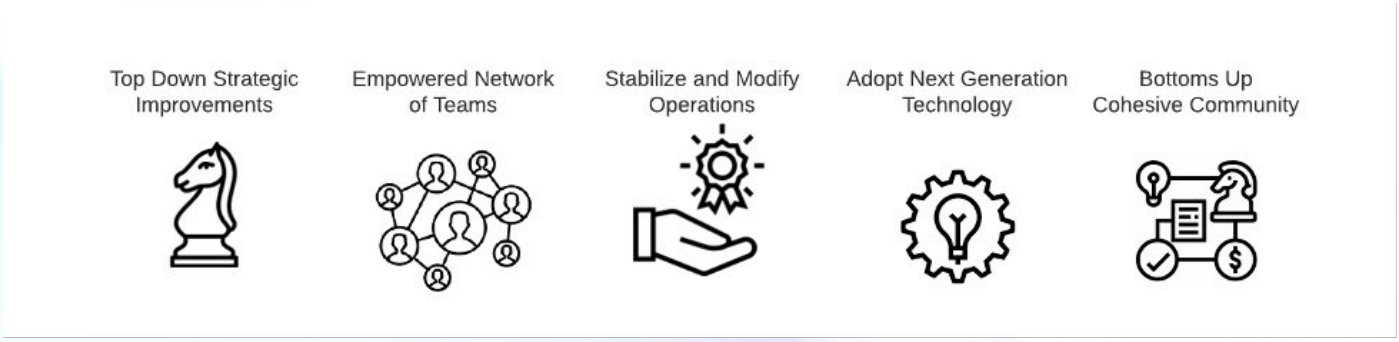
Old paradigm

Traditionally, organisations have lengthy Information security policies, frequently well-written and often overcomplicated. The guidelines were intended to clarify security intentions and outcomes, but they often resulted in significant gaps between reality and the desired state of security. The unintended consequence was confused workforce friction, or worse, forcing employees to work around the controls meant to protect the organisation. The rate and volume of changes in a hybrid or fully remote environment accelerate digital transformation or makes organisations reprioritise efforts to establish transformation goals. The older and slower information security governance paradigm collapsed.

Increasing irrelevant Information security programs compounded with a rapid pace of change require a new way to approach modernisation efforts. The willingness to adapt is no longer an option.

Our experience and research demonstrate new information security programmes can adopt new practices. We have created five key steps to lead your organisational transformation journey to a successful outcome.

Five steps to modernise



There are five key steps to modernise your programme in the new reality while keeping policy, protection, and business enablement goals intact:

1. **Top-down strategic improvements.**

   Set meaningful, simplified strategic objectives. In the face of change, goals need to be easy to distill and with a rubric that allows agility. Streamline governance and policy objectives when setting strategic plans. Cloud-first technology, such as next-generation monitoring systems, offers clear advantages in security automation and should be part of any program renovation. Concise articulation of protection goals centered around critical assets is vital to success.

2. **Empowered network of teams.**

   Establish clear accountability around goals and create robust, reliable security communities of practice to act as problem owners. Identify and do not tolerate problems standing in the way of creating a culture of collaboration and ownership. Ensure staff understand protection obligations and empower them to make sensible decisions.

3. **Stabilise and modify your operations.**

   Prioritise renovation of fragile security technology artifacts, such as protection infrastructure. Eliminate traditional physical security operations centers and embed security operations laterally across different teams and stakeholder operations.

4. **Adopt next-generation technology.**

   Do not be afraid to give up the status quo. Adopt new technology and robotic process automation. Identify the top five-10 manual security processes that can be augmented or eliminated through intelligent deployment of automation.

5. **Bottom-up cohesive community.**

   Create an organisation where it is okay to make mistakes, and people learn from them. Invest in staff training in cloud-first virtual technologies, modern security techniques, offensive and defensive practices, and mentorship opportunities. Listen closely to staff members closest to the problems and be open to receive ideas from within the organisation.

While some of the steps may seem intuitive, many firms fail to create an approachable way to achieving transformation. Focusing on these five steps will likely increase the overall value an information security programme is delivering.

Gain visibility and resilience

As your programme evolves, the visibility into risk, security operations, and the internal environment will improve. This visibility may seem daunting to achieve, but it is foundational to any good security operational effect on the environment. Security quality problems are typically associated with a lack of visibility. As the internal observability improves and daily operations become more transparent, other areas for improvement may emerge. This improved visibility should inform the strategic roadmap for goal adjustment and additional areas of investment. The bottom line: it is impossible to manage and lead what you cannot see.

Continual learning

Invest in the education and development of staff members and encourage a culture of continuous learning. Security awareness and exercises are a tiny part of the journey. Consider creative ways to reach employees, such as competitions, in-person labs, and modern training platforms. Use metrics and data to your advantage to provide targeted employee training material that facilitates the culture of continuous learning.

Deliver value

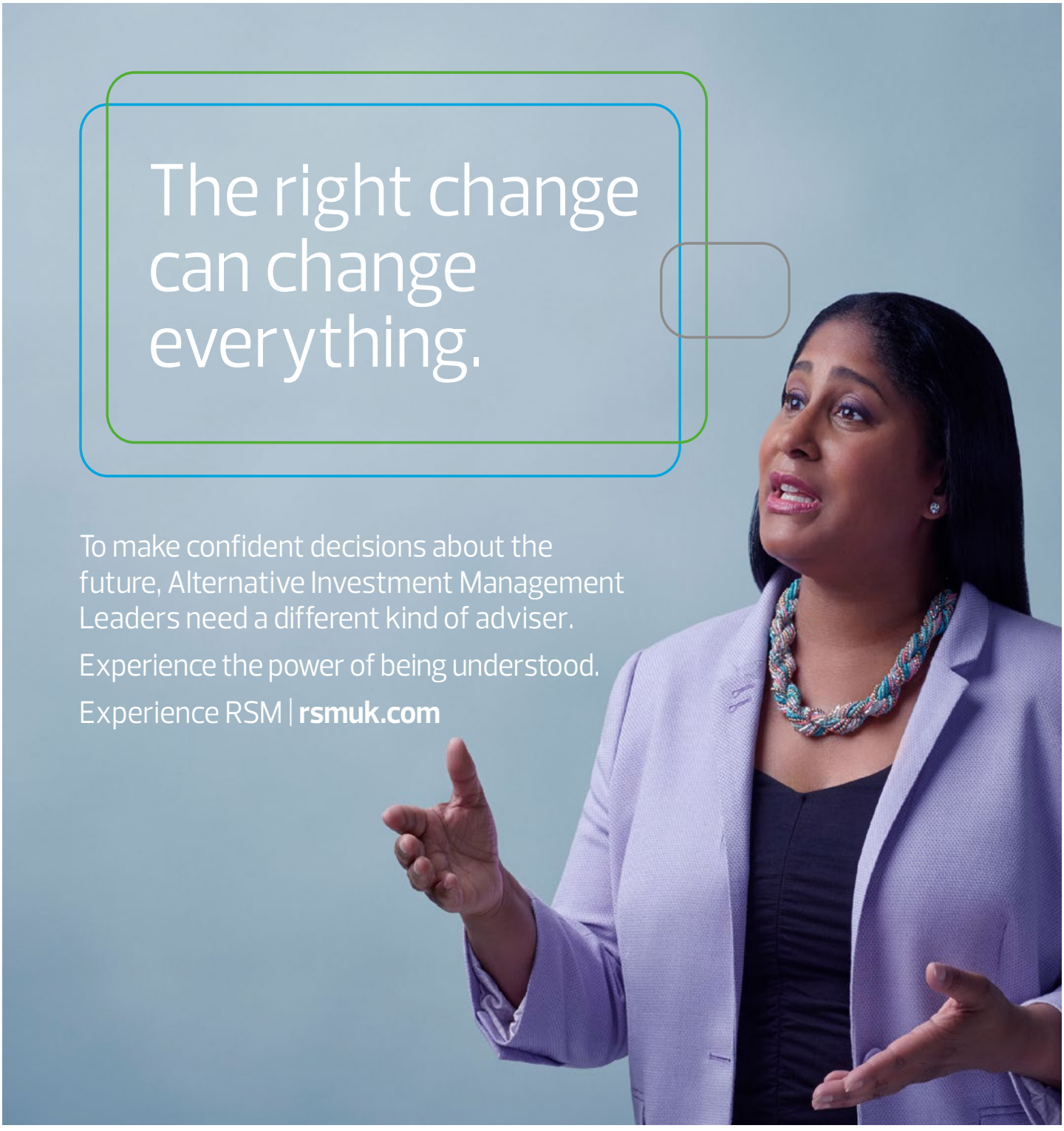
A final piece is your Information Security program portfolio is well-understood and adaptable over time. Without a clear definition of what ‘done’ means, an iterative roadmap that adjusts in the face of priority changes, and a repeatable process to update plans, security initiatives are likely to fail in the front of continuing daily pressure.

Information security programmes need to evolve continually as business protection goals change. These five recommended steps will aid in gaining focus and clarity on programme renovations. Applying these steps to re-orient and recalibrate changes in the organisational environment will improve your information security programme.

SS&C

The global leader in hedge fund administration

For more information, visit
ssctech.com



THE POWER OF BEING UNDERSTOOD
AUDIT | TAX | CONSULTING

RSM

Alternative investment managers: The brewing war for tech talent

Paul O'Leary
Partner, Technology Risk Assurance
RSM UK

Steve Rake
Director
Harvey Nash Group

nvestment talent will continue to be a primary driver for most alternative investment management firms, but are the digital skills and capabilities just as valuable?

