AIMA Journal

The forum for the global alternative investment management industry

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From our members

So now we know, but there's a lot we don't...

By Jack Inglis, CEO, AIMA

The UK's decision on 23 June to leave the European Union is a huge one and will have long-term implications for our members in the UK and internationally. Quite what those are it is impossible to conclude until the direction of negotiations becomes clear.

Just as participants had begun to adapt to AIFMD, EMIR and MIFID II so we now have uncertainty as to their long term applicability for many. We recognise that our members have made large investments in getting compliant with these rules and will be looking for clarity as to what to do about future expenditure plans. It is extremely important for members from outside the EU that they continue to have access to EU markets and EU investors and that those inside the EU should continue to have access to the UK market. This position will drive our advocacy work in the period ahead. We want to communicate with our members as we formulate our stance on every issue that is important to you and along every step of the way. On 24 June, AIMA's Government Affairs Committee* met to discuss the impact of the vote and the next steps. Although recognising the ongoing uncertainty and the limitations of what we can do in the short term we agreed that all members should be asked to highlight priority areas on which we should engage with both the UK and EU, and which will require renewed guidance for our members. We anticipate the key areas of focus to be:

- AIFMD Passport – will the UK be granted this?
- MiFID II - to prepare or not to prepare?
- EMIR – where to clear?
- UCITS – setting up an EU management company?
- FTT – is the risk gone?

Please contact Jiri Krol (jkrol@aima.org), Jennifer Wood (jwood@aima.org), Paul Hale (phale@aima.org) or Adam Jacobs-Dean (ajacobs-dean@aima.org) with your suggestions or if you want to discuss any items. We also have a general email for Brexit-related matters, brexit@aima.org.

Prior to the referendum, AIMA published a Note for members regarding the UK's relationship with the EU. An updated version of the Note is published from page 5 (and here). Although the full impact of a UK withdrawal is still difficult to predict, the Note attempts to identify issues and sketch out the possible consequences for the financial services and alternative investment management industry. It will be updated in due course as the implications of the vote become gradually clearer. We have also begun to organise a series of educational events for members to discuss the impact of Brexit - see the AIMA Events section.

**The Government Affairs Committee is the substantive committee that oversees all the policy and regulatory work of AIMA. It comprises 15 representatives of manager firms all of whom have considerable experience and expertise in this field. They are mandated to steer our work in the interests of our broader hedge fund community as opposed to just their individual firms.*

AIMA Note: The implications for the alternative asset management industry of the UK's decision to leave the EU

The United Kingdom (UK) has voted to leave the European Union (EU) in a referendum held on 23 June 2016. This note attempts to provide a realistic assessment of possible outcomes alongside a description of some of their practical implications for asset managers.

The note sets out a number of broad issues before discussing the three possible post-exit arrangements to the UK: (a) the European Economic Area (EEA) and the European Free Trade Association (EFTA) or equivalent bespoke agreement option; (b) the third-country passporting option; and (c) the independent policy option.

1. General issues

There is little precedent for what leaving the EU would mean for the UK. The rules for exit are set out in Article 50 of the Treaty on European Union (TEU). [1]However, the withdrawal mechanism has never been used before, and the potential outcome is difficult to predict as the views of each Member State will need to be considered, including that of any potential future government in the UK.

1 Treaty on European Union - Article 50:

1. Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.
2. A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.
3. The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.

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Article 50 allows a Member State to notify the EU of its withdrawal and obliges the EU to try to negotiate a "withdrawal" agreement.[2] There is a great deal of uncertainty about how it would work. The European Commission will need to seek a mandate to negotiate from the European Council, without the UK present. The final agreement will, apart from the Council, also require the consent of the European Parliament.

It is likely that the UK Government will negotiate a new agreement with the EU, for which unanimity among EU Member States would be necessary. The agreement would likely contain transitional arrangements, as well as provide for the UK's long-term future relationship with the EU.

The UK Government will need to unravel the regulatory framework from EU law for the financial sector. Regardless of the outcome of the exit negotiations, this will be a large and complex task. EU law is incorporated into a substantial majority of the UK's legislative framework for financial services, either as a result of direct application via an EU regulation or transposition of EU directives into UK law.

EU directives and regulations govern all major financial sectors, including banking, insurance, wholesale and retail investments, provision of market infrastructure, payment, clearing and settlement systems and asset management. One consideration for the UK Government will be how to implement a comprehensive UK domestic legislative framework now that the country will no longer be bound by EU law. This will involve questions over how and to what extent EU law could or should be incorporated into domestic law.

Another consideration will be the status of UK firms whose existing business operations in EU Member States are authorised under EU law, and of firms based in EU Member States with operations in the UK. As a result of the European passporting regime, UK financial firms – including banks, insurers and asset managers – generally have the right to sell financial services and establish branches anywhere in the EU without other countries being able to impose different or additional requirements.

EU policy making influence. The UK has always been a strong promoter of goods/services and capital markets integration. Examples such as the Markets in Financial Instruments Directive (MiFID) and the Market Abuse Directive (MAD) demonstrate that the EU financial services law is largely moulded by UK perspectives. The loss of the UK's ability to directly impact EU policy could mean that diverging rules in financial services are subsequently developed between the UK and the EU.

The UK will still have a presence in the G20 and remain a member of international financial standards bodies, such as the Basel Committee, IMF, FSB and IOSCO.[3] However, it seems unlikely that the UK would be able to maintain the level of influence that it currently holds in the EU processes.

In 2015, the EU Commission launched an action plan to build a Capital Markets Union (CMU). The project, welcomed by AIMA and the wider asset management industry at the time (submission), was aimed at creating deeper and stronger capital markets by bringing down existing cross-border barriers. A significant amount of work has already been put in by industry bodies and public authorities in order to make the case for markets working more efficiently. After the UK voted to leave the EU, the European Commissioner for Financial Stability, Financial Services and Capital Markets Union, the British peer Lord Jonathan Hill, stepped down and was replaced by the Latvian Commissioner

2 HM Government. The process of withdrawing from the European Union (February 2016): "It is probable that it would take an extended period to negotiate first our exit from the EU, secondly our future arrangements with the EU, and thirdly our trade deals with countries outside of the EU, on any terms that would be acceptable to the UK. In short, a vote to leave the EU would be the start, not the end, of a process. It could lead to up to a decade or more of uncertainty."

3 Treasury Select Committee (TSC) James Chew – "EU legislation in relation to banking regulation is the consequence of priorities being set by the G20, and established by the FSB and the Basel committee. So the EU institutions have merely reflected those priorities in the context of the single market. Having said that, the EU has become less of an attractive place to conduct business. Economic inflows and foreign direct investment have partly shifted elsewhere and emerging markets took advantage of the period for growing their own economies, while continental Europe has been stagnating for long. Reduced liquidity in the financial markets and restrictions on the ability of businesses to access credit are certainly challenges for economic growth."

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Valdis Dombrovskis. The European Commission President Jean-Claude Juncker said that Mr Dombrovskis would "ensure continuity".[4] Nevertheless, the final outcome of the CMU is now more uncertain.

London. The predictability of the UK legal system, expertise of the workforce and use of the English language, among other factors, are relevant considerations for London's continuation as a leading financial centre. One could say that there is little prospect of London being immediately dislodged as Europe's leading international financial centre: this is sustained by inherent advantages and a large network of financial and professional services that is hard to replicate. There are some areas where the UK is a destination in its own right, in terms of some of the markets it provides.

The common theme among the three main exit options *(set out below)* is the extent to which the UK retains a degree of control in exercising choices and whether it will maintain freedom to change policy or tactics in relation to its business with the EU. In all exit scenarios, however, there are increased risks and uncertainty which makes quantification of any costs/benefits difficult.

2. EEA/EFTA or equivalent bespoke agreement option

Once the UK invokes the Article 50 TEU process, the UK may seek a relationship with the EU (like Norway) as a member of the EEA and the EFTA or an equivalent bespoke solution. However, it is important to note that an EEA-like arrangement, while being the closest to the status quo as regards market access for financial services industry, would likely involve contribution to the EU budget and a significant degree of free movement of persons. This option would thus be attractive from the point of view of minimising disruptions to business but fairly antithetical to the broad political inclinations behind the 'Out' vote – control over immigration and the desire to do away with financial contributions to the EU budget. On the issue of sovereignty, this option is interesting insofar as the bulk of the financial services regulation has been negotiated already and implemented and so complying with EU rules without having influence would not present an insurmountable political obstacle in the near to medium term. This is especially so as the EEA-like option would provide the UK with significant freedoms in other policy areas such as justice or fisheries.

In any event, ceasing to be a member of the EU will be the result of at least a two-year process, where a number of separate steps will be needed (i.e., the UK would have to negotiate with EFTA to become a member of EFTA and to remain or re-join as a member of the EEA).

As the EEA is comprised of small- and medium-sized states when compared to the UK, reaching an agreement on EEA membership might be complex. Consideration should be given to the fact that financial services regulation is covered by the EEA agreement, but developments since the global economic crisis have fractured the coherence between the two regimes (EU v. EEA/EFTA).

Historically, the single market in financial services has extended to certain EFTA member states as part of the EEA Agreement. However, this extension is not automatic and, since 2010 and the establishment of the European Supervisory Authorities (ESAs), there are problems in the way the EEA Agreement operates as certain powers conferred to the ESAs cannot be directly exercised in EEA Member States. Unfortunately, it is not clear how this will be resolved and there is a risk that continued access by EFTA members to the single market could be in jeopardy.

3. Third-country passporting option

If the UK fails or does not wish to negotiate EEA-like access to the Single Market, there could be a significant impact on the UK's financial services industry. The UK becoming a third country would require UK firms to consider how their businesses are structured and how they provide financial services and distribute financial products across the EU, in particular if their ability to passport services across the EU ceases either temporarily or permanently. One way to continue enjoying access to the EU market would be via the use of a third country

4 http://europa.eu/rapid/press-release_STATEMENT-16-2332_en.htm

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passport, or other third country access mechanism which have been introduced in a number of financial services directives and regulations recently.

Markets regulation

MiFID II / MiFIR. The revised MiFID II framework is likely to apply from 3 January 2018, which in all probability will be before the UK's formal exit from the EU. However, once the UK has left the EU then a number of consequences will follow:

1. some pieces of the regime will continue to apply by virtue of a UK fund manager undertaking trading activities in the EU;
2. some aspects of the regime will cease to apply, even for activities involving other firms in the EU;
3. the ability to satisfy certain MiFIR requirements by using a UK-based infrastructure will be curtailed; and
4. passporting rights will be removed.

The following examples illustrate these different effects:

- **Dealing commissions**: One of the most problematic provisions of MiFID II is established in Article 24 (8); When providing portfolio management the investment firm shall not accept and retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients – the ban on inducements. Given that the UK is to leave the EU, conceptually the UK could be in the position of revising the transposition of MiFID II to remove this restriction, even though it is very unlikely to do so given its previous policy position. Further, due to Article 24(9) of MiFID II, counterparties within the EU would not be permitted to pay inducements, even to non-EU firms. The Article states that investment firms are regarded as not fulfilling their obligations where they make payments that are not in line with the inducements provisions. Hence, the substantive requirement would be highly likely to remain the same for UK investment managers.
- **Transparency obligations**: MiFIR includes obligations on pre- and post-trade transparency in respect of instruments that can be traded on a trading venue, even when traded on an over-the-counter (OTC) basis. When activity occurs on a trading venue, the venue is responsible for fulfilling MiFIR transparency obligations. When activity takes place OTC, the investment firm involved would have to publish post-trade data via an Approved Publication Arrangement. Consequently, UK fund managers would come within the scope of MiFIR transparency obligations when dealing on EU venues or OTC with EU counterparties (noting that they might not be directly responsible for satisfying those obligations).
- **Position limits**: Article 57 of MiFID II establishes position limits for commodity derivatives. The obligation does not refer to the domicile of the person who holds those positions, and so applies on an extraterritorial basis to any person that trades commodity derivatives on any EU trading venue. Level 2 measures are still under development to determine the extent to which contracts entered into outside the EU must be included in the calculation of a person's positions. It is likely that it will not be possible to net positions on non-EU venues with those taken on EU venues, which could be challenging for firms with greater long exposures on UK venues and greater short exposures on EU markets.
- **Derivatives trading obligation**: Article 28 of MiFIR establishes the obligation to trade derivatives on regulated markets, multilateral trading facility (MTFs) or organised trading facility (OTFs) (the derivatives trading obligation), and captures transactions between third-country entities "that would be subject to the clearing obligation if they were established in the Union" and financial counterparties or non-financial counterparties above the clearing threshold. Given our current understanding of EMIR, on which the MiFIR formulation is based (see the EMIR section of this note), fund managers outside the EU should be treated as though they were "non-financial counterparties" for this test, which will mean that some will fall outside of mandatory clearing and the trading obligation by virtue of the scale of their activities in OTC derivatives markets (i.e., if they are below the clearing threshold, or "NFC-s"). In brief, the MiFIR derivatives trading obligation would not apply to some funds managed from the UK, even if the fund were to be facing a European entity.

  On the other hand, for those that fall within the scope of MiFIR obligations, it would also restrict the range

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of venues available to comply with the obligation. Article 28 (1) of MiFIR states that: (a) regulated markets (b) MTFs; (c) OTFs; or (d) third-country trading venues, provided that the Commission has adopted a decision in accordance with paragraph 4 and provided that the third country provides for an effective equivalent system for the recognition of trading venues authorised under Directive 2014/65/EU to admit to trading or trade derivatives declared subject to a trading obligation in that third country on a non-exclusive basis. Equivalence has, in other contexts, led to protracted discussions between the European Commission and third-country authorities and it is difficult to determine whether the process will be swift.

- **Passporting**: Investment firms authorised by the UK authorities currently enjoy passporting rights under the MiFID framework. Under MiFID II, Member States will be able to require third-country firms to establish a local branch for services provided to retail clients. Third-country firms will be able to provide business to professional clients and eligible counterparties on a direct basis (or cross-border from an EU branch), but only if the European Commission has adopted an equivalence determination in respect of the third country's rules. In the absence of such a determination, it is left to individual Member States to define the access criteria for third-country firms providing services to professional clients and eligible counterparties.

It is worth noting that, in all of the examples cited above, ceasing to be subject to MiFID/MIFIR obligations does not mean that UK firms will not be subject to rules which are either identical or greatly similar in nature as the UK will likely continue to operate under a regime which will be quite close to the EU regime for pragmatic and policy reasons (e.g., desire to obtain a favourable equivalence decision).

Short-Selling Regulation (SSR). There will not be much change for financial institutions such as investment funds when it comes to the application of the SSR to trading in EU financial instruments. This is because rules relate to where the shares or instruments are issued/traded, rather than where the manager is based. The disclosure requirements of the SSR are extraterritorial in nature, and ESMA has made clear that "[n]either the domicile or establishment of the person entering into a transaction on these financial instruments nor the place where the transactions take place, including in third countries, are of any relevance in this regard".