Many alternative asset managers have reported good financial results and demonstrated their resilience over the past 18 months. A key enabler for this has been the accelerated and innovative use of technology and data to allow more time and resources to be invested on business strategy, organisational design, and data-informed decision-making. Other firms have accepted less efficient working practices whilst working remotely and are now starting to consider how technology and data could be better used in the future.

Leading firms have invested significantly in their digital capabilities to:

- Better measure the strength of their operational processes through analytics and enhance key functional areas such as tax, regulatory compliance, reporting and investor servicing.
- Understand how changes in operational demand drivers relating to new products, new strategies, new distribution channels and volume of transactions impact their complexity profile and inform strategic planning.
- Identify and measure cost reduction opportunities, including the use of automated workflows, straight-through processing of data, and automating routine and repeatable processes.
- However, for organisations that have started to realise the benefits from embracing digital technology, to have a successful execution of the strategy requires tech talent that is in high demand such as software development, architecture, big data and analytics, cloud, and cyber security.

What tech talent is in demand?

Based on our experience, alternative investment managers are seeking:

- **Big data and advanced analytics** — advanced analytics and visualisation provides insights across the entire investment lifecycle. Big data provides the technologies to capture and enrich the data, while advanced analytics applies the algorithms to create insights from the aggregated data that can be actioned. Anecdotal evidence suggests that the number of firms using this to unearth new investment opportunities and underpin new strategies is only going to increase.

- **Cyber security** — business risk goes beyond portfolio performance and market risk. Investors and regulators hold the Board and senior management accountable for making proportionate investment when dealing with cyber security. While alternative investment manager have their own unique challenges, they understand the threats. To address new security challenges, they are adopting a relentless focus on protecting the firm's revenue streams, business processes, intellectual property and client data.

- **Software development** — artificial intelligence (AI) and robotic process automation (RPA) solutions are now commonly being used. Examples include identifying key contractual risks and obligations from agreements, automating know-your-customer processes, self-help chat bots, and progressing new investment opportunities only when they meet predefined criteria.

How do you attract and retain tech talent?

If someone tells you that culture and social purpose are the most important things when looking for a job, you are in the presence of a very rare person indeed, because recent survey findings place 'pay' very, very firmly in that number one position.

SOURCE: Harvey Nash Tech Survey 2020

It is a rather brutal conclusion, especially where many organisations make a big play on how their mission is to change the world, but there is no doubt that one of the sector's biggest attractions is how it rewards people.

That said, it is clearly not the only factor and, research tells us, for most people pay only matters to the extent that they feel they are paid a 'fair worth' for their skills, at which point other factors become more important.
The next most important factors centre around the personal life of that person; work/life balance, flexible working, location.

It is only when we get past these that we begin to see factors that relate directly to the company or job role - working on innovative projects, company culture and a good boss. It suggests that to attract people organisations need to be able to show people how a role will work with their own personal life, not just how amazing the job is itself.

Does location matter?

The only consensus right now is that there isn't one. The roadmap for future working continues to emerge with a view that face-to-face time is valuable for collaboration, innovation, and coaching. But most envision a hybrid arrangement and, in some cases, have already indicated some may no longer need to return to 'the office' at all.

We have seen firms accelerating their approach to recruiting new talent 'outside of region', particularly when searching for the most in demand tech talent. For example, in the UK, tech hubs are expected to remain such as London, Cambridge, Manchester and Newcastle. However, there are also some new hotspots emerging such as Bristol, Leeds, Basingstoke, and Sunderland. This is generally happening across the globe and other examples would include central European countries looking to utilise talent in Eastern Europe and the Americas as a whole, being a talent pool for managers in the US. As well as expanding the available talent pool, there is also an opportunity to build a much more diverse and inclusive team.

Of course, the other key consideration, is the accessibility and augmentation of services and best of breed solutions provided by third parties. An example of this at work is in the UK, there can be near-shoring (e.g. Ukraine) and off-shoring (e.g. Vietnam) as options. Another alternative is the virtual chief information security officer (VCISO) option, which is gaining traction. Partnering for software development can also provide a cost-effective opportunity to maximise productivity and value.

What is clear is that alternative investment management firms have an opportunity to accelerate their digital strategy, and this will require skills and capabilities which are in high demand, clarity on the desired business outcomes, and a path to achieve them.

Cybersecurity and cyber insurance: The multimillion dollar ransomware industry and current state of play

Edward Brennan
Executive Director, Head of Howden FI Retail
Howden Insurance Brokers

Neil Warlow
Associate Director, Legal, Technical and Claims
Howden Insurance Brokers

Asset managers have historically considered themselves relatively insulated against cyber incidents compared to other finance sectors. They have no major public-facing network exposures, and an income stream that is somewhat shielded against interruptions. However cyber security and ransomware is big news. Attacks are more frequent, more sophisticated and more severe, and the asset management space is certainly not immune.

Recent reported examples include an attack on TCW and MetWest Funds in June 2020,[1] and in Q4 2020 data from asset and wealth management companies was found on public data leak sites by ransomware operators Sodinokibi and NetWalker.[2] With these recent attacks, attitudes now appear to be changing, with increased investment in cybersecurity and cyber insurance. That is not before time. In the ongoing game of chicken and egg, investment in cybersecurity in other sectors risked the asset management industry becoming 'low hanging fruit' for cyber criminals.

Attacks on major institutions indicate, though, that increased cyber security is not a complete answer to the issue. Cyber insurance offers a key complementary means of protection — but the cyber insurance market is heavily impacted by recent developments and in a state of significant flux. So what are the key developments, and what do policyholders need to know when they come to consider their exposures and policy renewals? We'll seek to answer those questions below.

Ransomware — big news; even greater cost

Ransomware attacks are now frequently in the press — first coming to public attention with the NotPetya attack in 2017 and progressing through to recent examples such as the attack by the DarkSide group on the Colonial Pipeline in the United States. Publicly reported examples are, however, the tip of the iceberg and there are a number of factors at play that have driven this.

First, frequency of attacks has increased as barriers to entry have reduced (in terms both of skills and cost). Ransomware-as-a service (RaaS) is now a common business model, with a central developer providing specialist software development and operation, and charging fees for use by either third party or affiliated

1 https://www.institutionalinvestor.com/article/b1mf8l9ksvfhm2/Cyber-Attackers-Hit-Bond-Giant-TCW-MetWest-Funds?utm_medium=email&utm_campaign=The%20Essential%20II%2007102020&utm_content=The%20Essential%20II%2007102020%20Version%20A%20CID_652ed4b8ad135c4eeeac5d046a8c12aa&utm_source=CampaignMonitorEmail&utm_term=Cyber%20Attackers%20Hit%20Bond%20Giant%20TCW%20MetWest%20Funds

2 https://www.digitalshadows.com/blog-and-research/threats-to-asset-and-wealth-management-in-2020-2021/

groups who conduct the attacks themselves. Some of the most high profile and sophisticated groups operate in this manner, using a closed list of associates – including for example the REvil/Sodinokibi group, whose attacks crippled Travelex in late 2019 and have more recently targeted Acer[3] and Pierre Fabre[4] with US$50 million and US$25 million demands respectively.

The nature of attacks also continues to develop. Traditional ransomware attacks involved only encryption of data, but from late 2019 there was a shift to include theft of files prior to encryption. That has now developed such that there are dedicated data leak sites for each ransomware operation. This, in turn, appears to be extending to attackers contacting journalists, emailing major customers directly, and now even reaching out to market traders and offering inside information (allowing investors to avoid losses when the attack becomes public).[5] The theft of data and threat of public shaming provides attackers with additional leverage even in the event that the target is able to restore their systems. All of this increases the complexity and cost of response, both financially and in management time, as well as potential future related exposures.

Finally, ransomware attacks have not only grown in frequency, but have grown exponentially in cost and severity. The average ransomware payment rose from approximately US$100,000 in Q1 2020, to US$233,817 in Q3 2020,[6] though has fallen slightly since (driven, it is suggested, by increased unwillingness of victims to meet demands). That cost is, though, only part of the relevant loss. The average cost to rectify the impact (considering downtime, people time, device costs, ransom and other costs) has been calculated at US$732,520 for organisations that don't pay the ransom, rising to US$1,448,458 for organisations that do pay[7] — indicative both of the ransom cost but also the more complex nature of those incidents.

How is the cyber insurance market responding?

The increased frequency and severity of cyber incidents generally, but ransomware attacks in particular, has had a direct impact on the profitability of insurers' books of business. Insurers are also concerned by a number of other factors — including increased exposures due to the rise of remote working; increasing regulatory risk globally; and attacks on software and managed security service providers which potentially impact thousands of companies (such as the recent SolarWinds and Microsoft Exchange hacks). Increasing loss ratios and the prospect of claims aggregation (multiple linked claims) is attracting more attention from senior executives and reinsurers. This is putting pressure on underwriters to raise rates and manage exposures and line sizes.

The industry has responded with upwards pricing momentum, which started in 2020 but has increased considerably in the early months of 2021. Insurers are applying increasingly stringent underwriting guidelines, and/or have pulled back from writing certain classes of business or reduced their available limits of cover. This has resulted in significantly increased costs, with projected rate increases starting anywhere from 30% to 50% on average (even where the insured has not itself been subject of an incident). This has impacted not just primary layers of cover, but also excess layers given the increase in claim values — the exposed 'burn' layer for large privacy risks, for example, has increased considerably.