Accordingly, UK managers will still be bound by certain SSR obligations in respect of EU shares and debt. However, the regime will no longer apply to UK shares and government bonds, unless the UK were to introduce similar obligations in its domestic legislation.

European Markets and Infrastructure Regulation (EMIR). It is unlikely that the UK leaving the EU will translate into major changes to the OTC derivatives framework currently contained under EMIR.[5] EMIR derives from an internationally agreed policy framework and rules that the UK is unlikely to reverse unilaterally. Mandatory clearing, minimum margin requirements and reporting to trade repositories will all continue in a post-exit UK.

Below we consider how individual aspects of the EMIR framework could be affected:

- **Reporting**: EMIR reporting applies to all financial counterparties (FCs) and non-financial counterparties (NFCs) as defined under EMIR. The definitions are largely based on physical "establishment" in the EU. The definition of FC also applies in certain situations involving non-EU funds that utilise EU managers, including any non-EU AIF managed by an authorised or registered AIFM or by a MiFID investment firm using a sub-delegation arrangement with a non-EU investment manager. A UK exit means that UK investment firms and non-EU AIFs with UK AIFMs will no longer need to report under EMIR, as they will fall outside the definitions of both FC and NFC. However, the UK is unlikely in practice to repeal the substantive reporting obligation currently contained under EMIR for domestic firms.

- **Clearing obligation**: The EMIR clearing obligation applies in the circumstances of a transaction involving at least one FC or NFC that meets the relevant clearing threshold (NFC+) as well as, theoretically, transactions between

5 Regulation (EU) No.648/2012 on OTC derivatives, CCPs and trade repositories.

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two third-country entities if the contract in question is held to have a direct, substantial and foreseeable effect within the EU, or where it is necessary or appropriate to prevent the evasion of any provisions of EMIR. The UK's exit will limit the application of the EMIR clearing obligation by taking certain UK established entities outside the scope of the definitions of FC and NFC+. However, such UK entities could still be caught by the EMIR clearing obligation when transacting with an EU counterparty that is an FC or NFC+. This is in addition to the possibility of a non-EU fund's purely third-country transactions becoming subject to mandatory clearing if the contracts are deemed to have direct, substantial and foreseeable effect within the EU or where such is necessary or appropriate to prevent the evasion of any provisions of EMIR.

- **Recognition of UK CCPs**: UK-established CCPs authorised by the Bank of England under EMIR are permitted to provide clearing services to clearing members and trading venues throughout the EU. In particular, UK CCPs are able to clear sufficiently liquid and standardised contracts that have become subject to the EMIR mandatory clearing obligation. Post-exit, UK CCPs will no longer be established in the EU, no longer able to meet their conditions for authorisation under EMIR, and therefore no longer able to clear mandatorily clearable contracts in satisfaction of EMIR. To be able to clear mandatorily clearable contracts entered by EU counterparties in satisfaction of EMIR, UK CCPs would have to be registered with ESMA as third-country CCPs. However, before this could occur, an equivalence decision would have to be made by the European Commission in relation to the UK's CCP regulatory and supervisory regime. It is likely that procedural timing and political pressures would be the only barriers to obtaining equivalence and registration of UK CCPs bearing in mind the UK regulatory regime is based on EMIR and unlikely to change following the eventual exit.

- **Bilateral risk mitigation**: Conditions for timely confirmation, portfolio reconciliation and dispute resolution for non-cleared OTC derivatives mirror their application to EMIR reporting, applying to all FCs and NFCs. Non-cleared margin rules apply to FCs and NFC+s. However, like clearing, it is possible for EMIR risk mitigation requirements to apply directly to two third-country entities where the contract between them is deemed to have direct, substantial and foreseeable effect within the EU and/or where such is necessary or appropriate to prevent the evasion of any provisions of EMIR. It is also the case that all third-country entities are caught indirectly by EMIR risk mitigation obligations when transacting with EU FCs or NFC+s, due to the fact that EU counterparties have to comply with the EMIR obligations regardless of the location and categorisation of their counterparties.

Following the exit, UK entities will cease to be FC and NFCs, thus will not be subject to EMIR risk mitigation obligations directly.[6] However, such counterparties will still be subject to EMIR's risk mitigation rules indirectly when transacting with EU counterparties, with the latter needing their non-EU counterparties to facilitate their compliance with their EMIR.

Market Abuse Regulation (MAR) / Directive on Criminal Sanctions for Market Abuse (CSMAD). Following the UK's exit, very little will change with regards to MAR and the CSMAD. CSMAD, MAR and its predecessor MAD are heavily influenced by the UK and its approach to market abuse rules, which is unlikely to change post exit. The UK has already opted out of CSMAD, instead continuing to apply its own domestic criminal market abuse regime. MAR generally attaches to instruments rather than entities, thus will still apply to any trading of in-scope financial instruments and other products by UK firms. However, the scope of such instruments and products directly caught by MAR will be narrower. Those falling outside MAR will be swept up by UK market abuse rules likely to be largely identical to MAR.

Prospectus Directive.[7] The UK is a jurisdiction where many companies are listed because of its deep financial markets. The Prospectus Directive lays down that Member States shall not allow any offer of securities to be made to the public within their territories without prior publication of a prospectus. A prospectus that has been approved

6 Unless their contracts are deemed to have direct, substantial and foreseeable effect in the EU or to be used for the purposes of evasion.

7 FTI Consulting – Briefing: Impact of Brexit on Financial Services: http://brussels.ftistratcomm.com/wp-content/uploads/sites/5/2015/08/150812-FTI-Briefing-Impact-of-Brexit-on-Financial-Services.pdf

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in one Member State is valid for the public offer or admission to trading throughout the EU as long as this is notified to ESMA and host Member States. This means that no further approvals of such prospectus are required. This will change once the UK leaves. Prospectuses approved in the UK will no longer be automatically valid throughout the EU, which could decrease the attractiveness of the UK as a location for listing, although the European Commission can deem other jurisdictions as equivalent to the EU.

Asset management

There will not be a single impact on the UK investment management industry - rather it will affect individual firms in different ways, depending on the extent to which they are UK/global or EU focused, the types of products they offer to investors, and can be mitigated by the amount of business they are able or willing to conduct outside the EU.

UCITS. A UCITS fund, unlike an AIF, can only be established in the EU and will be either a "self-managed" fund or will appoint a management company (ManCo), which must also be in the EU. Consequently, the impact of the EU exit on UK investment managers who are active in the UCITS markets could be significant, especially if their funds and/or ManCos are domiciled in the UK.

Without a negotiated settlement that permits the UK to remain a UCITS domicile, all non-EU legal entities would need to be re-domiciled and/or re-authorised.[8] For so long as the fund remains in the UK, there is a question as to whether the Financial Conduct Authority (FCA) and the EU would regard the fund for UK regulatory purposes as a type of non-UCITS retail fund, which would be categorised as an AIF under the AIFMD.

This means that, to the extent that the fund is marketed in the EU, then it would be subject to additional marketing restrictions and largely unavailable to retail investors. It would also need to comply with the different operational, reporting and transparency obligations that AIFMD brings with it.

Under a potential agreement between the EU and the UK, full compliance with the UCITS Directive could be achieved if the EU introduces a third country passport in the UCITS Directive. The UK could build its own UCITS-style vehicle to compete with the EU, but this will not have the benefit of being passportable across the EU.

The options for UCITS/UCITS management companies appear to be as follows:

	UK UCITS	UK UCITS ManCo
Redomicile in an EU Member State	Most likely option as can then continue to access retail investors in the EU and be branded as a UCITS.	Most likely option as can then continue to access retail investors in the EU and manage a fund which is branded as a UCITS.
Remain in the UK but change regulatory status	Would no longer be able to access EU retail investors and would become a non-EU AIF for purposes of marketing into the EU. Query whether there would be a special dispensation from other countries for existing retail investors?	UK UCITS management companies remaining in the UK would become non-EU AIFMs for regulatory purposes. UK UCITS management companies would no longer be able to manage UCITS – but UK firms could probably still sub-advise if they meet the requirements of the country where the UCITS is domiciled.

8 As a way of exemplifying the role that the UK has had in driving the EU policy: the proposed bonus cap on UCITS V was blocked by the EP 348 votes to 341. If the UK representation had not been there, the outcome could have been different.

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AIFMD. Under the AIFMD, UK management companies that are authorised as alternative investment fund managers (AIFMs) by the FCA are currently considered to be EU AIFMs. UK AIFMs that are in full compliance with the AIFMD can currently manage AIFs established in the EU and market those EU AIFs in the EU via the AIFMD marketing passport procedure.

Third country AIFMs (i.e., those from outside the EU) are currently unable to become authorised so, in order to market to investors within the EU, must either (a) make use of local private placement regimes (NPPRs) where these exist or (b) depend on reverse solicitation (a framework that may differ significantly amongst Member States and can be complex).

The aim is for the European Commission to allow the AIFMD passport to be extended to third countries' funds and managers, resulting from the approval by ESMA that the legislative and supervisory regime in the third country concerned meets certain standards and complies with minimum requirements.

UK AIFMs will of course cease to be EU AIFMs. The UK may choose to apply a lighter post-exit regulatory regime on its asset managers. Conversely, a UK AIFM wishing to market its funds to investors in the EU would be required to either (a) use local NPPRs where available (or rely on reverse solicitation) or (b) delay its marketing until the UK is evaluated and approved by ESMA and the AIFMD passport is extended to it (and to the third country in which any relevant non-EU AIF is established).

Non-EU AIFMs who market AIFs to investors in the EU must still comply with certain transparency and reporting obligations, including Annex IV reporting to local regulators. Where access to the marketing passport is allowed and the non-EU AIFM elects to make use of it, however, the full provisions of the AIFMD will apply.

As NPPRs may be phased out over time, the option of relying on NPPRs may, consequently, be only temporary. A non-EU AIFM using the marketing passport will be required to choose an EU Member State of reference to act as its "home regulator" within Europe. A UK AIFM could, in time, find itself subject to an equivalent regime as before Brexit, but within the competence of an EU Member State regulator, in addition to the FCA.[9]

9 **Statistics on UK AIFMs:**

(Tables based on stats from ESMA Opinion covering period 22 July 2013 to 31 March 2015)

- 3161 AIFMs were authorised in accordance with Article 7 AIFMD. Of these AIFMs, 438 use the EU passport for marketing AIFs in other EU Member States. By way of comparison there are more than 580 UK firms that have US clients and investors and are registered investment advisers or exempt reporting advisers in the US.
- 7868 AIFs, including sub-funds of umbrella AIFs, were notified for marketing in other EU Member States in accordance with Article 32 AIFMD, with the highest number of outbound notifications coming from the UK.

	UK	Luxembourg	Ireland
Origin of EU AIFs making passport notifications in other MSs	5,027	1,260	1,229

Statistics on US AIFMs marketing into the UK/rest of the EU:

(Tables based on stats from ESMA Opinion covering period 22 July 2013 to 31 March 2015)

- Majority of Non-EU AIFMs marketing in EU are marketing in the UK (1,777 in EU, 1,013 in the UK)

	EU (including UK)	UK
Non-EU AIFs marketed by Non-EU AIFMs under the NPPR	1,777	1,013

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Tax

Taxation is largely a matter of Member State sovereignty, subject to complying with the broader requirements of the TEU, in particular the fundamental treaty freedoms. The potential implications of the UK's exit from the EU are less significant for taxation when compared with other areas.

However, tax policy is one area where the EU is trying to gain a greater level of influence.

- VAT – this is a EU tax and could be abandoned or revised but, given the relative significance of VAT to the government's receipts and its efficacy as a tax, we would not expect substantial changes regardless of the UK's status;
- It is uncertain to what extent Court of Justice of the EU (CJEU) tax case law would remain applicable or have become part of UK tax law, but the absence of the fundamental freedoms could permit some measures that were repealed for EU infringement to be reintroduced;
- Further, a UK Government will be unconstrained by EU state aid rules and will be able to provide UK businesses with more favourable tax treatment, if deemed necessary;
- It is highly doubtful that the application of the new international tax framework, such as the various measures developed by the OECD to counter base erosion and profit shifting (BEPS) or the automatic exchange of tax and financial information, will be any different in a post-exit UK. Forthcoming EU proposals such as the directive on administrative cooperation or tax transparency that might go beyond the BEPS framework could avoid transposition into domestic law.

Financial Transaction Tax (FTT).[10] Whatever structure an eventual FTT takes (if the 10 Enhanced Cooperation Procedure (ECP) Member States were to reach an agreement), the end position in economic terms is probably much the same: if a UK person enters into a transaction that is within the scope of the FTT, the burden of the tax will ultimately be borne by that person. This may be because the EU establishes that the UK (while a Member State) can be required under the Mutual Assistance Directive to administer a FTT so far as it is chargeable on UK financial institutions or because counterparties subject to the FTT will, under their terms of business, require UK financial institutions to indemnify them.

4. Independent policy option

Following the UK's exit, there will be scope for the Government and the FCA/PRA to amend and change all or most of the requirements imposed by EU directives. It could be that the UK will prefer to craft financial services independently of the EU legal framework and without regard to the ability to obtain a passport in one or more of the areas of regulation.

In this scenario, the UK financial services regulatory framework would not be driven by the desire to retain access via a passporting regime, but solely by domestic and/or other international considerations – for example by following more closely the US regulatory regime which, in many instances already affects EU managers (e.g., central clearing and reporting of derivatives). Under this option, gaining access to the EU market via a passport would not be a priority although it would not necessarily have to be discarded in a case-by-case approach, depending on the development of EU regulation itself.

10 Mark Carney, Governor of the Bank of England – Oral evidence, Treasury Select Committee (8 March 2016): "in terms of hierarchy of risks of remaining in the EU, I would not put FTT near the top. Any financial transaction tax supplemental to stamp duty which currently exists in the UK, will be best pursued (if at all) at a global level, as opposed to a partial (EU) level, or as it is the case today, on the basis of a subset of EU Members States. As currently discussed, FTT would have potentially an element of extraterritoriality, now - that element is subject to legal challenge, but that legal challenge cannot be pursued until a Directive comes into force. FTT is not included in the BoE report, because (i) it will create impediments for market functioning not financial stability (one of the remits of the BoE), and (ii)_ following one's judgement of its probability of coming into force."

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Under this option, the AIFMD, MiFID or any other passport or access right could be a less attractive option with the UK being focused on its own policy goals which would, if they resulted in significant divergence, result in the passporting rights or other third country access rights to be lost or not obtained in the first place.

In the AIFMD context, managers would have to rely on NPPRs, to the extent these would remain operational in the future. If there were no possibility of qualifying for a third country passport, the EU could still be accessed by a UK firm if it set up an AIFM in either an EU Member State or a jurisdiction that has been authorised to use the passport.