3 https://www.bleepingcomputer.com/news/security/computer-giant-acer-hit-by-50-million-ransomware-attack/

4 https://www.bleepingcomputer.com/news/security/leading-cosmetics-group-pierre-fabre-hit-with-25-million-ransomware-attack/

5 https://www.scmagazine.com/home/security-news/ransomware/ransomware-gang-offers-traders-inside-scoop-on-attack-victims-so-they-can-short-sell-their-stocks/

6 https://www.coveware.com/blog/ransomware-marketplace-report-q4-2020

7 https://secure2.sophos.com/en-us/medialibrary/Gated-Assets/white-papers/sophos-the-state-of-ransomware-2020-wp.pdf

Cover does of course remain available, and the benefits of that cover are considerable. However insurers are able to be selective in their underwriting and pricing. It is therefore critical that to mitigate the impact of the market, clients engage early and positively with their broker ahead of renewal, and ensure that adequate responses are provided to insurer questions where possible.

What is 'silent cyber' and what additional impact does that have?

Whilst individual client risks are increasing, insurance industry-wide changes also mean that specific cyber insurance policies are more important than ever for asset management firms. This has been ultimately driven by the requirement from 1 January 2021 for the insurers known as 'Lloyd's syndicates' to clarify their position on 'silent cyber' in professional indemnity (PI) policies. 'Silent cyber' is the term used for potential cyber exposures in traditional property or liability policies, where cyber coverage is neither explicitly excluded nor clearly included. This can result in ambiguous coverage, an increased risk of disputes, and cover that doesn't match policyholder expectations. Lloyd's of London, insurers and regulators are concerned that underwriting and risk pricing may not accurately reflect the cyber risks for which cover is 'silently' provided. The Prudential Regulatory Authority (in January 2019[8]) and then Lloyd's (in July 2019[9]) have made insurers put into action plans to reduce those 'silent' exposures - either by excluding them, or providing affirmative coverage.

The process is likely to be ongoing for some time. However given the mandate and the short timeline, most Lloyd's syndicates have initially moved to exclude rather than to affirm cover – and they have been followed by company insurers (given the PRA intervention). Some had already started to put this in place before the deadline, while others are only now responding or have not yet reacted.

The ultimate impact is that policyholders are likely to see cyber exclusions being discussed and potentially applied to their PI policies on renewal. Exclusions vary in scope, but even if narrowly framed the intent is to ensure that specific cyber insurance policies are now the core 'home' for cyber-related exposures — both first party costs and third party liabilities.

Accordingly, policyholders will need to carefully review their current policies alongside their broker and examine any exclusion proposed, to ensure that it is fully understood and not overly broad. They should also assess the extent to which they already have cover for cyber liabilities in place. Despite the difficult market discussed above, in many cases a standalone cyber policy will remain the best solution to ensure coverage and fill gaps resulting from a silent cyber exclusion.

8 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2019/cyber-underwriting-risk-follow-up-survey-results

9 https://www.lloyds.com/~/media/files/the-market/communications/market-bulletins/2019/07/y5258.pdf

howden

Helping you to achieve more in a challenging market place

It has never been so important to work together with an Insurance Broker that understands both the sector that you operate in and your unique business risk profile.

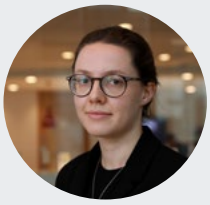
Howden Asset Management is the largest specialist broking team in your sector.

Our London based team of over 30 dedicated experts offer a wide and integrated service to our broad client base, providing innovative insurance products, placement negotiation and claims advocacy across all lines of insurance.

To find out more, please contact:

Ed Brennan
Executive Director
T: +44 (0)7891 963 416
E: edward.brennan@howdengroup.com

Dale Smith
Manager, Financial Services International
Tax and Transaction Services
EY, UK
Email Dale Smith



Mark Boyle
Partner, Financial Services International
Tax and Transaction Services
EY, UK
Email Mark Boyle

Clare Eagle
Advisor, Financial Services International
Tax and Transaction Services
EY, UK
Email Clare Eagle

Darrin Henderson
Associate Partner, Financial Services
International Tax and Transaction Services
EY, UK
Email Darrin Henderson

UK asset holding companies for credit funds

At Spring Budget 2020, the government announced an initial consultation on the tax treatment of asset holding companies (AHCs) in alternative fund structures.

The government published its response to the consultation in December 2020 and announced a second-stage consultation which concluded in February 2021. In parallel with this the government launched a wider non-tax-specific review of the UK funds regime in January 2021 and is also expected to take forward a review of the VAT treatment of fund management fees during 2021.

The launch of these consultations provides a strong indication of the direction of travel of UK government policy surrounding the asset management and funds industry. This article discusses the possible tax features of a UK AHC regime, with a focus on the issues of most relevance to the credit fund industry.

To date, asset-holding SPVs within credit fund structures have generally been located in jurisdictions which tax the SPVs on a margin commensurate with the role performed in aggregating investment profits and returning this to investors. However, under current UK rules, tax deductions for distributions are typically limited where results vary depending on the performance of the underlying investments.

Consequently, it can be difficult for investors to generate returns linked to the performance of an underlying investment in a tax-efficient manner where such investments are held by a UK entity.

What could the future of UK fund taxation look like?

In response to the initial AHC consultation, the government has confirmed there is a clear case to introduce a new and bespoke tax regime for AHCs, rather than by making general changes to the UK tax system. The regime is expected to be elective in nature, and subject to eligibility requirements.

Substantial progress has been made with the public consultation process on the AHC regime to date, with draft legislation expected during 2021, followed by a technical consultation period ahead of its inclusion in the next Finance Bill. We

outline below some of the key pressure points associated with an AHC regime which have been identified by the government in response to the consultation to date.

What could a new AHC regime look like?

In the Government's responses to the initial AHC consultation, three features were outlined as being key for a new AHC regime:

1. Robust eligibility criteria to limit access to intended users (i.e., investing funds rather than corporate groups)

2. The AHC being a taxable entity, and liable to UK corporation tax to a degree commensurate with its role

3. Rules to ensure UK investors are taxed on income and gains received from an AHC broadly as if they had invested in the underlying assets directly

We consider below how such goals may be achieved in practice.

1) Eligibility

Investors

The AHC regime is expected to focus on structures which facilitate pooling of capital from either multiple unconnected investors, or institutional investors acting as an investment channel for others. However, the rules should also accommodate situations where investments are made by strategic co-investment partners or indirectly via special purpose vehicles.

The regime may require that either an AHC is owned by a vehicle which itself falls within an already well-defined fund regime for UK regulatory purposes (e.g. a collective investment scheme (CIS) or alternative investment fund (AIF)), or alternatively, there may be requirements such that an AHC is not itself controlled by a small number of non-institutional investors, via some form of 'non-close' test. Alternatively it has been suggested that the regime could leverage the definition of 'excluded entities' within the OECD Base Erosion and Profit Shifting (BEPS) 2.0 Report on Pillar Two Blueprint.

Managers

To be eligible for the AHC regime, assets held by an AHC may be required to be managed by an independent investment manager, authorised to undertake asset management and subject to supervision in its jurisdiction. The definition of 'independent' may draw on regulatory concepts or tax definitions (e.g. the independent capacity definition used for the investment manager exemption (IME)).

Character and activities

The required activity of an AHC will likely be to enable investors to participate in or receive profits or income arising from the acquisition, holding, management or disposal of certain investment assets. The Government note that definitions for such character and activities may be derived from established regulatory or tax definitions.

Additional characteristics of an AHC may include a minimum capital requirement, or a well-defined investment policy and practice of reinvesting or returning capital to participants when assets are sold.

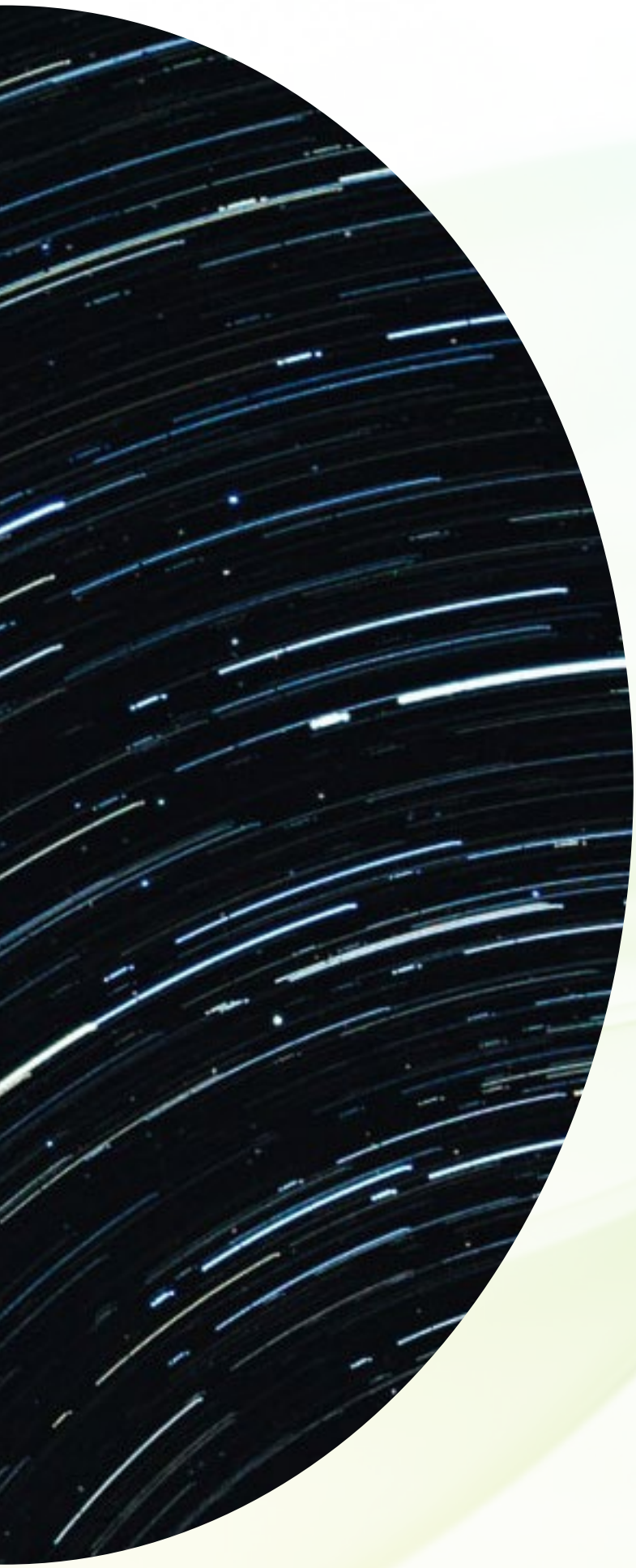
2) Taxation of AHCs

The UK government have confirmed that AHCs will be subject to UK corporation tax via a specific regime, and that the taxation of an AHC should be commensurate with the activities it performs in facilitating the flow of income and capital between investors and investment assets. A successful AHC regime should therefore result in an AHC being taxed on a profit margin, with investors not being materially disadvantaged by indirectly investing in assets via an AHC rather than doing so directly.