Day to day portfolio management could be delegated back to the UK firm, provided the AIFM retains enough substance to avoid becoming a letterbox entity and that delegation requirements are not changed in subsequent EU legislation in a way that would lead to the inability to use the current model of delegation.

In the “full sovereignty” option, the UK would have to come up with its own set of rules to oversee the financial services industry. There could be benefits in diverging greatly from EU rules for certain types of businesses in the future, but also potential disruptions as both the internal and third country passporting access rights could be given up as a result.

For internationally active firms, this could mean greater overlap and duplication of rules where firms would most likely have to follow US, EU as well as UK domestic regimes if they wished to be active in these three important markets. It would also mean that a greater use of EU subsidiaries to conduct business in the EU would be the likely outcome.

Conclusion

The UK’s decision to leave the EU will have a significant impact on the UK and EU political and regulatory environment. Many uncertainties remain as to:

(a) who will lead the negotiations on the new arrangement;

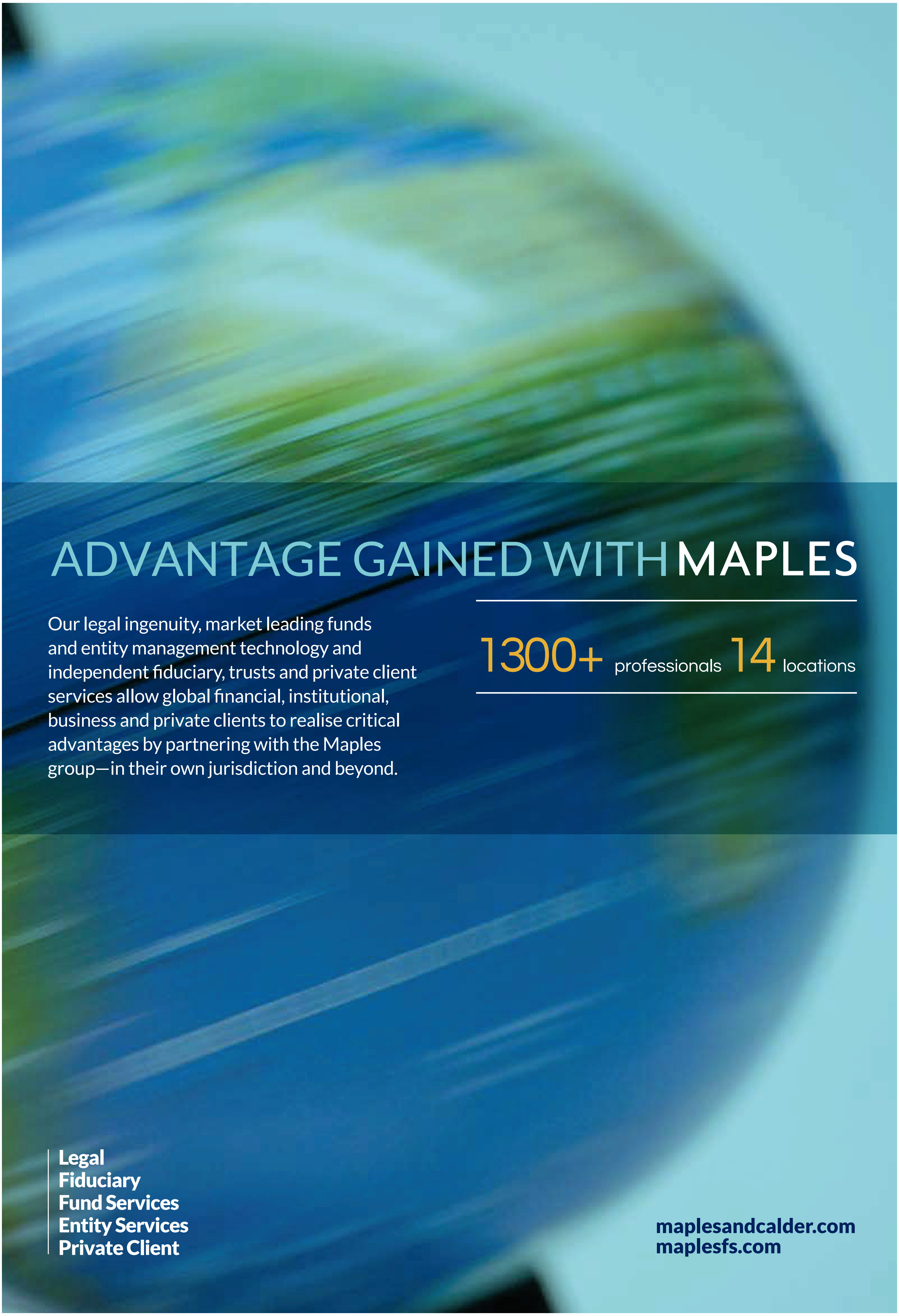
(b) when the formal process to leave under Article 50 will be triggered;

(c) the priorities of those in the UK leading the negotiations and which kind of outcome they will aim to achieve; and

(d) the priorities of the EU actors and which kind of outcome they will aim to achieve.

Until these uncertainties become resolved, it will be difficult for businesses to plan and adjust. One way to ‘future proof’ one’s ability to access the EU for asset managers would be to consider setting up subsidiaries or management companies as well as funds on the continent. This, however, could be a costly exercise, especially if, under certain circumstances, the UK status post-Brexit will be very close to the existing status quo.

AIMA will work closely with policymakers in the UK, EU as well as other key jurisdictions to ensure continued market access and to achieve as smooth a transition for our members as possible. To help us achieve it, we ask AIMA members to contact the AIMA executive and provide us with your concerns and policy preferences.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The AIMA Regulatory Update strives to provide a succinct update to members on the current state of play on the most important files in the Government and Regulatory Affairs space. It is a one-stop-shop for members seeking to gain a quick overview of the main points of interest to the hedge fund industry while also providing links to a number of internal and external documents for those interested in greater detail. The issues treated in the update do not provide an exhaustive list of AIMA's work in the area and we encourage members to contact AIMA's Government and Regulatory Affairs team if they wish to be informed on the progress of work on issues which are not covered.

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Asset management regulation

Remuneration

The European Securities and Markets Authority (ESMA) has published final Guidelines on sound remuneration policies under the fifth Undertakings for Collective Investments in Transferable Securities Directive (UCITS V) and the Alternative Investment Fund Managers Directive (AIFMD). The UCITS Remuneration Guidelines provide clarity on the requirements under the UCITS Directive for management companies when establishing and applying a remuneration policy for key staff. The Guidelines will apply to UCITS management companies and national competent authorities from 1 January 2017.

ESMA has also written to the European Commission, European Council and European Parliament on the proportionality principle and remuneration rules in the financial sector. In the letter, ESMA highlights that a key element of the UCITS Remuneration Guidelines relates to proportionality and, in particular, whether proportionality can lead to a situation in which the specific requirements on the pay-out process (i.e. the requirements on variable remuneration in instruments, retention, deferral and ex-post incorporation of risk for variable remuneration) set out in the Directive may be disapplied. ESMA considers that the disapplication scenarios should remain possible in certain situations and, in its letter to the European institutions, suggests that further legal clarity on this possibility could be beneficial to all the interested parties. The amendment to the AIFMD guidelines, which relates to the section of these guidelines dealing with the application of the remuneration rules in a group context, will also come into force on 1 January 2017. However, the current AIFMD Guidelines will not be amended to bring them into line with the UCITS Guidelines pending clarification on the application of the proportionality principle. AIMA has produced a summary of the final guidelines.

In the U.S., the Securities and Exchange Commission (SEC) is requesting comment on a joint proposed rule (the 'proposed rule') to revise the proposed rule published in the Federal Register on 14 April 2011, and to implement section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 956 generally requires that the SEC and other agencies jointly issue regulations or guidelines: (1) prohibiting incentive-based payment arrangements that they determine encourage inappropriate risks by certain financial institutions by providing excessive compensation or that could lead to material financial loss; and (2) requiring those financial institutions to disclose information concerning incentive-based compensation arrangements to the appropriate Federal regulator. The proposed rule will apply to investment advisers with $1 billion or more of total assets (exclusive of non-proprietary assets) shown on the investment adviser's balance sheet for the most recent fiscal year end.

The SEC will presumably be looking to investment advisers' responses to Item 1.O of Form ADV which asks if the investment adviser has $1 billion or more of total assets and "assets" for this purpose are the investment adviser's balance sheet assets, as is the case in the proposed rule. Client assets under management do not count toward the $1 billion for purposes of the proposed rule or the reporting requirement on Form ADV. All covered investment advisers would be prohibited from having an incentive compensation plan that encourages inappropriate risks by paying excessive compensation or benefits or leading to material financial loss. The proposed rule also contains oversight, disclosure and recordkeeping requirements. The proposed requirements become more onerous as total assets reach $50 billion and again at $250 billion.

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UCITS V

The Delegated Regulation supplementing Directive 2009/65 (the UCITS Directive) has been published in the EU's Official Journal. There has been no extension of the three-month scrutiny period by the Parliament and pursuant to Article 25, this Delegated Regulation will apply from 13 October 2016. The delegated act sets out further details on the UCITS depositary requirements, such as (i) the particulars that need to be included in the written contract between the UCITS management company and the depositary, (ii) the duties of the depositary and (iii) the conditions for performing the depositary functions. AIMA has produced a summary of the Delegated Regulation, which is available here.

AIMA has responded to the European Securities and Markets Authority (ESMA) discussion paper on UCITS share classes (the 'consultation'). In the response, welcomed ESMA's consideration of the merits of developing a common understanding of what constitutes a share class of a UCITS, but shared concerns in relation

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to the types of hedging arrangements that should be permitted in different share classes and the transition period for share classes that will be required to be closed down by firms seeking to come into compliance.

AIMA contacts: Jennifer Wood (jwood@aima.org) and Anna Washington (awashington@aima.org)

AIFMD

The European Securities and Markets Authority (ESMA) has published an updated version of its Questions and Answers (Q&As) on the Alternative Investment Fund Managers Directive (AIFMD). The document adds one new question on the notifications of alternative investment funds (question 3). This document is intended to be continually edited and updated as and when new questions are received.

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Securitisation

AIMA has produced a briefing note setting out its comments on the answers to the technical questions that were posed to the European Commission (the 'Commission') for which the Commission provided a response to in its questions and answers (the 'Q&As') on the simple, transparent and standardised ('STS') Securitisation Proposal (COM(2015)472). In the briefing note, AIMA provides additional information in response to questions posed regarding collateralised loan obligations and the definition of 'sponsor', as AIMA disagrees with the answers provided by the Commission.

AIMA contacts: Jennifer Wood (jwood@aima.org) and Anna Washington (awashington@aima.org)

Loan origination

ESMA has published an opinion setting out its view on the necessary elements for a common European framework for loan origination by investment funds. ESMA states that it is of the view that a common approach at EU level would contribute to a level playing field for stakeholders, as well as reducing the potential for regulatory arbitrage. This could in turn facilitate the take-up of loan origination by investment funds, in line with the objectives of the Capital Markets Union. This opinion will inform a future European Commission consultation in this area. ESMA intimates in the opinion that some harmonisation is necessary but keeps open the possibility that any such regime could be 'opt-in'. The AIFMD is the most likely framework for this and ESMA advises the Commission to consider whether 'additional requirements which exceed those already contained in AIFMD' may be required. The opinion also suggests that any such loan origination vehicles should be closed ended and not engage in maturity transformation. On leverage, ESMA does not suggest a specific limit, only that one is likely to be required. However, they also invite the industry to submit further evidence on what the need for leverage in such funds is. Finally, they also invite the Commission to consider the implications of loan origination funds for systemic risk and therefore what additional macro-prudential tools may be required.

AIMA has also submitted a response to the *Trésor* in relation to the proposed French decree fixing the conditions on which certain investment funds may grant loans to companies (*Décret Fixant les conditions dans lesquelles certains fonds d'investissement peuvent octroyer des prêts aux entreprises*, the 'Decree'). In the response, AIMA agreed with Trésor that loan origination requires certain risks to be addressed suggested that the *Trésor* reconsider the two key issues of the limitations on the investment of proceeds from borrowing and the restriction on the domicile of the fund vehicle.

AIMA contact: Jennifer Wood (jwood@aima.org) and Anna Washington (awashington@aima.org)

Cross-border distribution of funds

The European Commission has published a consultation document entitled "CMU Action on Cross-Border Distribution of Funds (UCITS, AIF, ELTIF, EuVECA and EuSEF) Across the EU". The consultation covers all types of funds as well as tax issues. Amongst other things, the consultation asks a number of questions about (i) marketing restrictions; (ii) the imposition of fees and other requirements in connection with the use of the passport; and (ii) notifications processes. The public consultation runs until 2 October 2016.

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SEC Proposed Rule on the Use of Derivatives

AIMA and Managed Funds Association (MFA, together the Associations) have submitted a joint response to the Securities and Exchange Commission's (SEC's) Proposed Rule on the Use of Derivatives by Registered Investment Companies and Business Development Companies (the Proposed Rule). While generally supporting several aspects of the SEC's proposal, including asset segregation requirements and an activities-based approach to regulation, the Associations expressed concerns with the adverse effects of the Proposed Rule's imposition of a new notional-based leverage limit on registered funds. The response also questions the SEC's attempt to redefine and regulate derivatives as "senior securities" under Section 18 of the Investment Company Act of 1940.

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ELTIF

The European Securities and Markets Authority (ESMA) has published its Final Report and draft Regulatory Technical Standards (RTS) for Regulation (EU) 2015/760, the European Long-Term Investment Fund Regulation (ELTIF). The RTS set out in the final report have been submitted to the European Commission for endorsement. The European Commission should take a decision on whether to endorse the RTS within three months. ESMA's key proposals include (i) the criteria to determine the circumstances in which financial derivatives are used solely for hedging purposes; (ii) the life of an ELTIF should be determined with reference to the individual asset within the ELTIF portfolio which has the longest investment horizon; and a grandfathering provision, whereby ELTIFs have one year after the RTS come into force to comply with these rules.

AIMA contacts: Jennifer Wood (jwood@aima.org) and Anna Washington (awashington@aima.org)

EBA report concerning categorisation of investment firms

The EBA has published a report on investment firms in response to the Commission's call for advice of December 2014 on the suitability of certain aspects of the prudential regime for investment firms. The EBA report recommends that the European Commission (Commission) reconsider the categorisation of investment firms, creating a new category of investment firms to which only certain aspects of CRD IV would apply. This new categorisation could apply to many AIMA members. We are now preparing to engage proactively with stakeholders at the EBA and the Commission to try to inform the development of these new categories, and the regulations that would apply to them. AIMA has prepared a detailed note, setting out further background to these changes, and in particular, the areas of prudential regulation that are being re-examined by the EBA, which members can view here.

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Insolvency

AIMA has submitted a response to the European Commission's consultation on an effective insolvency framework within the EU. In the response, AIMA commented, amongst other things, that measures ensuring that individual creditors, particularly secured creditors, have the right to enforce debts may need to be balanced with those designed to preserve value for all creditors.