The government has set out several possible approaches to achieving this goal.

Deductions for payments to investors

As noted above, under current UK tax rules, deductions on distributions are typically limited where results vary depending on the performance of the underlying investment portfolio. Therefore, where distributions to investors are linked to the performance



of underlying assets, an AHC could suffer taxation on significant profits in a period where investments have performed well.

To address this issue, the AHC regime may allow AHCs to obtain tax deductions for interest payments on results-dependent debt. Alternatively, it may permit tax deductions as expenses for any amounts returned to investors, regardless of the method of return.

Transfer pricing

An AHC should not be able to obtain relief for payments to investors that would reduce its profit below an amount commensurate with its role. This could be achieved by ensuring transfer pricing rules apply to tax an AHC in line with the complexity of its operations.

Withholding taxes (WHT)

Under current tax rules, payments of UK-sourced yearly interest to non-residents are generally, absent the availability of any domestic or treaty reliefs, subject to WHT at 20%. While overseas funds can generally claim relief, the Government recognises that this can be administratively cumbersome.

As such, the second stage AHC consultation considers whether a bespoke WHT exemption for AHCs making interest payments may be appropriate. Such an exemption would likely need to be supported by some form of main purpose test or qualifying territories list, to avoid artificial diversion of investment income to low-tax territories.

3) Taxation of UK investors

Under the AHC regime, UK investors in an AHC should be taxed on amounts received from an AHC in accordance with the character of the underlying income (or gain).

If an AHC has obtained relief against taxable income in respect of payments to UK investors, the regime should include rules to ensure such amounts are taxable as income (not capital) in the hands of the UK investors. These rules should also include specific overrides to ensure amounts treated as interest in the hands of UK investors are taxed as income, even where the payment

made may be classed as a distribution at the AHC level. The government also notes in the second-round consultation that distributions to UK investors associated with assets within the loan relationship rules will be considered as income, even where such amounts arguably have a capital component.

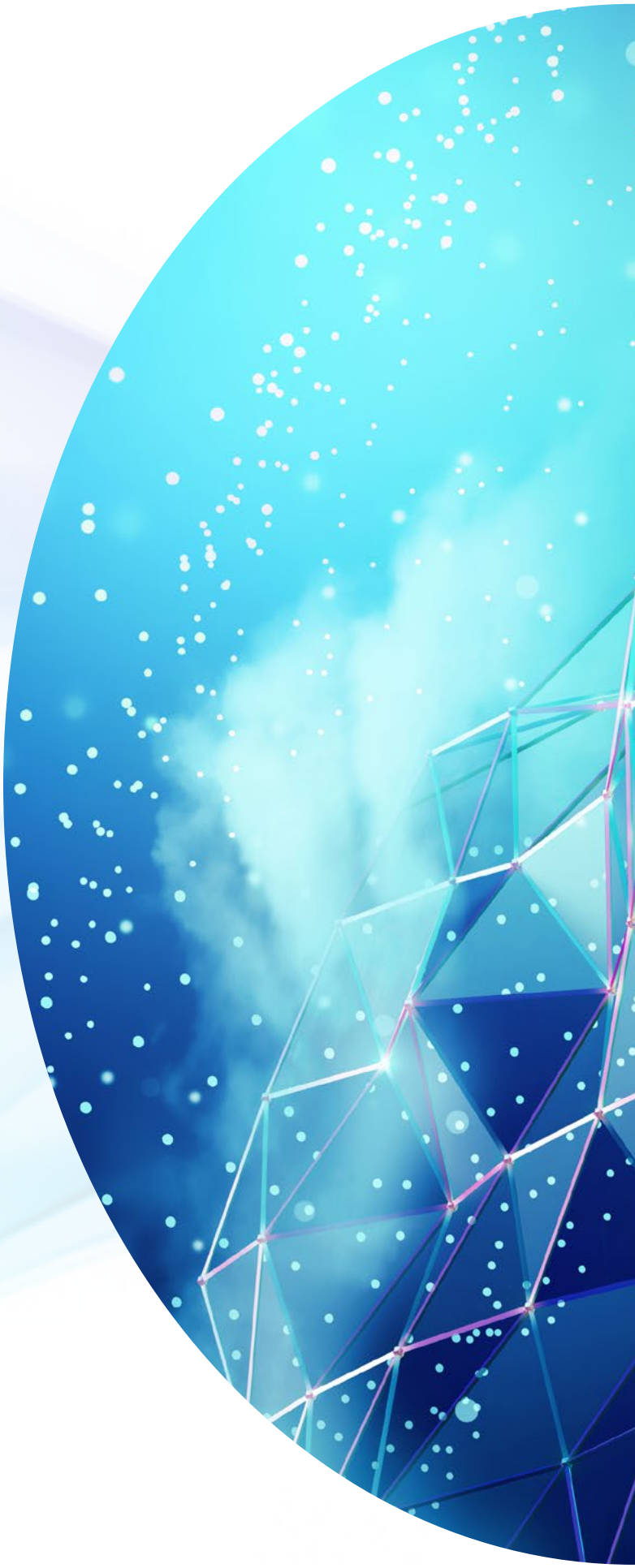
Non-domiciles

Non-domiciled UK residents (non-doms) generally do not pay tax on foreign income or gains unless they are remitted into the UK. The government acknowledges that absent any specific rule, investments in a UK AHC by a non-dom may represent a remittance. To ensure an AHC is also attractive to non-doms, the regime should be drafted so that an AHC falls outside the remittance legislation.

Implications for asset management groups

2021 will be an important year for asset managers and funds, with responses to the UK funds regime review expected later in the year, draft legislation associated with ongoing consultations to be included in the Finance Bill and a commitment from the Government to take forward a review of the VAT treatment of fund management fees.

The global tax environment is evolving, and conditions associated with beneficial ownership, economic substance and purpose are often key requirements to the success of any claim for withholding tax or capital gains relief under many double tax treaties. The presence in the UK of a developed financial services infrastructure, expertise in portfolio management, and a well-defined regulatory and legal framework mean that going forward it may increasingly be viewed as an appropriate jurisdiction for the location of AHCs in terms of commercial purpose and substance.



Brexit simplifies? FCA consultation on changes to UK MiFID's conduct and organisational requirements

Richard Frase
Partner
Dechert LLP

Philippa List
Professional Support Lawyer
Dechert LLP

Simon Wright
Counsel
Dechert LLP

On 28 April 2021, the UK's Financial Conduct Authority (FCA) published a consultation paper (CP21/9)[1] setting out proposals to change certain conduct and "best execution" obligations required under the UK implementation of the second Markets in Financial Instruments Directive (UK MiFID) . In this article we look in detail at the proposals and the impact they would have on market participants.

Why is the FCA proposing changes?

Following the on-shoring of EU legislation post-Brexit, UK MiFID is now spread across primary and secondary legislation, the FCA's Handbook and regulatory technical standards. The FCA is working with HM Treasury on capital markets reform, which involves looking at the UK's regulatory regime for capital markets to develop a package of changes. These changes are to ensure the regulation of investment business in the UK is adapted to the specific structures of UK markets. CP21/9 forms part of the capital markets reform work, and covers changes in two areas to the conduct and organisational rules in UK MiFID.

Proposed changes

SME and fixed income, currencies and commodities (FICC) research

Historically, many equity brokerage firms 'bundled' research costs with transaction commissions (i.e. the cost charged to clients to trade in shares) so that investment managers buying execution services were paying at the same time for research.

MiFID II required executing brokers to charge only for their execution costs, and for any research to be billed separately. This requirement applies not only to commission charges on equity trades, but also to principal dealers such as bond traders who did not charge a commission but instead made a turn on the bid-offer spread they quoted. Investment managers receiving research are currently required either to pay for research themselves from their own resources or agree a separate research charge with their clients. Any other form of inducements linked to an execution service was prohibited (the inducements prohibition), apart from a limited range of low-level inducements known as 'minor non-monetary benefits'.

The FCA is proposing to broaden the list of permitted minor non-monetary benefits to include research on small and medium-sized enterprise (SMEs) with a market cap below £200 million and FICC research, so that they will no longer be subject to the current prohibition on investment managers receiving 'free' research as an inducement to give business to the research provider. The FCA also plans to make rule changes on how inducement rules apply to openly available research and research provided by independent research providers.

1 FCA Consultation Paper 21/9 is available here.

The SME exemption

The FCA proposes creating an exemption from the inducement rules for SME research below a market capitalisation of £200 million. The £200 million threshold would be assessed for the 36 calendar months preceding the provision of the research, provided it is offered on a re-bundled basis or for free. Under the exemption, research on such firms that is provided on a re-bundled basis or for free would constitute an acceptable minor non-monetary benefit and therefore not be an inducement.

The FICC exemption

The FCA proposes to create an exemption from the inducements rules for third party research that is received by a firm providing investment services or ancillary services to clients, where it is received in connection with an investment strategy primarily relating to FICC instruments. The proposal would allow FICC research to be 'rebundled'.

In fact, the market has been saying for some time that the requirement for investment managers to pay dealers for FICC research is unworkable because there is nothing to unbundle. The FCA for its part insisted that the research cost must somehow be included in the bid-offer spread. It appears that the FCA now accepts that this is not in fact the case, and acknowledges that bid-offer spreads have not narrowed as a result of the unbundling requirement.

Further research exemptions

The FCA proposes to create an exemption for research provided by independent research providers, by including in the list of minor non-monetary benefits research provided by independent research providers, where the independent research provider is not engaged in execution services and is not part of a financial services group that includes an investment firm that offers execution or brokerage services. The FCA's final proposal relates to 'openly available research'. The list of minor non-monetary benefits will be extended to include written material that is made openly available from a third party to any firms wishing to receive it or to the general public.

Best execution reports

MiFID II introduced reporting requirements for execution venues (RTS 27) and for firms executing and transmitting client orders (RTS 28). The aim was to improve investor protection and transparency as to how brokers execute client orders.

RTS 27 requires execution venues to publish quarterly execution quality metrics at the level of individual financial instruments.

RTS 28 requires executing firms to publish an annual report listing the top-five execution venues where they have sent client orders in the preceding year, and a summary of the execution outcomes they have achieved, broken down by venue and class of instrument. Firms who carry out portfolio management or reception and transmission of orders are required by the UK MiFID delegated regulation to produce reports equivalent to RTS 28.

The FCA's view is that RTS 27 and RTS 28 have not delivered on their objectives in a meaningful or effective way and are not used by market participants, while at the same time being costly for execution venues and firms to produce.

As a result, the FCA is proposing to remove these two sets of reporting obligations from the FCA Handbook. CP21/9 is silent on whether firms can continue to provide the RTS 27 and 28 reports if they wish to do so (as opposed to being obliged to provide the reports).

For portfolio managers and firms who receive and transmit orders, the requirements are not in the FCA Handbook but in secondary legislation in the UK MiFID delegated regulation. HM Treasury is considering the case for amending the delegated regulation in line with the FCA's proposed changes. The FCA says that its changes to the FCA Handbook are dependent upon whether or not such changes are also made to the secondary legislation.

How will the proposed changes be made?

The FCA proposes to effect the changes by making amendments to the Conduct of Business Sourcebook and the Technical Standards (Markets in Financial Instruments Regulation) (Best Execution) Instrument 2021. Appendix 1 to CP 21/9 sets out the draft text of the amendments.

Are the proposed changes a UK version of the EU's MiFID 'quick fix'?

In 2020 the European Commission consulted on possible changes to MiFID II. That consultation led to a number of changes to MiFID II — referred to as MiFID 'quick-fix'. The EU enacted these changes in February 2021 as part of its Capital Markets Recovery Package to support post-COVID-19 economic recovery.

The MiFID 'quick fix' amendments were published in the Official Journal of the EU on 26 February 2021, and EU Member States are required to transpose them into their national frameworks by 28 November 2021, with amendments due to apply from 28 February 2022. As these changes were agreed and will take effect after the end of the Brexit transition period, they do not apply in the UK.

However, whist the FCA's proposed changes cover two areas included in the MiFID 'quick fix' package, the FCA's changes as set out in CP 21/9 do not go further and propose that the UK on-shores the remaining parts of the EU's MiFID 'quick fix' package. Several other changes in the EU's MiFID 'quick fix' package would, in the FCA's view, be best made through changes to the UK MiFID delegated regulation, and it is expected that HM Treasury will propose changes to the delegated regulation in due course.

What next?

The FCA is looking for responses to CP 21/9 by 23 June 2021 and will then consider the feedback it receives. If the FCA chooses to proceed, it would publish any rules or guidance in a Policy Statement in the second half of 2021.

Following CP 21/9, HM Treasury will issue a consultation paper looking at the broad themes of capital markets reform and cover a range of high-level and more detailed questions. It will help prepare the ground, in due course, for proposals for changes to primary legislation, as well as helping to establish changes that could be made more quickly through secondary legislation.

Connall McGuckian
COO, Alternative Investment Solutions, Asia Pacific
State Street

“Assessing opportunities in Asia’s evolving funds landscape”

Fund onshoring has become an increasingly prominent trend in Asia as international tax and regulatory requirements have evolved. At a recent roundtable discussion, we explored the fund landscape in Singapore and Hong Kong and discussed some of the structural differences between Hong Kong’s Limited Partnership Fund (LPF) and Singapore’s Variable Capital Company (VCC), two fund structures that were enacted in 2020 to attract global fund managers to set-up shop in Asia.

Speakers included **Armin Choksey**, partner at PwC in Singapore, and key author of a white paper on VCCs and instrumental in the legislation; **Michael Atkinson,** partner at PwC in Hong Kong and a financial services specialist; along with State Street’s **Cora Tang**, managing director of the Alternatives segment in Hong Kong.

Hong Kong’s LPF was passed into law on 31 August 2020, replacing the Limited Partnership Ordinance (LPO), which had lacked the flexibility demanded by modern asset managers. The LPF was the missing link to provide for private equity and venture capital funds that are usually closed-ended. Fund managers are already showing willingness to sign up, with 211 LPFs registered with the Company Registry as of 30 April.

Meanwhile, Singapore enacted its VCC on 15 January 2020, aimed at providing investment funds with greater flexibility in the treatment and movement of capital. Around 250 managers have used the structure to date. The two vehicles have many similarities, as both were created with the goal of simplifying regulations to entice investors to domicile their funds onshore.

Table: Similarities between Singapore’s VCC and Hong Kong’s LPF

SINGAPORE VCC	HONG KONG LPF
Enacted on 15 January 2020	Passed into law on 31 August 2020
Investment agnostic — it does not state what you can and cannot invest in	Contractual freedom — no requirements on what you can and cannot invest in
Provides flexibility for shareholders entering and exiting the fund	Allows withdrawal of capital contributions and distribution of profits
Can apply for an exemption that reduces the corporate tax rate from 17% to 0%	Concessional tax treatment for carried interest (effective from 1 April 2020) and 0% tax rate for qualifying carried interest. Examples include carried interest received from private company investments.
Requires a Singapore office	Requires a registered office in Hong Kong
Must have a fund manager that is licenced and regulated in Singapore	Needs an investment manager that is a Hong Kong resident
Appeals more to collective investment schemes	Appeals more to private equity and venture capital

Advantages of LPFs and VCCs that are appealing to fund managers

Which attributes of the new fund legislation are resonating most with asset managers?

Cora Tang: LPF has the whole industry very excited. It's the right direction to enhance Hong Kong's competitiveness in the asset management space, but the majority of clients are taking a wait-andsee approach. They still lean toward what investors are familiar with, which is Cayman or the British Virgin Islands and are eagerly waiting for the carried interest bill to pass*.

Armin Choksey: Singapore sits on a network of 90-plus double-taxation treaties. Therefore, it enables the VCC fund structure to be tax efficient if it is domiciled in Singapore and has a legal entity status. A unit trust and a limited partnership do not get a legal entity status. The VCC's distinction is its umbrella-like feature. You can break it into pieces and run it as an umbrella structure with various sub funds, where each sub-fund's assets are legally segregated — the assets of one sub-fund can never be utilised to extinguish the liabilities of another.

Michael Atkinson: There are quite a lot of advantages to LPFs. The definition of the fund in the legislation is fairly broad and similar to the VCC. It's very commercial.

Similar to the Cayman's Exempted Limited Partnership structure, to which LPF is frequently compared, an LPF allows different types of investment strategies. The LPF is currently most attractive to the private equity and venture capital industry, who were instrumental in getting LPF created.

The LPF brings an equivalent structure to Hong Kong to those that were typically being set up overseas. Now, fund managers will have the option to only have to deal with considerations, laws and regulations of Hong Kong. Not having to deal with different jurisdictions obviously has some advantages. It's also very cost effective to set up.

Early demand from Chinese and global fund managers

How strong has the industry's appetite for LPF and VCC been so far?

Armin Choksey: It is driven by need and the cost differential plays a part too. From a business perspective, both Singapore and Hong Kong are very open as a place to do business, and there are only marginal differences in the licensing, registration and time to market. Ultimately, it's the institution's organisational structure or preference. If they want proximity to China then it makes sense to be in Hong Kong.

We have a separate North Asian task force because of language, as well as the number of queries coming in. There is growing interest among Chinese high-net-worth investors as well as Chinese managers to set up their operations outside, and they're looking at Singapore a lot more. But these are enquiries. We are yet to see that translating into actual domiciliation and launches. That is mainly because these enquiries only started at the end of last year and nobody can make a decision that quickly.

Cora Tang: For Chinese asset managers it really depends on what type of limited partnership (LP) they are targetting. If managers are capturing funding from the United States or Europe, they will probably be inclined to use the Cayman Islands and Singapore.

If managers are aiming for offshore capital from Hong Kong and China then the LPF would be their preference. This trend might change when international LPs become more familiar with Hong Kong's LPF structure.

Quite a few global asset management clients have already set up a VCC structure. The VCC has definitely been the front runner.

Michael Atkinson: In Hong Kong there's interest from local managers and family offices, and China's asset managers. Asian investors often look more towards the general partner to set the appropriate structure, so they have more freedom to launch an LPF.

We see quite a few well-established private equity players who have established one, or in some cases, multiple LPs. We are also seeing boutique or niche firm's register an LPF. I would say that the interest is often governed by who those fund managers are targetting as investors.