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Australia - Portfolio holdings disclosure for super funds

ASIC has issued ASIC Corporations (Amendment) Instrument 2016/351 which defers the commencement date of the choice product dashboard regime for super funds to 1 July 2017 and the first reporting date for portfolio holdings disclosure by super trustees to 31 December 2017.

The instrument also means the obligations of certain intermediaries to provide a notification that an asset invested is a super fund asset or derives from a super fund asset, do not need to be complied with until 1 July 2017 and that intermediaries receiving such a notification do not need to provide investment information to the super trustee until on or after 1 July 2017.

The deferral is to allow further time for the amending

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legislation and regulations to be made, which propose to remove or make some significant changes to some of these requirements. For the background on this issue, please see our 7 March 2016 newsletter.

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Hong Kong - SFC Circular on Cyber security

The Hong Kong Securities and Futures Commission (SFC) has issued a circular to all licensed corporations following its recent review of cyber security within selected larger licensed corporations. The SFC states that:

"[C]yber security within licensed corporations has, for some time, been of concern to the SFC and is increasingly being viewed by the SFC as a matter of priority given the ongoing occurrence of cybersecurity incidents being reported across the financial services industry."

The SFC intends to focus on firms' cyber security preparedness given the persistence of threats and the continuing need for firms to improve their cyber security defences and expects them to take appropriate measures to critically review and assess their cybersecurity controls. Whilst the SFC found that most of the licensed corporations had prioritised resources for maintaining cybersecurity controls, its review identified some key areas of concern including:

- inadequate coverage of cyber security risk assessment exercises;
- inadequate cyber security risk assessment of service providers;
- insufficient cybersecurity awareness training;
- inadequate cybersecurity incident management arrangements; and
- inadequate data protection programs.

The SFC's circular sets out the SFC's recommendations regarding appropriate cyber security controls, which including ensuring that (i) the review and assessment of cyber security risks have been, or are in the process of being, comprehensively and effectively undertaken, (ii) any weaknesses identified as a consequence of such review and assessment have been, or are in the process of being, rectified, and (iii) the enhancement of cyber security controls is being treated as a matter of priority.

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China – New fund raising rules for private funds

The Asset Management Association of China (AMAC) announced on 15 April 2016 new rules relating to fund raising by private funds. The new rules will come into effect on 15 July 2016. AMAC, which is China's self-regulatory body for the funds industry, announced the new administrative measures to govern all non-public fund offerings within mainland China. These measures aim to regulate conduct around fund raising by private fund managers ("PFMs") as well as distribution conducted by third party agents on behalf of the PFMs.

The measures cover all major stages of the fundraising life cycle, i.e., fund promotion, fund distribution, fund subscription and redemption etc. and seek to comprehensively address the roles and responsibilities of Fundraising Institutions ("FIs") at each stage. Key highlights:

- The new measures stipulate that the regulatory obligations owed by PFMs to investors shall not be transferred or abrogated by the mere delegation to a third party distribution agent.
- It spells out in explicit terms the regulatory obligations of FIs around preventing conflicts of interest, duties of clear explanation and disclosure to investors, as well as anti-money laundering requirements.
- There are also detailed obligations around ensuring investor suitability. For example, Article 15 sets out six procedural gateways to navigate before a subscription contract is deemed completed and the monies raised can be transferred to the FIs. FIs are expected to qualify and assess prospects for eligibility taking into account their risk appetite. A 24-hour mandatory cooling-off period has also been introduced. There is also a concept of a "return visit" which mirrors a call-back safeguard procedure in some jurisdictions allowing for validation or reconfirmation of the investor's instructions.
- Aside for PFMs who may raise private funds they have established themselves, all fund raising activities must be conducted by onshore institutions that are concurrently registered with the China Securities Regulatory Commission to carry on the private fund distribution business and are members of AMAC. Individuals employed by FIs that are engaged in fundraising must possess the requisite regulatory registrations and qualifications.
- Article 24 stipulates prohibited conduct around fund

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raising including the use of false and misleading language as well as descriptive expressions which may give rise to wrong impressions of safety around a particular investment e.g., "safe", "guaranteed", "high returns" etc.

- Article 25 provides guidance on the different media and communication channels which are prohibited for private fund raising.

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Markets regulation

Capital Markets Union

In May the European Commission held a Public Hearing on its Call for Evidence on the EU Regulatory Framework. The public hearing consisted of a series of panel sessions, focusing on the gaps, overlaps and inconsistencies in reforms since the crisis, and the impact of regulation on economic growth. Lord Hill also gave a speech on his key areas of focus. In particular, he reiterated his drive to achieve de-regulation and to take a more proportionate approach to reduce the burden on smaller financial firms, including for example, through the EMIR review.

At the Public Hearing, the Commission released a Summary of contributions to the 'Call for Evidence'. The summary provides a factual overview of the contributions to the Call for Evidence, and does not provide insight into the Commission's position on the issues raised. A number of the issues raised in AIMA's written submission to the Call for Evidence have been highlighted in the summary. In particular, inconsistencies and duplications with regard to the various reporting and disclosure obligations across key reforms has been raised by a number of stakeholders. The Commission have indicated that they are likely to complete their analysis of the issues raised through the Call for Evidence in the summer, at which time they can be clearer about any further actions they will take.

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MiFID2/MiFIR

The European Commission, Parliament and Council have now reached agreement on a legislative amendment to delay the application of MiFID2 until 3 January 2018, with the transposition date for member states also shifting back a year until July 2017. The amendment also includes a number of "quick fixes" to the primary legislation, including a new empowerment for the European Securities and Markets Authority to develop tailored transparency rules for packaged transactions – a welcome addition from AIMA's perspective.

The European Commission continues to adopt a steady stream of MiFID2/MiFIR implementing measures, which are then subject to review by the Parliament and Council (who have the possibility of vetoing drafting). It is therefore likely that the bulk of the MiFID2 legislative framework won't be in place until the end of 2016, with domestic implementation continuing into 2017.

AIMA has kicked off a project to develop guidance on a number of aspects of the MiFID2/MiFIR framework, with new drafting groups established on best execution, algorithmic trading, commodities markets, and product governance. We hope to realise the first round of guides later this year.

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EMIR

In early June, the European Commission stated publicly that it does not intend to meet the current timeline for implementation of EU margin for non-cleared OTC derivatives rules – with the first round of variation and initial margin standards having been due to enter into effect on 1 September 2016. The draft technical standards were due to be endorsed by the Commission in the next month or so, however, they are now expected to be delivered by the end of the year. There is some uncertainty regarding the new implementation timeframe, but it is expected that the first phase of initial and variation margin for entities with a group gross amount of derivatives of €3tn will become effective in the middle of 2017. The US implementation timeline is not anticipated to change.

In May, EU Commission Delegated Regulation 2016/592 with regard to regulatory technical standards (RTS) on the clearing obligation came into effect. The Regulation confirms the phase-in dates for the mandatory clearing of certain credit derivatives contracts (untranched iTraxx Index credit default swaps (Europe Main and

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Europe Crossover: five year tenor, series 17 onwards, denominated in Euros)):

- 9 February 2017 for Category 1 counterparties;
- 9 August 2017 for Category 2 counterparties;
- 9 February 2018 for Category 3 counterparties; and
- 9 May 2019 for Category 4 counterparties.

The Commission has subsequently adopted a further draft Delegated Regulation with regard to RTS on the clearing obligation, confirming phase-in dates for the mandatory clearing of interest rate swaps in several non-G4 European currencies (Swedish Krona, Polish Zloty and Norwegian Krone). The new RTS will be subject to a period of scrutiny by the Parliament and the Council and will then similarly take effect over a three-year period:

- Six months after entry into force of RTS for Category 1 counterparties;
- 12 months after entry into force of RTS for Category 2 counterparties;
- 18 months after entry into force of RTS for Category 3 counterparties; and
- Three years after entry into force of RTS for Category 4 counterparties.

In addition, Commission Delegated Regulation EU 2016/822 will come into effect on 15 June 2016, amending the RTS to reduce the margin period of risk (MPOR) for central counterparty client accounts from two days to one day for exchange-traded derivatives and securities held in gross omnibus accounts or individual segregated client accounts (where certain conditions are met). The amended RTS aims to align the MPOR time horizons with that of the US, following the equivalence decision by the EU Commission in respect of CFTC clearing rules.

AIMA has also co-signed a paper prepared by the International Swaps and Derivatives Association (ISDA) on improving derivatives transparency espousing the benefits of single-sided reporting, published on 12 April. The paper had a total of 13 signatories (including ISDA, AIMA, the Investment Association and the Managed Funds Association) and has also been sent directly key legislators and policymakers in relevant jurisdictions. The paper advocates in favour of single-sided reporting on the basis that it will reduce costs, avoid duplication, streamline reporting obligations and make it easier to harmonise international reporting requirements. While early indications are that reporting will be an area of focus under the EMIR Review, the authorities currently appear committed to retaining dual-sided reporting, but improving it where possible. The Commission has not yet taken a position on the scope of the changes that it might put forward.

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CFTC Regulation AT proposals

Back in March, AIMA submitted a response to the CFTC's Regulation Automated Trading (Regulation AT) proposals. Regulation AT is a significant rulemaking intended to regulate the entire algorithmic trading landscape of futures on US Designated Contract Markets (DCMs) – from trading firms through to the DCMs themselves. AIMA's response built on our position supporting proportionate and well-tailored regulation of all participants in the algorithmic trading chain – ensuring that all 'AT Persons', Clearing FCMs and DCMs maintain their own pre-trade and other risk controls, as well as utilising robust testing and development processes. Nonetheless, we expressed specific concerns about the current definitions contained within Regulation AT – for example, the fundamental definition of 'Algorithmic Trading' which we argue is far too broad and would capture activities which are demonstrably not algorithmic trading. The principal source of concern for AIMA members were the CFTC's proposals to obtain summary access to all AT Persons' source code as part of the Regulation AT 'source code repositories' framework. AIMA's response strongly pushed back on this proposal on the basis of security risks to extremely commercially sensitive information and the lack of any commensurate supervisory benefit.

Further to its Regulation AT work, the CFTC reopened its comment period on certain aspects of the Regulation AT proposals for a two week period commencing 10 June. This followed and is focused on the topics posed for public discussion during a CFTC Public Roundtable on 10 June that discussed topics including: (i) the definition of DEA; (ii) the determination of AT Persons; (iii) alternatives to imposing direct obligations on AT Persons; (iv) compliance when using third-party algorithms or systems; and (v) source code access and retention.

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Market Abuse Regulation

EU Market Abuse Regulation

As we move towards the entry into effect of the EU Market Abuse Regulation (MAR) on 3 July this year, AIMA manager members have been looking to finalise their updated compliance procedures. AIMA held a breakfast briefing event at the beginning of June hosted by Simmons and Simmons to flag key areas of interest under MAR for hedge fund managers. The key areas of focus were the obligations for systems for to detect and report suspicious transaction and orders, obligations for receiving market soundings, scope of investment recommendation rules for alpha capture systems, application of MAR to secondary listings and legality of blanket order cancellation policies upon the receipt of inside information.

Level 2

The Level 2 legislation necessary to implement MAR has been published gradually over the last few months, with many measures undergoing their period of scrutiny by the European Parliament and Council. Measures published in March, April and May include delegated regulations on requirements for persons making market soundings, systems and procedures to detect and report suspicious orders and transactions and the technical arrangements for the objective presentation of investment recommendations. Particular concerns exist regarding the availability of systems to enable compliance with the obligations for persons professionally arranging orders and transactions to detect and report suspicious orders and transactions. ESMA has confirmed though its first Questions and Answers document on MAR that this obligation applies to all buy-side firms placing orders professionally, including proprietary traders. Limited best-endeavours forbearance is likely to be applied by the FCA for certain RFQ systems, in particular. Although in all other cases compliance is expected in full as of 3 July.

Level 3

In March, AIMA submitted a response to ESMA's draft guidelines on the obligations to be applied to recipients of market soundings under MAR. The response was broadly supportive of the proposed guidelines, including a robust internal analysis of information received, internal procedures for information distribution on a 'need to know basis' and recordkeeping. However, the response did push back strongly against the proposed obligation for all recipients to maintain lists of all staff members in possession of information passed during the course of a market sounding, for all soundings. The draft guidelines also covered circumstances whereby a delay in disclosure of inside information is necessary to prevent the legitimate interests of an issuer being prejudiced and when a delay is likely to mislead the public, although our response did not provide comments. A second ESMA Level 3 consultation was also conducted during Q2 2016 regarding guidelines on the definition of inside information for commodity derivatives, namely the type of information that can be reasonably expected or required to be disclosed by law, regulation or market convention. The final 'comply or explain' guidelines on all of the above topics will not be published until after the entry into effect of MAR. It remains unclear as to how the guidelines for market soundings recipients, in particular, will be amended in light of ours and other industry feedback.

UK

In May, AIMA submitted targeted comments to the FCA's most recent CP on MAR implementation dealing with its Decision Procedure and Penalties manual (DEPP) and enforcement guide (EG). The response focused on the UK's proposals to delete the defences against market abuse penalties currently available in cases where a person can prove that they believed on reasonable grounds that their actions were not illegal, or that they had taken all reasonable precautions to prevent illegal behaviour. The response argued that the reasonableness provisions are legal under MAR and, importantly, are vital bearing in mind the broadened scope of MAR and ease with which liability can be incurred.

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EU rules on benchmarks

Both the EU Council and the Parliament have now approved the Level 1 text for the Benchmarks Regulation on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds. The Regulation, first proposed in 2013 in response to the LIBOR rigging scandals, is intended to place particular requirements on the administrators of any EU benchmark or any third-country benchmark used by a supervised entity in the EU. The Regulation is expected to enter into force by the end of June 2016, and will take effect 18 months after it applies.

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ESMA released a broad Discussion Paper on the Level 2 measures in February for public consultation. AIMA submitted a response to highlight that the interpretation of an index being 'made available to the public' should be limited to where an index is made available without charge to the general public, to avoid inadvertently capturing routine communication of information to clients or investors. ESMA has now released its Consultation Paper, which is proposing draft technical advice narrowing the interpretation by clarifying that an index will be deemed to be made to the public when it is accessible by a large or potentially indeterminate number of recipients, either directly or indirectly, where a supervised entity's (including investment firms, AIFMs and UCITS) use of an index (e.g. tracking performance by reference to an index, or referencing an index in a financial instrument or contract) makes it available to an indeterminate number of people.

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EU short-selling rules

AIMA are currently in the process of developing a letter to the European Commission to highlight key areas of the EU Short Selling Regulation which merit attention to improve efficiencies and reduce regulatory burdens on industry in light of the current Capital Markets Union initiative. The issues to be covered by the letter include, among other things, the need for a centralised data source for the purposes of making net short position calculations, as well as additional time to submit private notifications for significant net short positions in shares and sovereign debt.