Near-term developments to monitor

Can fund managers expect more positive news – on VCC 2.0 and carried interest rules – in the near future?

Armin Choksey: Will there be an uplift to VCC? Yes, there is a plan. It has has been coined VCC 2.0, and that's the market term for it now. Hopefully, this will allow the VCC to be expanded to the single-family office sector as wealth management is very big in Singapore. There is also a hope to allow the real estate sector – currently exempted — to utilise the VCC. There could be some news about it in 2022, so a wish list has been created and shared with the Monetary Authority of Singapore. Obviously, there are policy decisions to be made and research of demand, at which point a framework would be developed for legislation.

Michael Atkinson: Hong Kong's carried interest tax concession is something that has been very long in the making. The industry has been lobbying for this for quite some time. There was always that level of uncertainty in Hong Kong as to how the local tax authority would view carried interest. Would the authority view carried interest as income from services being provided, or would the authority view carried interest as the industry always hoped it would — as a capital gain?

In the Hong Kong tax regime, capital gains are exempt from tax, but you pay corporate tax on service and fee income. So, it will be a very big difference for Hong Kong managers if carried interest was considered income rather than capital. What the tax concession basically brings in is a 0% tax rate on eligible carried interest for a corporation.

It also allows employees who receive eligible carried interest from having to declare that amount as employment income. So, it creates an exemption from salaries tax as well. That bill came out at the end of January and although it still needs to be passed*, it was very well received by the industry, because it helps to eradicate that uncertainty that previously was there.

**After this roundtable discussion took place, the bill was gazetted and formally became law on Friday 7th May 2021.*

Silos.
Great for corn.
Bad for data.

Real time intelligence.
One single source of truth.

Full-cycle data management on

STATE STREET ALPHA℠

statestreet.com/alpha

Fiona Fong
Partner
Deacons

Reforms and incentives provide Hong Kong with an attractive private fund platform

Hong Kong introduced the open-ended fund company (OFC) regime in 2018 to provide an option for collective investment funds to be established in corporate form. For many Hong Kong-based fund managers, the default hedge fund structure has historically been an offshore limited liability company: the OFC regime offers an alternative domestic legal structure.

The advantages for a Hong Kong manager in setting up an OFC over an offshore fund mostly centre on the simplicity and savings in management time and money in dealing with a single jurisdiction and a single regulator. However, interest in launching OFCs was at the outset lukewarm, largely due to drawbacks, such as investment restrictions, affecting private funds and their managers.

In September 2020, the Hong Kong Securities and Futures Commission (SFC) introduced welcome enhancements to increase the competitiveness of the private OFC. Shortly after, the government promised financial incentives to promote the regime, and issued a much anticipated proposal to allow offshore funds to migrate to Hong Kong.

Key features of the private OFC

Structure

An OFC is a Hong Kong-incorporated company with separate legal entity status. Designed as a fund vehicle, it has greater flexibility than conventional companies incorporated under Hong Kong's Companies Ordinance. OFCs can be set up either as standalone funds or as umbrella funds with segregated liability between its sub-funds. Investors hold shares that are transferable and redeemable. The OFC will have shareholder-investors, a board of directors responsible for its governance, a fund manager and a custodian of assets. The fund manager has to be licensed or registered with the SFC for type 9 (asset management) regulated activities.

Regulator

The SFC is the primary body responsible for the registration and regulation of OFCs. The Companies Registry (CR) is responsible for the incorporation and administration of the OFC's statutory corporate filings.

Establishment

OFCs benefit from a simple, one-stop process for registration, incorporation and business registration which requires direct dealings only with the SFC. The SFC will then notify the CR of the registration of an OFC and the CR will issue a certificate of incorporation. Business registration with the Inland Revenue Department is conducted in the same manner.

Taxation

Upon the introduction of the regime, a major drawback related to the limited and complex exemption from taxation for private OFCs. This was addressed in 2019 when Hong Kong enacted legislation which extended a tax exemption for offshore funds to those domiciled in Hong Kong, subject to certain conditions, and removed any advantage enjoyed previously by overseas domiciled funds to qualify for relief from Hong Kong profits tax.

Enhancements to the OFC regime

On 11 September 2020, following a market consultation, the SFC published its Consultation Conclusions on Proposed Enhancements to the OFC Regime which introduced a number of reforms to better meet the needs of the industry.

Removal of investment restrictions

One change was to remove the requirement for a private OFC to invest at least 90% of its gross asset value in securities and futures contracts

as defined under the Securities and Futures Ordinance. Private OFCs now face no restrictions on the types of investments they can make or on the size of their position in any given investment, subject only to any investment restrictions in their offering document.

Expansion of entities eligible to act as custodians

Until the enhancements took effect, the custodian of an OFC had to be a Hong Kong or overseas bank, or a trustee of a registered scheme under Hong Kong's Mandatory Provident Fund Schemes Ordinance. The SFC has expanded the category of eligible entities, to include entities licensed or registered with the SFC for type 1 regulated activity (dealing in securities). This allows for an OFC to appoint its broker (provided it is appropriately licensed) as its custodian. The SFC also confirmed that an OFC may appoint multiple custodians; a hedge fund structured as a private OFC may appoint both a cash custodian and one or more prime brokers as the top-level custodians.

Re-domiciliation of offshore funds to Hong Kong

For many Hong Kong based fund managers, an obvious missing piece to the regime was the lack of a practical re-domiciliation mechanism to migrate their existing offshore funds to Hong Kong. Responding to this feedback the SFC confirmed that it will introduce such an infrastructure, and a proposal was put forward by the Financial Services and the Treasury Bureau of the Hong Kong government on 1 February 2021. Given the increasing regulatory complexities and costs for corporate funds established in overseas jurisdictions in recent years, the opportunity to transfer to Hong Kong is a welcome development. Under the proposal, existing funds can re-domicile and register an OFC in Hong Kong provided they meet the same eligibility requirements for a new fund to be registered as an OFC. The existing fund's identity will be preserved upon re-domiciliation, which translates into numerous benefits:

- Any contract made or resolution passed prior to re-domiciliation will remain intact;
- All rights, functions, liabilities or obligations, and property of the fund before its registration in Hong Kong will be preserved;
- Previous legal proceedings by or against the fund will not be rendered defective; and
- The re-domiciliation does not amount to a transfer of assets or a change in beneficial ownership, hence no stamp duty implications arise.

The proposal is expected to be introduced to Hong Kong's Legislative Council in the second quarter of 2021. We expect re-domiciliation to appeal to offshore hedge funds that are managed from Hong Kong.

Government subsidy scheme

In May 2021, the SFC announced the commencement of a grant scheme to assist with OFC set-up costs. The government has allocated HK$270 million to the scheme, which covers 70% of the expenses paid to Hong Kong based-service providers for the establishment or re-domiciliation of OFCs in Hong Kong, subject to a cap of HK$1 million per OFC. It is available on a first-come-first-served basis and is limited to a maximum of three OFCs per fund manager. The government has the right to claw back the grant if the OFC commences winding-up or terminates the registration within two years of its incorporation or re-domiciliation.

Conclusion

Hong Kong continues to support the growth of its fund management sector. The synergies of the recent reforms provide greater flexibility and more certainty to fund managers seeking to 'onshore' their funds in Hong Kong. Following the government's announcement of financial subsidies, we've seen a noticeable uptick in interest and anticipate that the use of, and opportunities arising from the OFC will continue to increase once investors become more familiar with the regime.

The information contained herein is for general guidance only, reflecting the position as at 16 June 2021, and should not be relied upon as, or treated as a substitute for, specific advice. Deacons accepts no responsibility for any loss which may arise from reliance on any of the information contained in these materials. No representation or warranty, express or implied, is given as to the accuracy, validity, timeliness or completeness of any such information.

A personal perspective on the future of discretionary asset management

Michael Weinberg
Managing Director, Head of Hedge Funds and Alternative Alpha
APG Asset Management

If you were to ask a discretionary investment fund manager to draw a Venn diagram of the set notation where digitalization meets discretionary investing, many would not show the sets as overlapping. Moreover, they believe that the investment world is bifurcated and the discretionary managers are independent of the quantitative. I would argue that not only are the two sets converging but that the quantitative managers pose an existential threat to the discretionary managers, or perhaps will 'Pac-Man'-style consume the discretionary managers.

In this paper, we will demonstrate how the 'old school' managers are under siege by quantitative managers by presenting the top-10 reasons discretionary investors tell me they are impervious to digitalisation, and refute them one by one.

1. You can't know what a black box will do

Discretionary investors will state that one can't know what a black box, i.e. a systematic model will do. Moreover, they argue that it can be like the proverbial robot that runs amok, like HAL in the film 2001: A Space Odyssey. I would argue the contrary. Best-of-breed autonomous learning investment strategies (ALIS) managers are systematic strategies based on mathematical models, statistics and have rules and risk guidelines that are human encoded. This is no different to understanding what a discretionary investor does and why. The first ALIS fund I met over five years ago was predicated on models created by Benjamin Graham and David Dodd, the founders of value investing, philosophy of investment. Moreover, I would pose, what is a bigger black box than a discretionary investor's brain? How do we know that person will follow rules, not deviate, make errors or lose one's mind?

2. AI can't and won't buy more down

Some discretionary investors contend that humans have the advantage of being able to buy more down if the thesis still holds, although, from my time as a portfolio manager at Soros Fund Management, I know that's often easier said than done. Regardless, the best managers do this despite the innate wiring that makes this difficult from a behavioural investment perspective.

However, if one has a systematic investment programme this can be automatic, not discretionary. Another comment I have heard is the fund's terms will not allow this and investors will redeem at the bottom. The fund's terms can be whatever one needs and should be cohesive with the strategy. If the strategy can suffer material draw-downs then the terms should be long enough and the liquidity staggered so that investors are not able to sell the bottom when they should be buying more. Incentives, i.e. fees, can even be structured so that investors invest more when the fund is down. Conceivably, a capital call structure could even be employed, to effectively 'force' investors to buy more down, when securities are most compelling. ALIS funds should be structured with terms that are cohesive with the investment philosophy just as discretionary funds should be.

3. Systematic strategies don't know about new product releases and related consumer sentiment

I've heard it argued that systematic strategies can't know about new product releases. Well, they can and do. Systematic managers use natural language programming (NLP) to 'learn' about new product launches as well as how they are doing. One can also systematically monitor the consumer sentiment from new product launches.

A discretionary investor may check a handful of websites, as I did while running a hedge fund portfolio. However, a systematic manager can check the sentiment on thousands (or more) of websites and aggregate that for a more accurate read very rapidly.

4. Computers can't read newspapers

When I was running portfolios, I read major newspapers and a multitude of trade publications. Aside from the voluminous quantity of trees that were eviscerated for this, it was time-consuming and often tedious. A systematic strategy can and does effectively 'read' tons of papers and trade rags with NLP effortlessly and quickly without fatigue.

5. An AI can't judge company management quality

Discretionary investors often tell us that a system can't judge management qualitatively as well as a discretionary manager can. I would contend a systematic manager can do that better. How is one judging management quality? How about using historic returns to shareholders as a proxy? Well, that's easy: a systematic programme can easily look at thousands of stocks, their C-level management, using the CEO as the independent variable, and see what the returns to shareholders, the dependent variable, under their auspices. When I ran discretionary portfolios, we did this non-systematically, by noting which management teams generated excess returns for shareholders, and then investing in companies they went to subsequently, and the opposite when we were engaging in bearish investments. Instead of investing by 'shooting from the hip' — as my former partner and visionary Jeffrey Tarrant would say — systematising this could allow one to invest more statistically and consistently; at least 'shooting from a brain' even if artificial.

6. They can't tell if a company's management is prevaricating

I will preface this one by saying we are not there yet and admittedly there are many assumptions built into this example, but, in my view, we could be there in no time. Through supervised learning and off-the-shelf web cameras, it is now possible to estimate heart rates from facial recognition videos. One instance where this could be applied is when a CEO reports a company's earnings on a videocast. A ALIS manager could theoretically use that imagery-based forecast heart rate to determine if the CEO was prevaricating. This may have implications on the fund's views on the veracity of the CEO's statements and result in buy, sell or hold recommendations on the company. One could not only analyse the current imagery but could compare it to prior imagery by the same person for greater accuracy and determine recurring patterns on the speaker's honesty. We are not there yet but it's only a matter of time.

7. A machine doesn't have the perspective in comparing companies or industries

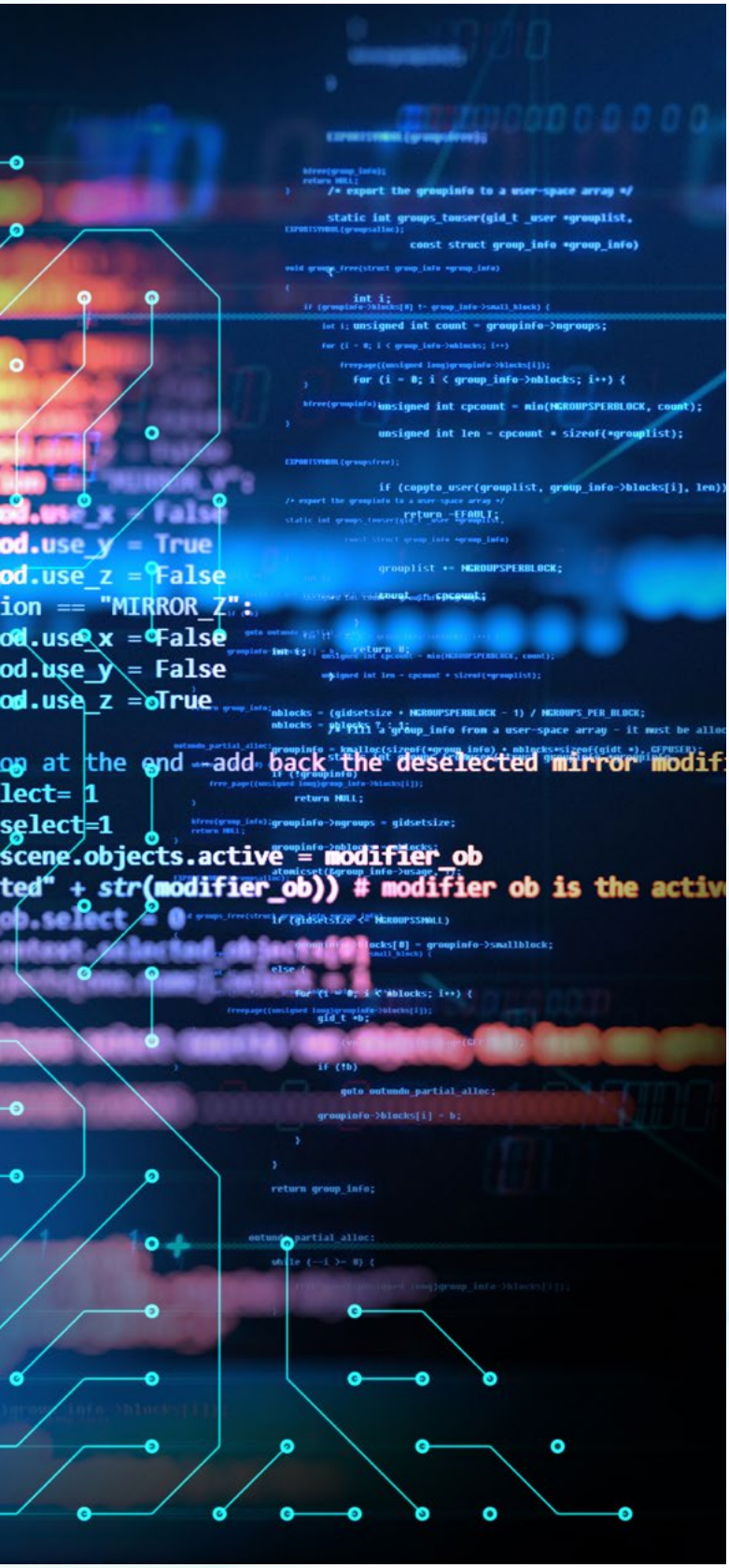
Despite this assertion, the ALIS fund based on Graham and Dodd's work uses neural nets that do exactly this. Due to a large amount of structured financial data, record low processing and storage costs, the manager not only compares companies to their prior performance and their competitors, as well as companies in other industries. Many discretionary investors are too young to remember the Nifty 50, coincidentally now nearly 50 years ago. An ALIS fund might conclude that Apple is still a value stock because it is akin to Eastman Kodak during the Nifty 50 boom, or maybe the way it looked before the bust. There are very few active analysts today that could have traded through that period and remember how that stock, along with hundreds of others behaved then.

8. Doesn't know what metrics are important for out-performance

When I ran the portfolio at Soros Fund Management, we could only look at so many data points. Some income statement metrics, some balance sheet metrics, etc. We may think we know which metrics are important in determining the value of a company. However, I know another Graham and Dodd-style ALIS fund that looks at 10,000 data points per company and through machine learning has distilled that down to the 250 most important metrics. Again, with the confluence of record low processing and storage costs, data, data science and machine learning, this is easy for an ALIS manager.

9. Can't understand what is important in a 10Q or 10k

I remember printing and reading Qs and Ks, including, for example, Enron and Adelphia during the late 90s and early 2000s. It takes some time for a person to read and understand them, especially Enrons, which for those that don't recall was hundreds of pages. For a computer using NLP, this can be done in no time and across thousands of securities. Discretionary investors may say that the computer won't pick up on red flags. On the contrary, it's easy to have the system pick up new terms related to litigation, reserves and increases or decreases in these numbers. Changes in tone can be picked up as well. Machines are now so widely applied to 'reading' 10Q and 10Ks, that company management is starting to adapt and change verbiage so that their language is 'read' by the machines as less negative, or even positively. For example, terms like 'liabilities', 'litigation' and other words, are now being extracted or replaced, with more euphemistic terms. This is a classic example of the iterative and evolutionary nature of markets, and why even systematic managers, must always be evolving, lest they suffer the same fate as discretionary managers.



10. You can't replicate a team of experts

Discretionary investors will assert that a systematic fund can't replicate a team of analysts, traders, risk managers and portfolio managers. A discretionary investor who is long cheap stocks and short expensive stocks has done exactly this with decision trees and Bayesian techniques. Two PhDs — one of those who studied at CBS, where I teach — programmed an ALIS fund to have virtual analysts, traders and portfolio managers. The virtual analysts have the metrics they look for. The virtual traders act as risk managers and can sell the virtual analysts stocks if certain parameters are hit, i.e. the stock is within x% of the target or the company is reporting earnings and the street opinion is too one-sided. The virtual portfolio managers optimise position sizing and portfolio construction as a human portfolio manager would. As we have written in prior papers, these are all roles formerly held by humans, typically MBAs, now replaced by PhDs, coders and developers.

To end on a higher note, I will provide two constructive thoughts. One: focus on the most inefficient and illiquid corners of the markets, such as emerging markets and non-exchange traded securities, that don't lend themselves to these systematic techniques, yet. For example, Asian markets, various credit markets, select commodity. More illiquid markets may all have less widely disseminated and available public data, which in turn diminishes the 'low-hanging fruit' of systematising them.