AIMA also still awaits ESMA questions and answers covering the matter of differing Member State interpretation and enforcement of the SSR's rules since its implementation. This issue was brought into sharp relief recently as numerous managers were fined by the Greek HCMC under the Article 12 prohibition on uncovered short selling when selling their allocations in the rights issues of certain Greek financial institutions listed on the Athens exchange. AIMA submitted a letter to both the HCMC and ESMA highlighting the need for further guidance and harmonisation wherever possible to improve legal certainty for participants.

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Securities financing transactions

In April, AIMA submitted a response to ESMA's initial Discussion Paper covering RTS and ITS under Regulation 2015/2365 on transparency of SFTs and of reuse (SFTR). The Discussion Paper was focused on SFT reporting issues, in particular the content and format of SFT reports themselves. It did not cover either periodic or pre-contractual disclosures of SFT permissibility and use by AIFMs or UCITS managers, with ESMA expressing its intention to rely on the Level 1 text alone for the details of such disclosures for the time being.

The response to the Discussion Paper reiterated AIMA members' concerns about dual-sided reporting of SFTs representing the largest unnecessary cost of SFT reporting under SFTR, although the response also noted that AIMA members will fall outside of SFT reporting and recordkeeping if they manage a fund or account entering SFTs that is established outside of the EU. The Response also made more technical points, including: our disagreement with the need to report both transactions and positions for CCP cleared SFTs; noting the inability for margin borrowers to report collateral for specific loans in a prime brokerage relationship when these loans are collateralised on a portfolio basis; and describing the disproportionality of requiring borrowers to report the particular collateral assets for a loan that have been reused. We now await the publication of ESMA's Consultation Paper on RTS and ITS under SFTR which should build upon industry responses, and will continue to engage on this file going forward.

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Basel III leverage ratio

In April, the Basel Committee on Banking Supervision released a consultative document entitled Revisions to the Basel III leverage ratio framework, asking for feedback by 6 July. The Basel III framework introduced a transparent, non-risk-based leverage ratio to act as a supplementary measure to the risk-based capital ratio. The latest consultative document proposes a set of changes to the standard released in January 2014, and includes suggested changes to the measurement of derivative exposures, for which the Committee is proposing to use a modified version of the standardised approach for measuring counterparty

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credit risk exposures (SA-CCR) instead of the Current Exposure Method (CEM). AIMA is working with other associations with a view to submitting a response to the consultation.

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Hong Kong - SFC publishes consultation conclusions on expansion of the scope of short position reporting

The Securities and Futures Commission (SFC) released its Conclusions on a consultation regarding new rules to expand the scope of Hong Kong short position reporting. As a recap, key highlights of the policy proposals were as follows:

- expanding the present short position regime to cover all securities that are determined by The Stock Exchange of Hong Kong Limited (SEHK) to be "Designated Securities";
- the reporting threshold trigger for Designated Securities that are stocks remains the same i.e. equals to or exceeds 0.02% of the market capitalisation of the listed issuer concerned or HKD$30 million, whichever is lower; and
- for CISs that are now caught under the expanded scope, the reporting threshold trigger is proposed to be set at HK$30 million.

The SFC has concluded that short position reporting will be expanded to cover all securities that can be short sold under the rules of The Stock Exchange of Hong Kong Limited. The reporting threshold for stocks will remain unchanged (being the lower of 0.02% of the stock's market capitalisation, or HK$30 million), while the threshold for collective investment schemes will be set at HK$30 million.

The proposed amendments to the rules will be submitted to the Legislative Council for negative vetting. To give the market a reasonable lead time for preparation, the SFC plans for the amended rules to come into effect on 15 March 2017, subject to the legislative process. The SFC will make further announcements regarding operational reporting arrangements for the expanded regime in due course.

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Singapore - AIMA responds to MAS Consultation on OTC Derivative Trade Reporting

AIMA has submitted a response to the Monetary Authority of Singapore's recent consultations on proposals to implement reporting of commodity derivative contracts and equity derivatives contracts (other than exchange-traded equity derivatives contracts), as well as revisions to fine-tune the reporting obligations for certain non-bank financial institutions.

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Tax

EU - Anti Tax Avoidance Package

The EU Commission presented in January, an Anti-Tax Avoidance Package intended to reform corporation tax within the EU. Primarily, there is a proposal for a Council Directive (ATA Directive) laying down rules against tax avoidance practices (which should be approved in June's ECOFIN) including: (1) a limitation on relief for interest payments; (2) an exit taxation provision and switch over clause which will limit tax exemption on profits received from companies in low tax jurisdictions; (3) a general anti-abuse rule (GAAR); (4) controlled foreign company rules; and (5) a framework to tackle hybrid mismatch arrangements. In addition, the Commission proposed to amend the Directive on administrative cooperation (to become DAC4) to include the exchange of tax-related information on multinationals (and so enacting the OECD's country-by-country reporting rules).

With regard to DAC4, the Council has formally adopted the Directive to amend the DAC (2011/16/EU). The DAC has been the subject of a series of amendments in recent years, and its current form can be explained (as the EU has done here) as follows: (1) the original DAC(2011) set out to enhance administrative cooperation in the field of direct taxation, and included provision for the exchange of tax information on request; (2) in December 2014, the DAC was amended to incorporate the OECD's Common Reporting Standard (CRS) framework, which facilitates automatic exchange of financial account information (DAC2); and (3) the latest text agreed is DAC3 which extended automatic exchange of information to advance cross border rulings and advance pricing arrangements (applying from 2018). To this will be added the new Directive DAC4, which will apply country-by-country reporting to

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certain MNEs from 2017.

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Non-cooperative jurisdiction list

The EU Commission published Council conclusions endorsing the Commission's Communication on external strategy and Recommendation on measures to prevent treaty access in inappropriate circumstances which were part of the Commission's January 2016 package of anti-tax avoidance measures (ATAP). The conclusions call for a swift and comprehensive implementation of the internationally agreed standards on transparency and exchange of information developed by the OECD and encourage all jurisdictions to commit to implement international standards as soon as possible. They also agree the establishment by the Council of an EU list of third country non-cooperative jurisdictions and to explore coordinated defensive measures at EU level without prejudice to Member State competence, while stressing the need to work with the OECD to draw up the international criteria in this area and to take into account the work of the Global Forum when developing the EU list of non-cooperative jurisdictions. The criteria on transparency for establishing a list of non-cooperative jurisdictions would have to be compliant with internationally agreed standards on transparency, both on exchange of information on request and automatic exchange of information. The conclusions also welcome the proposed provisions with regard to a principal purpose test and permanent establishments to be included in bilateral tax treaties agreed by a Member State, while acknowledging that bilateral tax treaties remain the competence of the Member States and that other measures elaborated in the context of OECD BEPS Action 6 may be helpful, such as limitation on benefits (LOB) clauses (if compliant with EU law).

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Financial Transaction Tax (FTT)

FTT has not seen any significant progress in the second quarter of 2016. The ECP Member States, now reduced to ten as Estonia has withdrawn from the group, have not met their self-imposed deadline for application of the FTT as from January 2016, and at this point even meeting a January 2017 deadline seems to be unlikely. The ECP Member States disagree on core aspects of the FTT and differences remain in satisfying the different needs of small and large participating jurisdictions. There must be progress at a technical level before any negotiations are taken forward to the representatives of the Member States.

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Base Erosion and Profit Shifting (BEPS)

The OECD released in 2015 the Base Erosion and Profit Shifting (BEPS) deliverables which form a comprehensive set of changes to the international basis of corporate taxation. The proposed framework operates as a combination of minimum standards, reinforced international principles and best practices, and includes these areas: (i) the interaction between different domestic tax rules (such as controlled foreign company regimes, hybrid mismatch arrangements); (ii) the substance of international tax provisions and model tax conventions (anti-avoidance provisions to prevent treaty abuse, changes in the definition of a permanent establishment, transfer pricing principles); and (iii) transparency and certainty of MNE tax liabilities (country-by-country reporting).

Action 6 - Prevent the granting of treaty benefits in inappropriate circumstances (treaty abuse)

In its final report on BEPS Action 6 (concerned with preventing access to tax treaty benefits inappropriately) the Organisation for Economic Cooperation and Development (OECD) acknowledged in response to issues raised by the asset management sector that further work was required on the tax treaty entitlement of those funds (non-CIVs) such as alternative investment funds which are not classified by the OECD as collective investment vehicles (CIVs, broadly UCITS and equivalent funds). Further, in April 2016 a consultation was published to seek views on the issues raised, in particular threshold qualifications for regulation and widely held ownership that might qualify non-CIVs for treaty access, the treatment of non-CIVs which are tax transparent entities, and means of identification of ultimate investors in a non-CIV.

AIMA submitted its response to the OECD consultation on tax treaty entitlement for non-CIV funds (broadly, collective investment vehicles that are not UCITS or equivalents). The discussion draft for the most part is seeking comments on the limitation on benefits

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(LOB) provision, in particular proposals put forward by commentators on earlier discussion drafts, although issues around the principle purpose test (PPT) are also discussed. AIMA welcomes the effort that the OECD has made on this issue, but sees this as an ongoing process where different practical complexities and governing interests will need to be taken into consideration, and this should be reflected in the recommendations incorporated into the Model Tax Convention and the Commentary that accompanies it.

Action 15 – multilateral instrument

The OECD released a consultation paper on the development of a multilateral instrument to implement those BEPS measures which are related to tax treaties. Public comments are invited on technical issues identified in a request for input from stakeholders. The report on Action 15 of the BEPS Action Plan (Developing a Multilateral Instrument to Modify Bilateral Tax Treaties) concluded that a multilateral instrument was both feasible and desirable. The Ad Hoc Group established on 27 May 2015 with the objective of developing the multilateral instrument now includes 96 countries, all participating on an equal footing, as well as a number of non-state jurisdictions and international organisations participating as observers. The Ad Hoc Group aims to conclude its work and open the multilateral instrument for signature by 31 December 2016. Responses are invited to the specific questions included in the request for input, as well as other technical issues that may arise from implementing the treaty-related BEPS measures in the context of the network of existing bilateral tax treaties. Comments and input should be received by the OECD by 30 June 2016.

Action 4 - UK HMRC consultation response

HMRC issued a second UK consultation paper on tax deductibility of corporate interest expense. The consultation provides details of the policy design and implementation of the interest restriction rules which are intended to be introduced from 1 April 2017 in line with BEPS recommendations (Action 4). AIMA responded to the first consultation paper and will now evaluate whether to react to this more complete set of proposals. The new rules will cap the amount of relief for interest to 30% of taxable earnings before interest, depreciation and amortisation (EBITDA) in the UK, or based on the net interest to EBITDA ratio for the worldwide group. To ensure the rules are targeted where the greatest risk lies, there will be a de minimis threshold of £2 million net UK interest expense per annum and provisions for public benefit infrastructure. The proposed framework will take account of specific regimes for sectors such as the oil and gas industry and the position of the banking and insurance sector. This consultation is open until 4 August 2016 and the government will consider responses in the drafting of the legislation for Finance Bill 2017.

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Transparency/ Automatic Exchange of Information (AEOI)

On the policy side, the OECD is aiming to converge two of the key international tax projects. The Base Erosion and Profit Shifting (BEPS) project and the measures for exchange of tax information among jurisdictions have a single objective of global tax transparency. The outcomes of the BEPS project are now starting to be adopted at national level, the Global forum on transparency and exchange of information has now 130 members, and 101 jurisdictions have committed to implement the Common Reporting Standard (CRS), with the first automatic exchange of information beginning by 2017. In the backlash from the Panama Papers, the G20 has mandated the OECD to establish criteria to identify non-cooperative jurisdictions (which will add to the comparable EU initiative on external strategy). The OECD and the Global Forum, in partnership with the Financial Action Task Force (FATF), have been mandated by the G20 and the Anti-Corruption Summit to work on improving the availability of beneficial ownership information to ensure effective implementation of the standard that will enable tax and other authorities to identify the true owners behind shell companies and other arrangements.

On the practical side, the OECD's Common Reporting Standard (CRS) went live on 1 January 2016. Financial institutions (FIs) established in participating jurisdictions are required to implement due diligence procedures when new accounts are opened and to review existing accounts. Reporting will commence in 2017. The evolution from FATCA to the broader automatic exchange of information under CRS will be challenging, and AIMA will continue to take up members' concerns with the OECD, the EU Commission and tax authorities, while encouraging sound practices in the industry.

An example of industry's concerns can be found with regards to controlling persons, when those are from a non-participating jurisdiction (as is the case for the

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US). In the context of asset management structures, identifying and evidencing the ultimate underlying investors may be a challenge in various circumstances.

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HM Revenue & Customs (HMRC) consultations

HMRC has published consultation documents on renewing and extending the scope of the Double Taxation Treaty Passport (DTTP) scheme (here), and potential Reform of the Substantial Shareholdings Exemption (SSE).

DTTP was introduced as an administrative simplification in late 2010 for corporate-to-corporate lending into the UK in order to reduce the administrative burden of obtaining reduced rates of withholding tax (WHT) under tax treaties which can act as a barrier to overseas investors making investments in the UK. An overseas corporate lender may obtain a treaty passport under the scheme which can be used in respect of multiple loans to UK borrowers. This consultation is intended to ensure that the DTTP scheme still meets the needs of UK borrowers and foreign investors but also asks whether the DTTP scheme should be extended to investors entitled to sovereign immunity from UK tax, pension funds or non-corporate entities such as partnerships. The consultation is open until 12 August 2016.

The consultation on the SSE looks at its original policy intent, that the tax treatment of share disposal gains does not discourage trading groups from restructuring or making disposals and that it contributes to the UK's competitiveness as a holding company location, against fundamental changes in UK domestic and international tax laws (in particular, BEPS).

A number of proposals are put forward, for a more comprehensive exemption, a removal of the investor trading test or the reduction of the substantial shareholding requirement. Further, the consultation notes that the SSE does not extend to UK resident companies owned by tax exempt funds such as sovereign wealth funds or pension funds that generally are outside the scope of UK corporation tax on their investment gains (irrespective of whether the SSE applies). These UK subsidiary companies would be subject to corporation tax on gains relating to share disposals and cannot generally benefit from the SSE because of the substantial non-trading activities in the groups of which they are a part. Consequently, sovereign wealth funds and pension funds often choose to locate their holding platforms outside of the UK in countries where share disposals are exempt from corporation tax under a comprehensive participation exemption. The consultation asks whether there is a case for reform of the SSE to be targeted towards the funds sector and, if so, how SSE-qualifying funds should be defined. The consultation will run until 18 August.

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Partnership WG

AIMA's Partnership Tax WG was set up to consider changes to the UK taxation of partnerships which were subsequently enacted in Finance Act 2014. It is apparent that some members are experiencing difficulties in agreeing with HMRC the interpretation of the rules relating to the treatment of some members of LLPs as salaried members and therefore employees. This WG has been refreshed with the mandate to engage with HMRC on some of the practical implications that the legislation has produced.

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Reform of the German regime for investor tax reporting

Revised draft legislation to amend the German Investment Tax Act (GITA) on fund reporting is currently under the legislative process. If adopted, the proposed framework would introduce significant changes to the tax treatment of investment funds and their investors. There would be layers of taxation both at the fund and at investor level, while the current rules allow for transparency treatment at the entity level. The reason for the amendments appears to be the need to comply with EU law. While the new regime may provide a greater degree of certainty of treatment, it involves a fundamental shift in taxation that will need to be appropriately considered. Investment funds will be able to make an election on whether the existing or new proposed rules will apply to them. Under the proposed timetable, the new rules would come into force from 1 January 2018.

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US tax

The Internal Revenue Service (IRS) and US Treasury published Proposed Regulations regarding deemed stock distributions under section 305(c) of the Internal Revenue Code (IRC). Section 305(b) of the IRC establishes five non-cash transactions that have a dividend effect for income tax purposes, although no actual dividend is paid. Further, section 305(c) refers to deemed dividend rules for persons who only hold rights to acquire the stock such as holders of convertible securities ('deemed shareholders') and provides that "a change in a conversion ratio (CRA) that has the effect of increasing a deemed shareholder's interest in the assets or earnings and profits of a corporation is treated as a distribution". Due to uncertainty on whether tax reporting or withholding was required, and also on the amount of the deemed distribution, market practice has been that issuers of convertible securities and intermediaries have not reported or withheld on taxable CRAs.

The proposed regulations are intended to address these issues: (1) the amount of the deemed distribution would be the excess of (a) the fair market value of the right to acquire stock over (b) the fair market value of the right to acquire stock without the applicable adjustment, both determined immediately after the applicable adjustment; (2) new reporting rules require an issuer of convertible securities either to provide specified information on taxable CRAs to withholding agents and the IRS or to publish the information on its website. This is intended to capture the information necessary to collect tax on taxable CRAs; and (3) on withholding, the Proposed Regulations expand the responsibilities of withholding agents (derived from the enactment in 2010 of section 871(m) 'dividend equivalent' payment rules), but also provide relief by deferring the withholding obligation until such time as the agents have adequate information regarding the deemed distribution, which should clarify their position in situations where there is no cash payment corresponding to a deemed distribution or a withholding agent lacks knowledge of the transaction.

The Proposed Regulations would apply to deemed distributions occurring on or after the publication date of final regulations but do not offer guidance on the withholding treatment of deemed distributions prior to 2016. A criticism of the section 305 rules is that they do not distinguish between bona fide adjustments to convertible securities issued by publicly held corporations which protect the benefit of the bargain for the holder of the security and potentially abusive transactions by privately held companies which seek to disguise distributions of earnings. The Proposed Regulations, if adopted, will impose costs on the financial industry that may well exceed the amount of revenue that the government will collect.

Further, in the context of the well-publicised regulations against corporate inversions, the Treasury Department and IRS also issued new proposed rules under Section 385 Internal Revenue Code (IRC). These raise a number of technical issues which may affect arrangements for related party financing. There are two main categories of rules envisaged: (i) prospective new administrative requirements for most intercompany debt instruments in order to be classified as debt for tax purposes; and (ii) a new regime that will recharacterise certain instruments as equity regardless of whether they would currently be so considered or documentation requirements have been met, with an effective date from 4 April 2016. This new regime could have a significant impact on the financing by funds of portfolio companies, and how credit funds and other structures in the private debt fund space operate, including the loss of interest deductions, added complexity to intra group operations and arbitrary results for entities in scope.

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Hong Kong - Introduction of a HK Open-Ended Fund Company (OFC)

The Hong Kong Government commenced last January the legislative process to implement the OFC regime. It introduced the relevant bill into the Legislative Council (LegCo) with a view to securing the passage of the bill before the summer of 2016.

As part of this process, the Financial Services Treasury Bureau (FSTB) issued a concept paper to gauge views on the possible extension of the profits tax exemption to onshore privately offered OFCs. The Hong Kong tax committee along with the OFC working group which AIMA formed made a submission (April) stressing the outstanding issues that the proposed framework still face, and offering possible improvements/amendments to the draft rules in relation to 'investment scope' or 'custodian requirements'.

The Inland Revenue Department (IRD) of Hong Kong issued on 2 June the Departmental Interpretation and

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Practice Notes No. 51 (DIPN) ("Profits Tax Exemption for Offshore Private Equity Funds") which sets out the Department's interpretation and practice in relation to the relevant provisions in the Inland Revenue (Amendment) (No. 2) Ordinance 2015. The rules include some guidance on the salaries tax treatment of performance fees and carried interest distributed to executives or employees of a fund management company. The IRD's new guidance establishes that unless the allocation of such performance fees and carried interest represent a genuine investment return that is equivalent to the return on investments received by other third party investors, such allocations could be subject to salaries tax as employment income through application of general anti-avoidance provisions. The investment return will be deemed by the IRD as at arm's length if: (i) the return is on an investment which is of the same kind as investments made by third party investors; (ii) the return on the investment is reasonably comparable to the return to third party investors on those investments; and (iii) the terms governing the return on the investment are reasonably comparable to the terms governing the return to third party investors. Hong Kong based fund management companies should evaluate their executive and employee incentive arrangements surrounding carried interest allocations in order to estimate the salaries tax implications (penalties may apply).

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Australian developments

The Australian government introduced in its budget a new tax system for managed investment trusts (MIT). The implementing Bill has been passed by both the House of Representatives and Senate without any amendments. The explanatory memorandum to the Bill as well as the final Bill (upon Royal Assent) is available on the Parliament website (here). A MIT is a collective investment vehicle which is a trust that is widely held and primarily makes passive investments. MITs will be able to be treated as transparent vehicles for tax purposes, that is, 'character flow through' structures where the MIT's income will be taxed upon receipt by or attribution to its members on the basis of its character. Double taxation that might otherwise arise will be reduced because members will be able to make annual upward and downward adjustments to the cost bases of their interest in the trust. Examples of MITs are real estate investment trusts, trusts for managed funds and infrastructure trusts where the main source of return is in the form of dividend, interest, rent and/or capital gains on sale. The taxation treatment of tax deferred and tax free distributions made by the trust is clarified. The new tax system is intended to increase certainty, allow greater flexibility and reduce compliance costs, and enhance the competitiveness of Australia's funds management industry.

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India - Mauritius Double Tax Agreement (DTA) - Singapore implications

India and Mauritius have signed a protocol to their treaty for the avoidance of double taxation. From 1 April 2017, India will have the right to tax capital gains on the transfer of shares of Indian companies realised by residents of Mauritius, so that the present exemption from tax in India has been removed and the Indian domestic tax rules will apply instead. The protocol protects investments in shares acquired before 1 April 2017, so that investments made before 1 April 2017 will not be subject to capital gains taxation in India. The Protocol also provides for a transitional period in which capital gains arising to Mauritius residents from alienation of Indian shares between 1 April 2017 and 31 March 2019 will be subject to tax in India at no more than 50% of the domestic tax rate. However, this benefit has been made subject to a "limitation of benefits" article that will be introduced into the treaty. Since the capital gains exemption under the India - Singapore tax treaty is linked with the treatment under the India - Mauritius tax treaty, these changes would also have implications for residents of Singapore.

The 2005 Protocol to the India - Singapore Tax Treaty provides that the benefit of the capital gains exemption under the treaty is to remain in force only while the Mauritius - India tax treaty provides for capital gains exemption. Accordingly, the exemption will be lost for residents of Singapore also, but it is not clear that the equivalent protection for investments made before 1 April 2017 or the transitional measures will be available. The Indian government is said to be discussing this issue with Singapore, and AIMA has made submissions to the MAS/IRAS which raise potential concerns and identify situations that require special protection, such as the need for a grandfathering provision for investments made prior to 31 March 2017, revision of the withholding rates applied to interest and a transitional regime.

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Multi-managers: Solving tomorrow's problems

By Jack Inglis, CEO, AIMA

For some activities unless you really know what you are doing then the D.I.Y. approach might, in the longer term, cost you more. Hedge fund investing is still, at least in some areas, one such industry, even if the focus by both investors and the media continues to be on the cost of hedge funds and rather than the value they can add.

On 19 April 2016, AIMA hosted its first dedicated roundtable where a cross section of professional multi-manager hedge fund selectors, once collectively categorised as funds of hedge funds (FoHFs), discussed the challenges they are facing as they transition from intermediaries that provided access into alternative asset managers that offer solutions.

The hedge fund multi-manager industry is very different today from the one that started in November 1969 with Leverage Capital Holdings. The fund was launched to offer diversified access to hedge fund talent at a time when private investors had to put a minimum of $1 million in per hedge fund. Multi-manager hedge fund assets went on to peak at roughly $1.2 trillion in June 2008.

Today, is it hard to quantify the size of the industry as family and private investment offices run multi-manager hedge fund portfolios, cross holdings are common (leading to double counting) and some allocators include bespoke and customised hedge fund mandates in their reported multi-manager assets under management.

The most recent InvestHedge Billion Dollar Club[1] puts FoHF industry assets at $671 billion, equivalent to managing 25% of hedge fund industry's money, while other surveys suggest that pure commingled assets are more likely to be around 12%. What has happened is that the industry is continuing to polarise between the very large FoHFs and the smaller ones, with the top 10 largest (by assets) making up 43% of the multi-manager industry.

Whichever format, commingled or customised/bespoke, the days of buying a database and 'plonking' hedge funds in an alternatives bucket within a portfolio are over. Those investors that see hedge funds as a single and largely interchangeable universe may be those that are disappointed with hedge funds.

Looking at the InvestHedge performance league tables for 2015[2], FoHFs on average were flat and yet a cursory glance at the general multi-strategy FoHF category shows a number of multi-managers were up more than 7% for the year and in strategy-specific FoHF categories double digit returns were prominent.

What this shows is that just as there is performance dispersion among underlying managers, so too not all FoHFs are the same. Additionally, because the FoHF indices do not typically include the returns of customised/bespoke hedge fund portfolios, which often have higher returns, to the outside world FoHF returns may appear to be lagging especially when compared to the single manager hedge fund composites.

Allocating to hedge funds today is about isolating diversified streams of idiosyncratic or uncorrelated returns, which only truly talented managers, generally but not exclusively hedge funds, can still find. It may be that some of the best returns can be found in smaller, newer managers, frontier markets or capacity constrained strategies that are not worth researching by allocators trying to place a few billion at a time. Picking hedge funds in corners of the investment landscape such as these is not a trivial exercise. It is a skill that many of the multi-managers have honed over at least one, sometimes two decades.

Helping an investor understand how individual multi-manager businesses are run can also help to explain why FoHFs need to charge fees: operational due diligence, investor relations, research, legal, compliance, not to mention the increasing regulatory burden the marketing regulations add to the mix.

Today it is not the size of the team that counts, but the ability to solve an investor's problem. With regulations, low rates and volatile equity markets, returns are just as important as they were before, but costs (or more

1 InvestHedge March 2016 Volume 15 Issue 5

2 InvestHedge February 2016 Volume 15 Issue 4

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accurately value for money) and risk budgets and capital usage ratios need to be taken into consideration. The adviser, which can understand the investor's problem and then find the appropriate 'tools' to solve them, will be the winner in the alternative investments allocation game. Having the ability to identify truly idiosyncratic or uncorrelated managers, and charge accordingly, is likely to make a multi-manager a new beneficiary of assets in the new environment.

Consultant overlap was one of the key areas of concern among the FoHFs gathered at the recent AIMA round table. Some consultants, though not all, now offer their own pooled multi-manager hedge fund portfolios on which they can earn basis points on assets under management rather than a one off consulting fee to 'outsource' assets.

There is a trend in asset management in general towards fiduciary mandates being offered without competitive tender, according to KPMG's Fiduciary Management Market Survey[3]. In 2014, 75% of new mandates were awarded without a fully competitive tender, KPMG found. Ironically, in this competitive environment some multi-managers are 'giving away' their research and offering hedge fund allocation advice/consultancy to retain market share and clients.

The partial disintermediation of the FoHF industry was inevitable as institutional investors became more sophisticated but multi-managers will continue to find new ways to add value: product or service related mergers; co-investing; taking minority stakes in the GPS; offering managed accounts; funds of one; portfolio solutions; liquid alternatives; or thematic funds are different ways traditional hedge fund selectors are re-defining their offerings.

The FoHF industry should not be written off. It is worth noting that the first hedge fund A.W. Jones & Co., founded by Alfred Winslow Jones in 1949, has evolved into a fund of external managers that is still in operation in this structure seven decades later. There is a value to multi-manager hedge fund investing for those that understand how to truly look at costs and recognize the skillset. Today, however, using multi-managers is less about the '3Ds: diversification, due diligence and deniability and perhaps more about the 3C's: collaboration, (portfolio) construction and creativity.

3 https://assets.kpmg.com/content/dam/kpmg/pdf/2015/12/fiduciary-management-market-survey-2015.pdf

Forthcoming AIMA events

Brexit webinar - Update and Implications for the Alternative Asset Management Industry
Date: 5 July
Time: 1230 BST / 1330 CEST / 0730 ET / 1930 HK

AIMA Hong Kong Manager Only Breakfast Seminar: The week after Brexit - Implications for Hedge Fund Managers
Date: 5 July
Time: 0815 - 0930
This event is for manager members only

US - Brexit: Update and Implications for US alternative asset managers *(webinar here)*
Date: 12 July
Time: 0830 - 1000

UK - AIMA's Guide to Sound Practices for Investor Relations London Launch
Date: 12 July
Time: 0830 - 1030
Venue: PwC, 7 More London Riverside, London

UK - In Conversation with Commissioner Michael Piwowar, US Securities and Exchange Commission
Full details below

Canada – Adding hedge to your book
Date: 27 July
Venue: Ottawa

Canada - Montreal Summer Social 2016
Date: 28 July
Time: 1500 - 1800
Venue: Terrasse du Lac, Parc Jean-Drapeau, 1 Circuit Gilles Villeneuve, Montréal

Australia – AIMA Australia Alternative Investment Forum 2016
Date: 13 September
Venue: Sofitel Sydney Wentworth, Sydney

Singapore – AIMA Singapore Forum 2016
Date: 15 September
Time: 1400 - 1830
Venue: Bloomberg, 23 Church St, Singapore

Hong Kong – AIMA networking drinks
Date: 21 September
Time: 1830 - 2130
Venue: Zuma, Level 6, The Landmark, Central

Canada – AIMA Canada Hedge Fund Conference 2016
Dates: 5 - 6 October
Venue: Le Westin Montréal, Montréal, Québec

Educational/training seminars for managers

London - A Guide to Sound Operational Risk Practices for Hedge Funds
Date: 13 July
Time: 0800 - 0945
Venue: Wells Fargo, 34 Grosvenor Street, London

New York - NAV Triggers: the Practical Issues
Date: 13 July
Time: 0815 - 1000
Venue: Katten Muchin Rosenman LLP, 575 Madison Avenue, New York

FEATURED EVENT IN Q3

In Conversation with Commissioner Michael Piwowar, US Securities and Exchange Commission

This event, hosted by Macfarlanes, is an opportunity for members to hear directly from an SEC Commissioner on various topics including asset management and systemic risk; regulation of compensation; growth and regulation of non-bank finance; and developments in the '40 Act space.