Two: embrace digitalisation. If discretionary managers can not compete in more inefficient or illiquid markets then they must learn data science and/or coding or hire those that do. Discretionary managers should at least start to integrate alternative data into their investment processes.

AIMA Events

AIMA
THE ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION

AIMA continues to deliver a varied programme of events for members through virtual platforms. Hosting over 270 complimentary events annually, there is a wide selection of educational and thought leadership content for peer-to-peer learning.

15 September
AIMA Australia Annual Forum 2021

12-15 October
AIMA Global Investor Forum 2021

21 October
AIMA Singapore Annual Forum 2021

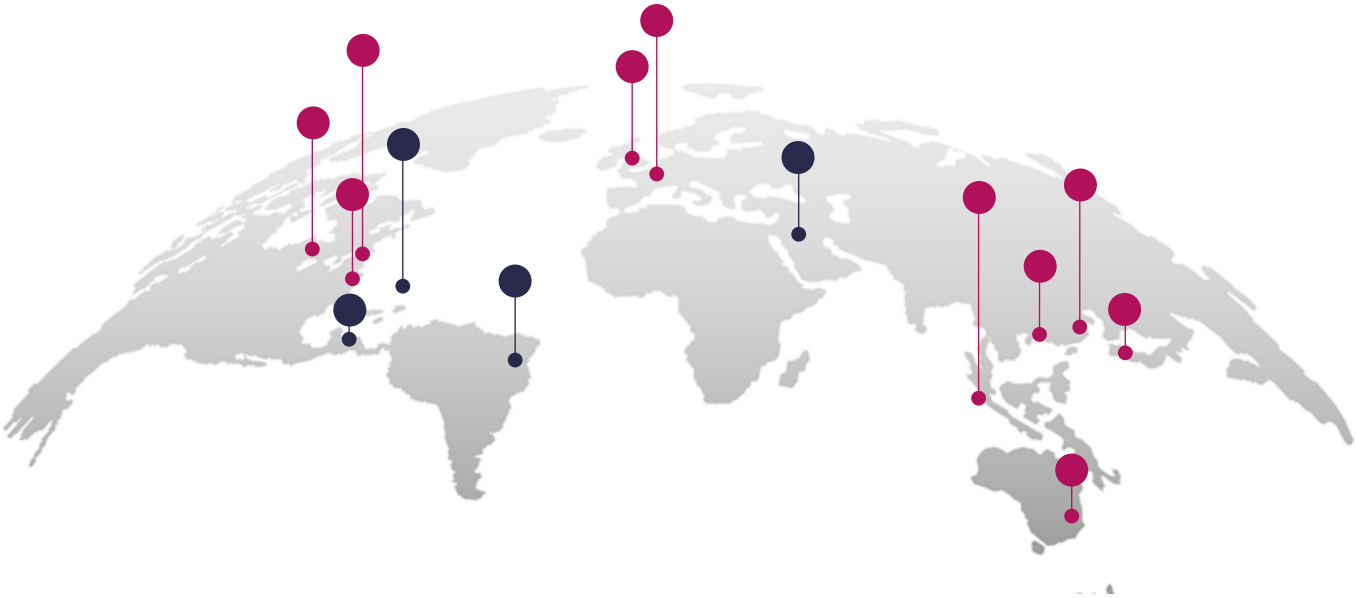
30 November
AIMA Japan Annual Forum 2021

9 December
AIMA China Live 2021

Visit our video library of event replays for continued learning here

View the full list of our upcoming events here

CONTACT US



Bermuda
usa@aima.org

Brazil
info@aima.org

Brussels
38/40 Square de Meeus, 1000 Brussels, Belgium
+32 2 401 61 46
info@aima.org

Cayman Islands
cayman@aima.org

Hong Kong
Unit 1302, 13/F, 71-73 Wyndham Street, Central, Hong Hong
+852 2523 0211
apac@aima.org

London (Head Office)
167 Fleet Street, London EC4A 2EA
+44 20 7822 8380
info@aima.org

Middle East
info@aima.org

New York City
12 East 49th Street, 11th Floor.
New York, NY, 10017, USA
+1 646 397 8411
usa@aima.org

Singapore
1 Wallich Street, #14-01 Guoco Tower, Singapore 078881
+65 6535 5494
apac@aima.org

Shanghai
Suite A10, 28th Floor SWFC, No. 100 Century Avenue, Pudong, Shanghai 200120, China
+86 136 1191 9817
apac@aima.org

Sydney
+61 (0) 412 224 400
apac@aima.org

Toronto
500 - 30 Wellington Street West, Box 129, Commerce Court, Toronto, ON M5L 1E2, Canada
+1 416 364 8420
canada@aima.org

Tokyo
+81 (0) 3 4520 5577
apac@aima.org

Washington
2001 L Street NW, Suite 500, Washington DC 20036, USA
+1 202 919 4940
usa@aima.org

THANK YOU TO ALL OUR SPONSORS

ACA Group
Allen & Overy
Citco
Clifford Chance
Dechert LLP
EY
Eze Castle Integration
Guotai Junan Securities
iConnections
K&L Gates

THANK YOU TO ALL OUR SPONSORS

KPMG
Man Group
Maples Group
PwC
RSM
Scotiabank
Simmons & Simmons
SS&C
State Street

PUBLICATION PLAN 2021

Q3 Edition 127

Deadline for submission 30th July
Publication 20th Sept

Please confirm by the 9th July if you wish to contribute to the Edition 127 of the AIMA Journal.

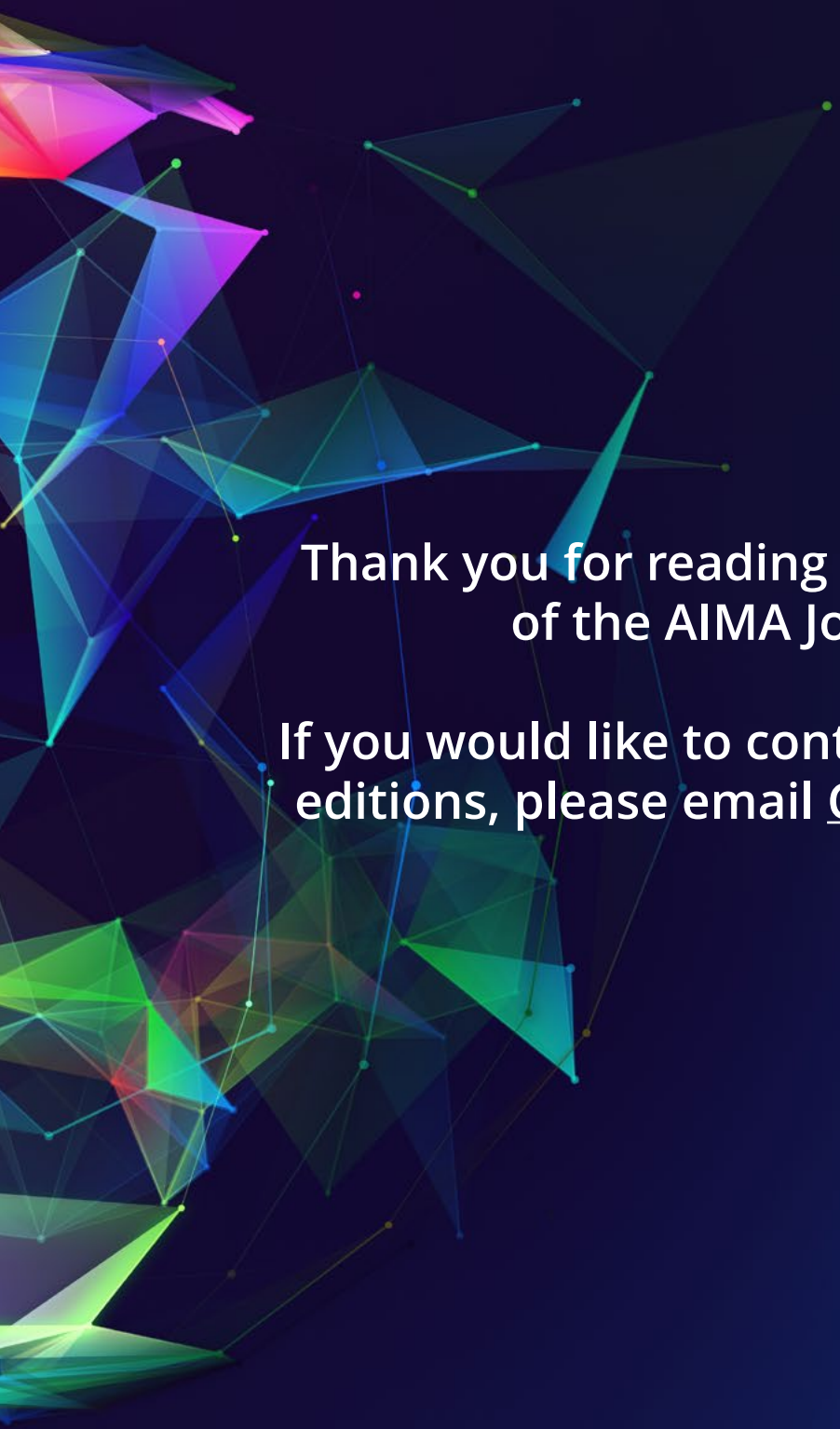
Q4 Edition 128

Deadline for submission 29th Oct
Publication 30th Nov

Please confirm by the 8th October if you wish to contribute to the Edition 128 of the AIMA Journal.

We might not be able to include any last minute submission.

AIMA JOURNAL EDITORIAL GUIDELINES



Thank you for reading the edition 126
of the AIMA Journal.

If you would like to contribute to future
editions, please email Caterina Giordo

aima.org