Date: 19 July
Time: 1230 - 1400
Venue: Macfarlanes, 20 Cursitor Street, London EC4A 1LT


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ESMA lends support for a harmonised European framework for loan origination funds

AIMA SPONSORING PARTNER

Dechert LLP

By Declan O'Sullivan, Partner, Emily Goodman, Associate, Dechert

Introduction

The European Securities and Markets Authority (ESMA) published an opinion on 11 April 2016 on the necessary elements for a harmonised European framework for loan origination by funds (the "Opinion") . The Opinion is issued to the European Parliament, Council and Commission at the request of the European Commission as part of its Action Plan on Building a Capital Markets Union (CMU), which was published on 30 September 2015. The goals of CMU include assessing the need for a coordinated approach to loan origination by funds, and consulting on elements of a European framework on loan origination. The European Commission intends to consult on that framework in the second quarter of 2016 (the "Consultation") and the Opinion, while not legally enforceable, is a useful indication of the direction of travel.

Which funds are in scope?

The Opinion and Consultation are of fundamental importance to EU fund managers of EU (and potentially also non-EU) funds originating loans. EU fund managers of other loan strategies, or of funds that invest through loans (for example, buy out or turnaround funds), managers of EuVECAs, EuSEFs or ELTIFs, and even funds managed by non-EU fund managers, could find themselves within the scope of the Consultation and resulting framework.

The Opinion focusses on "loan origination" (defined as providing credit while acting as a sole or a primary lender). It distinguishes "loan origination" from "loan participation" (defined as typically involving secondary market participations) and "loan restructuring" (defined as a fund investing in reaction to the restructuring of debt). However, managers of loan strategies other than loan origination may not be out of scope of the Consultation, which ESMA considers should include the harmonisation of loan participation and activities that fall between loan participation and loan origination. More fundamentally, ESMA's view is that funds "should provide credit under a suitable framework such that systemic risk is mitigated … and is no higher than that posed by bank lending". ESMA considers that the Consultation should review the exemptions relating to loan origination currently in place in Member States and available to private equity funds, venture capital funds and hedge funds, and threshold levels of loan originating activities. So the Consultation results will be of importance to managers across a spectrum of fund strategies.

While the Opinion expressly does not cover the EuVECA, EuSEF and ELTIF regulations, ESMA acknowledges that loan origination is possible (to some extent) for those types of funds, and raises the possibility of authorisation under the loan origination regime for managers of such funds, views within ESMA diverge on this point.

ESMA could not reach common ground on all issues, consequently its Opinion includes more and less interventionist positions on important points. Given the spread of views within ESMA, input from fund management industry bodies and participants will be important to the Consultation to ensure that an appropriate level of regulation is reached.

Background

While a majority of Member States currently permit loan origination by funds, approaches differ. Some Member States have long permitted loan origination to corporates on an unregulated basis (for example, the UK) while others permit loan origination only through specific regulated fund regimes (such as Ireland, Germany and Malta). ESMA considers "a common approach at the EU level would contribute to a level playing field for stakeholders, as well as reducing the potential for regulatory arbitrage". An overview of ESMA's assessment of Member States' differing approaches is annexed to the Opinion.

ESMA's key issues for loan origination

(i) Authorisation

ESMA considers that an "authorisation gateway" could be desirable for loan origination funds and their managers, particularly to assess credit origination operational capability, monitor systemic risk, and protect borrowers' and investors' interests. ESMA's desired end goal is a framework that provides national

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competent authorities with all necessary powers to monitor, supervise and enforce requirements for both managers and their funds. However, rather than concluding that the AIFMD is sufficient for this purpose, as a number of Member States have done in practice, ESMA appears to indicate either a further legislative proposal or an instrument supplementing AIFMD.

(a) Authorisation of managers

ESMA recommends that the Consultation should explore mandatory authorisation of managers of loan origination funds. As AIFMD already requires authorisation of managers above de minimis assets under management thresholds, the point here appears to be whether or not there should be a sub-threshold regime for loan fund managers. However, having re-opened this question, ESMA does not advance any cogent argument for differentiating loan fund managers from any other AIFM.

(b) Authorisation of funds

A key tenet of AIFMD is authorisation at the level of the manager and not the fund. However, the Opinion suggests that the Consultation should consider whether fund authorisation could be necessary, due to the "risks inherent in loan origination by funds". Again, this approach is at odds with AIFMD and ESMA does not explain why loan origination is perceived to be more risky than other AIF strategies beyond high-level assertions of systemic, liquidity, maturity transformation and imprudent lending risk; which AIFMD already addresses and are not unique to loan origination funds or to credit funds generally.

Jurisdictions such as Luxembourg and Malta have introduced or are introducing AIFMD compliant fund structures but which are not subject to any regulatory approval (see for example, the Luxembourg RAIF). Luxembourg and other Member States also offer fund structures which are both AIFMD compliant and subject to regulatory approval, such as the Irish QIAIF and Luxembourg SIF.

However, not all Member States offer regulated funds subject to a bespoke loan origination regime. For example, it has long been possible to structure private funds in the UK which engage in loan origination without any special authorisation at the fund level.

(ii) Types and scope of loan origination funds

(a) Liquidity

ESMA considers that loan origination funds should be closed-ended with limited redemption facilities at the manager's election and provided that investors are repaid on a non-preferred and equal basis at fixed intervals. ESMA is concerned by maturity transformation and potential short-term liquidity problems, and therefore considers that loan origination funds should not be permitted to provide loans with a maturity beyond the fund's life, and should be required to maintain "a level of liquidity appropriate to their activities".

(b) Scope of operations

ESMA notes that one Member State (Ireland) does not permit loan origination funds to conduct non-loan related investment activity (such as equity investment) in addition to originating loans while most other Member States allow loan origination funds to conduct other types of investment activity. The rationale for the Irish approach (following consultations with the European Systematic Risk Board) was to ensure that loan origination is seen as a specialist activity and not an "add-on". However, this has proven to be a commercially unattractive feature of the regime. ESMA does not express a view as to whether loan origination funds should be restricted from conducting other investment activity, but raises this as an issue for the Consultation and notes that if any resulting restrictions would reduce the types of funds permitted to originate loans, then there would be merit in a grandfathering or transitional regime.

(iii) Types of investors

Several of the Member States with existing loan origination fund frameworks do not permit investments by retail investors in loan origination funds, opting instead for AIFMD's professional investor based criteria. However, ESMA does not close the door to investment in loan origination funds by retail investors, particularly if afforded protections similar to those in the ELTIF Regulation.

(iv) Organisational requirements for managers

ESMA advocates a detailed operational and conduct framework for loan origination funds to mitigate the systemic, liquidity, maturity transformation, financial, legal, and "imprudent lending" risks that it identifies (but does not detail). As a minimum ESMA considers that managers of loan origination funds should be

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required to have policies, processes and procedures covering:

- risk appetite statement;
- risk management procedures;
- assessment, pricing and granting of credit;
- credit monitoring, renewal and refinancing;
- collateral management policy;
- concentration risk management policy;
- operational risk control appropriate to loan origination;
- assessment and scoring of borrowers;
- valuation, including collateral valuation and impairment;
- management of forbearance;
- identification of problem debt management; and
- capability and experience of staff.

These overlap substantially with the Irish loan origination regime's requirements, perhaps unsurprisingly as those requirements resulted from consultations with the European Systemic Risk Board.

(v) General requirements for loan origination funds: leverage, liquidity, stress testing, reporting

Member States' approach to the amount of leverage permitted for loan origination funds ranges from outright prohibition (e.g. Spain and Malta) to no stated limitation (e.g. Luxembourg). Although ESMA considers that leverage should be limited, it notes that loan origination funds should be permitted to incur some leverage in order to allow them to lend to small and medium-sized enterprises, a key focus of the CMU. ESMA recommends that the Consultation assess the permitted amount and types of leverage (whether from credit institutions only or from other sources as well).

ESMA recommends that loan origination funds should be required to conduct regular stress tests and that the stress test results should be reported to the board of the fund manager on a quarterly basis (this requirement is consistent with the Irish regime's stress test requirements).

ESMA also recommends the inclusion of additional reporting requirements into the AIFMD Level 2 Annex IV reporting regime to monitor the activities of loan origination funds and fund managers, and an assessment of possible mitigants to deal with systemic risk of loan origination by funds, including providing regulators with additional macro-prudential tools.

Summary comparison of the ESMA Opinion against key jurisdictions' current regimes

	ESMA Opinion	Ireland	Luxembourg	UK	Malta	Germany	Italy
Leverage limit	Open	200%	None stated but may be imposed	None stated but may be imposed	No leverage permitted	130%	130% (retail) 150% (professional)
Stress test requirement	Yes	Yes	Risk management process required	Risk management process required	Yes	Yes (risk management)	Yes
Borrower restrictions	Yes	Yes	Yes	No consumer loans	Yes	Yes	Yes
Requirement for credit policies, processes and procedures	Yes	Yes	Risk management process required	Risk management process required	Yes	Yes	Yes
Closed-ended only	Yes	Yes	No	No	Yes	Yes	Yes
Mixed asset classes permitted	Open	No	Yes	Yes	Yes	Yes	Yes
Retail investors permitted[8]	Open	No	No	Limited	No	No	Yes
Diversification requirements	Open	Yes	No	No	Yes	Yes	Yes

Please note that this a high-level comparison which does not take account of the nuances and detail of each jurisdiction's regulatory regime.

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(vi) Diversification, eligible investments and eligible debtors

ESMA recommends that the Consultation consider balancing the need for diversity at the investment level with the potential utility of funds specialised in industrial sectors with limited access to credit institution finance.

It considers that loan origination funds should be prohibited from engaging in short-selling and securities financing transactions (including securities lending), from using derivatives other than for hedging, and (as is consistent, for example, with the Irish regime) from lending to individuals, financial institutions, collective investment schemes, its manager and other related parties (such as depositary, general partner, or delegates).

Conclusion

The Opinion suggests that the conduct of loan origination by fund managers in the EU is likely to be subject to some additional regulatory requirements following the Consultation and resulting legislative measures. If appropriately implemented, harmonisation of Member States' loan origination regimes may benefit cross-border loan origination activity and the free movement of capital within the EU. Unless lessons have been learnt from AIFMD implementation, however, that seems a big "if".

Inappropriate implementation could result in an unnecessary additional layer of regulation, uncertainty and costs on top of a regime (AIFMD) that many consider to already be fit for purpose. This could constrict an important source of credit for EU companies (and SMEs in particular), contrary to the intent of the CMU to increase sources of funding for non-listed companies.

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The authors would like to thank Gus Black, Partner, Stuart Martin, Partner, and Ed Kingsbury, Senior Associate, for their contribution

Transitioning into alternative assets

AIMA SPONSORING PARTNER

By George E. Sullivan, Executive Vice President and Global Head of Alternative Investment Solutions, State Street Corporation

State Street research reveals the shift into alternative assets is continuing among sovereign wealth funds (SWFs) and public and private pension funds. Many of these institutional investors have been negatively impacted by the current low interest rate environment, and they are seeking to reposition their portfolios beyond traditional assets.

The pressure is particularly acute for many defined benefit (DB) pension schemes that face significant liabilities and deficits in the current low-return environment, combined with the longer-term challenges posed by increasing life expectancy. Meanwhile, some SWFs, particularly those whose incomes are oil or commodity dependent, are being called on to help plug major fiscal deficits. All of these factors have precipitated an increased focus on alternative assets that may offer positive risk-adjusted returns and greater diversification in this volatile market environment.

Our research underscores the long-term institutional shift toward alternatives. Research conducted by Oxford Economics on behalf of State Street found that 60% of SWFs plan to increase their hedge fund exposure over the next three years.[1] In the same survey, almost half of government pension schemes (48%) plan the same action over this time horizon.[2] Another survey by State Street of private and public sector pension funds found that 35% intend to increase their allocations to single manager hedge funds over the next three years, while 51% will boost their exposure to funds of hedge funds.[3]

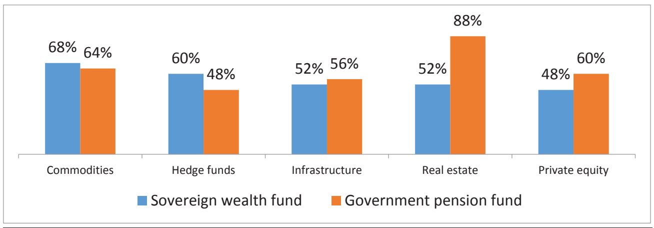
1 State Street 2015 Official Institutions Survey conducted by Oxford Economics

2 Ibid.

3 State Street 2015 Asset Owners Survey conducted by Longitude Research

Hedge funds are not the only beneficiaries of this trend. Nearly nine in 10 (88%) of government pension schemes expect to increase allocations to real estate while 48% of SWFs anticipate further inflows into private equity.[4] This appetite for alternative assets comes at a time when the industry is candid about some of the challenges they face in understanding the impact of these investments. In our global study of pension funds, 46% say they “lack transparency on the risks stemming from alternatives.”[5]

__Figure 1: Percentage anticipating an increase in allocations to alternative assets over next three years (sovereign wealth and government pension fund respondents)__



Source: State Street 2015 Official Institutions Survey (see end of article for summary of methodology)

Operational changes by investors

This evolution of investment behaviour has prompted internal changes at institutional investors. State Street found that 48% of public and private pension schemes plan to strengthen their internal risk teams over

4 State Street 2015 Official Institutions Survey conducted by Oxford Economics

5 Street 2015 Asset Owners Survey conducted by Longitude Research

continued ▶

the next three years.[6] This trend is mirrored in the official institutions sector, where 60% of government pension schemes and SWFs said they were "moderately extending" or "greatly extending" their risk and compliance teams.[7] Understanding investments and their associated risks is a crucial component of these institutions' fiduciary duties.

In addition, institutional investors are bolstering their own corporate governance approaches to enable them to better understand their diversified portfolios. More than nine in 10 (92%) of public and private pension schemes intend to upgrade at least one aspect of their governance in 2016. Among the actions being taken, 45% of respondents will increase training and education for their directors, while 44% intend to overhaul the recruitment process for corporate governance posts[8]: this is critical as many institutional allocators feel there is a need of development among their board of directors in core areas such as overall investment literacy. Just 23% of public and private pension funds think their governing fiduciaries have a solid understanding of alternative asset classes. [9]

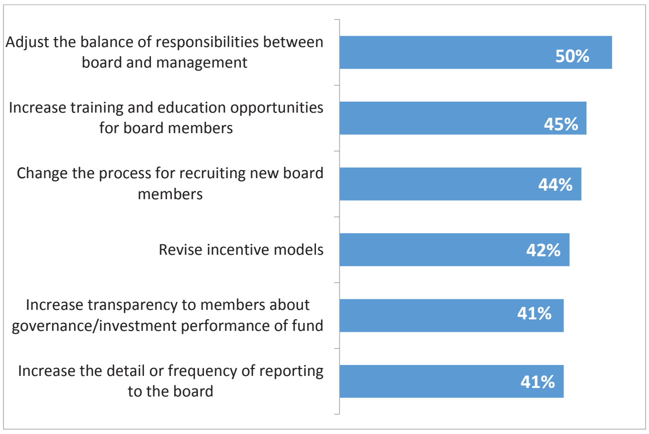
The improvements that are being made are doubly good news. In addition to strengthening the funds themselves, this deeper knowledge supports improved and more transparent dialogue between the funds and their external managers. This comes as hedge funds and other alternatives managers step up their own transparency efforts.

Specific approaches to risk are also growing more sophisticated. Almost all SWFs (96%) have either expanded or are looking to expand their use of risk factor analysis, while nearly two-thirds (64%) plan to increase their use of scenario modelling in the next three years.[10]

As institutional investors build out their internal risk teams, they are also bulking up their internal talent in other areas. Forty-five per cent of public and private pension schemes said they plan to increase their internal investment teams in the next three years. [11]This is likely to further improve institutional investors' knowledge of underlying asset managers and their processes, and help bring about their alignment and understanding with external managers.

Figure 2: Top governance actions for 2016 (public and private pension funds)

Source: State Street 2015 Asset Owners Survey (see end of article for summary of methodology)



Technology changes at investors

In addition to operational enhancements, institutional investors are building out and improving their technology systems. Government pensions and SWFs are making a number of technology enhancements around cybersecurity, performance and risk analytics, data warehousing and advanced scenario modelling. Sixty-one per cent of these institutional investors (SWFs, government pensions, central banks) intend to boost their headcount for individuals focused on technology.[12]

Having robust technology systems is crucial.

6 Ibid.

7 State Street 2015 Official Institutions Survey conducted by Oxford Economics

8 Street 2015 Asset Owners Survey conducted by Longitude Research

9 Ibid.

10 State Street 2015 Official Institutions Survey conducted by Oxford Economics

11 Street 2015 Asset Owners Survey conducted by Longitude Research

12 State Street 2015 Official Institutions Survey conducted by Oxford Economics

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Institutional investors are under increased scrutiny from their investors and regulators, and in turn are seeking greater insight and data from their underlying traditional and alternative asset managers. A minority of institutions go further and require the reports that alternative asset managers submit to financial regulators, such as Annex IV and Form PF. Aggregating and analysing this data reported by a diverse stream of hedge fund managers focused on multiple strategies, sectors and geographies may not be easy via manual processes or legacy technology systems.

The embrace of automation is a growing phenomenon at institutional allocators. These capabilities will help drive further confidence and understanding of their underlying investments. Managers will therefore start supplying in-depth data more frequently to their clients and enhance their own internal technology systems. This automation may encourage greater standardisation of reporting to end-clients to streamline the overall process.

The migration from traditional asset exposures to increased allocations to alternative assets has posed challenges for institutional investors — challenges that they are candid about rectifying. They are improving risk management, enhancing internal teams and strengthening governance procedures and technology systems to master these challenges.

A note on methodology

State Street 2015 Asset Owners Survey: *State Street surveyed 400 pension fund executives across 20 countries covering North America, Latin America and Caribbean, Europe and Asia-Pacific. Respondents included superannuation funds, public pension funds and private pension funds with assets ranging from sub-$500 million to more than $10 billion.*

State Street 2015 Official Institutions Survey: *During September and October 2015, Oxford Economics conducted a survey of official institutions on behalf of State Street. The survey captured 102 responses from senior executives around the world. Of these, 52 came from central banks and the remaining 50 from sovereign wealth funds (SWFs) and public pension reserve funds.*

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Cybersecurity risks, challenges and the path forward

AIMA SPONSORING PARTNER

EY Building a better working world

By Reto Aeberhardt, Senior Manager, Jaime Kahan, Principal, and Richard Wells, Executive Director, EY

Introduction: cyber risks — the rising challenge

Cybersecurity continues to be "top of mind" for hedge fund managers as the number of high-profile attacks continues to increase. The dynamic nature of the sector provides a unique set of challenges in the management of cyber risks. Over the past few years, we have observed firms establishing their strategic priorities and enhancing their adaptability to an interconnected global economy. This includes expanding business in high-growth markets as well as leveraging enterprise intelligence and data analytics as competitive advantages, all of which exposes hedge funds to new cyber risks compounded by an ever-evolving threat and regulatory landscape.

It has been estimated that up to 35 million attacks occur for large organisations every year. Typically it takes an organisation 200 days to detect an attack. Firms also continue to struggle to keep pace with the threat vectors, with limited resources and budgets.

Cyber risks should not be viewed only as a technology issue, but as a pervasive business and operational risk with the potential for a significant negative impact on assets, revenues, reputation and profitability. An organisation's cyber program should be focused on holistically managing cyber risk and protecting people, processes and technology, as well as protecting investor and other stakeholder value. Managers and fund directors need to think through the full range of cyber exposures and examine all contributing sources of cyber risk when designing this integral component of the organisation's enterprise risk management process. Regulators around the word are clearly increasing scrutiny on cybersecurity risk management.

Cybersecurity needs to be embedded within a firm's culture and organisation. Managers need to keep a few salient points in mind including that:

- It is not possible to prevent all attacks or breaches.
- The changing business environment will drive newer regulations.
- What companies used to know and do to protect their most valued information is no longer enough.
- Attacks from adversaries outpace traditional cybersecurity security responses.
- Technology-enabled transformation will change the existing cyber risk landscape.
- Early detection of cyber attack will be key.

Facts and trends: operating in a digital world invites new challenges and threats

Cybersecurity threats continue to evolve as attackers become more sophisticated, patient and persistent. Due to the relative ease of access via IP-addresses, digital systems are often targets for cyber criminals and should be included in an organisation's approach to improving cyber maturity. Attack surfaces also continue to expand beyond technology targets; increasingly, the human element is exploited by attackers to gain access to sensitive business data.

Typical points of weakness include:

- Smart devices and services can deliver unintended consequences and mass vulnerable data.
- Social media is 'always on' and information widely shared, without a full appreciation of privacy and security.
- Information is increasingly stored in the cloud or with third parties, resulting in less control, increased risk and a more complex cybersecurity ecosystem.
- Human behaviours are changing.
- New legislation and regulations are forcing changes in processes which can open up new vulnerabilities and widen the attack surface of the organisation.
- Reliance on third party outsource and cloud services providers creates additional pathways into an organisation.

EY conducts an annual Global Information Security Survey to identify industry trends in security program maturity, security investment prioritisation, and preparedness against attacks and data breaches. In 2015, 1,755 respondents representing all key sectors in

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67 countries participated in the survey. According to survey results, respondents from the asset management sector do not feel prepared in their ability to detect attacks and meet increasing cybersecurity demands. Key statistics revealed through our survey included that, in the asset management sector:

- Twenty-five percent of respondents listed “end user awareness” as the primary control failure that led to the most significant cyber events of the previous year.
- Thirty-three percent of respondents feel their organisation is unlikely to detect a sophisticated attack.
- Sixty percent of respondents say lack of skilled resources is a key challenge for managing IT security.
- Forty-seven percent of respondents do not have a Security Operations Center (SOC) that is responsible for the identification and resolution of security events.
- Forty-nine percent of respondents do not have a threat intelligence program.
- Twenty-two percent of respondents realised a financial impact between $100,000 and $1,000,000 due to information security events over the previous year.
- Fifty-one percent of respondents spend less than $1,000,000 on information security.
- More than 60% of respondents will either invest 5%-15% more on cybersecurity or invest the same as last year.

Increased regulatory requirements — overview

Conventionally, asset managers (including hedge funds) have invested heavily in remediating operational risks that maximise returns. As the number of security incidents and attacks intensify, managers need to adopt a proactive approach and familiarise themselves with the relevant regulations. Firms need to re-assess their operating models and cybersecurity eco-system and evaluate whether new policies, standards and procedures need to be implemented to strengthen the security controls and overall governance structure and comply with relevant global regulations.

In view of the recent developments in regulatory landscape, the traditional approach of confining regulatory challenges to a compliance officer needs to change. An environment where cybersecurity controls and leading practices are operationalised throughout the organisational structure should be encouraged.

The government mandates and regulatory rules may also increase to combat cyber threat actors in the rapidly evolving digital world which will add to the burden of organisational security management. Organisations need to be aware of the various cybersecurity regulatory requirements as guidance, as well as the differences in requirements amongst the various countries they have a presence in. Continued oversight by the senior management and proactive measures taken across the organisational structure to adhere with the regulatory standards and security controls will help reduce this burden and maintain stakeholder confidence. In addition, organisations must maintain documentation that demonstrates their compliance with their countries’ applicable cybersecurity regulations.

Ransomware — the unpredictable crypto devil

Ransomware is the term applied to a broad category of malware that prevents the victim from accessing critical data and functions of a system until a ransom, typically via the digital currency Bitcoin, is paid to the attackers.

It is malicious software, that when executed, encrypts all files on a target system, this can be a local hard disk drive or a server, preventing an authorised user from being able to access them. Attackers hold the files hostage until a ransom is paid. McAfee Labs has seen a 165% rise in ransomware in Q1, especially with the family CTB-Locker, along with new versions of CryptoWall, TorrentLocker, and spikes of BandarChor. Any organisation that has high value data is a potential target, which makes the asset management sector an appealing target in the eyes of malicious actors.

Ransomware can enter an environment through the same channels as other traditional malware – via an infected email attachment, malicious website URL or newsgroup postings etc. The most advanced versions of this malware can spread across the network increasing the number of impacted systems significantly.

Ransomware attacks are occurring more frequently and a new ransomware family has emerged - CTB-Locker. In recent months, headlines have been made as school districts and healthcare organisations were forced to practice crisis management while triaging ransomware attacks. Ransomware mitigation strategies include:

- A security-minded workforce is the best prevention

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mechanism to any malware attack. Annual security awareness training is no longer enough to mitigate this risk. Introducing email and telephonic phishing tests can test employee readiness to identify and report suspicious behaviour.

- A mature system backup and restore process will allow data to be recovered in the case of a ransomware attack by restoring data from a point prior to infection.
- The use of an SOC provides active defence by monitoring, identifying, investigating and resolving security events.

Are you prepared for a cyber incident?

A realistic cyber attack simulation can help you to understand your readiness to respond to a cyber attack — preparing for the inevitable

A response plan that has not been tested is as useful as having no plan. The midst of a security breach is not a good time to test the plan. Regular testing of your cyber incident response plan will help ensure everyone involved is familiar with the business decision making process and ready to react when a critical incident occurs.

The Hedge Fund Standards Board (HFSB), the standard-setting body for the hedge fund industry, held its first table top cyber attack simulation in December 2015 for hedge fund managers in London. The goal of the cyber attack simulation was to explore the responses to realistic attack scenarios, including data theft, financial infrastructure attack and crypto ransomware. The key insights on cybersecurity arising from the simulation were:

- Confusion over responsibilities can prevent an effective response. Managers should not consider cybersecurity as just an "IT" issue, given the legal, compliance, investor relations and reputational issues involved.
- Certain types of cyber attacks may exceed a manager's internal response capabilities. Managers should be prepared to quickly access external legal and IT expertise.
- Preparation in advance, through a cybersecurity incident response plan, is important. This planning establishes responsibilities, pre-identifies external resources and speeds decisions should there be an actual incident.

Cyber incident response — key challenges

- Keeping your response team current and well-versed in incident response, in the face of competing priorities
- Obtaining executive buy-in and participation in incident response planning and exercises
- Shortage of skills and internal capability to respond to an increasing number of complex attacks
- Learning of a cybersecurity breach from outside sources, such as law enforcement, a regulator or a client.
- Managing the media, when the news of a security breach has already gone viral
- Assuring customers, regulators, investors and other interested parties that the breach is under control

Today's reality:

- It's not a crime to be attacked; you can't stop being a target.
- The real problem is not realising you've been breached, and failing to react in a planned and coordinated manner.

Organisations typically overlook the importance of rehearsing the time-pressured business decision-making that is a critical component of responding to a cybersecurity incident.

Those who fail to prepare will struggle to contain an attack and will feel the impact to a far greater extent. Having a cybersecurity incident response process which manages an incident from identification through investigation, containment, remediation and follow-up is the first step.

Ten point action plan

The following are 10 considerations that managers should include when creating and updating their organisation's cybersecurity program:

1. Understand the business ecosystem including understanding internal and external stakeholders that impact business strategy and operations, threat actors across the ecosystem and understand how cybersecurity impacts your strategy and business relationships
2. Identify your most critical assets (crown jewels), threat scenarios and the potential impact to your bottom line if compromised
3. Prepare and assist your board and organisation to mitigate operational, economic and reputational risks in response to a breach

continued ▸

4. Define you cyber risk appetite and develop a cybersecurity strategy to help achieve your vision while maintaining agility and resilience
5. Improve cybersecurity awareness and focus on creating a security-minded workforce
6. Embed cybersecurity into your operating model, business architecture and operations through digital and cybersecurity transformation
7. Extend your cybersecurity framework with more detection mechanism and extend your SOC capabilities and incorporate cyber threat intelligence
8. Test your cyber incident response plan
9. Optimise your resilience strategy
10. Evaluate cyber insurance packages to properly cover you in the event of a breach

Summary

Attackers have access to significant funding; they are more patient and sophisticated than ever before; and they are looking for vulnerabilities in the whole operating environment — including people and processes. The resilience of digital systems becomes more and more important and more and more challenging at the same time. New technologies, regulatory pressure and changing business requirements call for more cybersecurity. However, securing digital system is not an easy task due to the complexities of the digital environments, legacy systems, and different vendor architectures.

So what can firms do to help manage cybersecurity threats? This question is an especially challenging one, as new threat vectors emerge every day, often in unexpected areas. Executives need a cybersecurity security lens on all aspects of the business: strategy, finance, operations, regulatory. Digital touches every part of your business, so cybersecurity needs to as well. Firms should work to develop a prudent cybersecurity risk management framework that can adapt to any threat that emerges. Organisations must remain diligent in supporting their firm's cybersecurity program and continue to adapt to changing environment and especially including more attack detection mechanism in within their environment.

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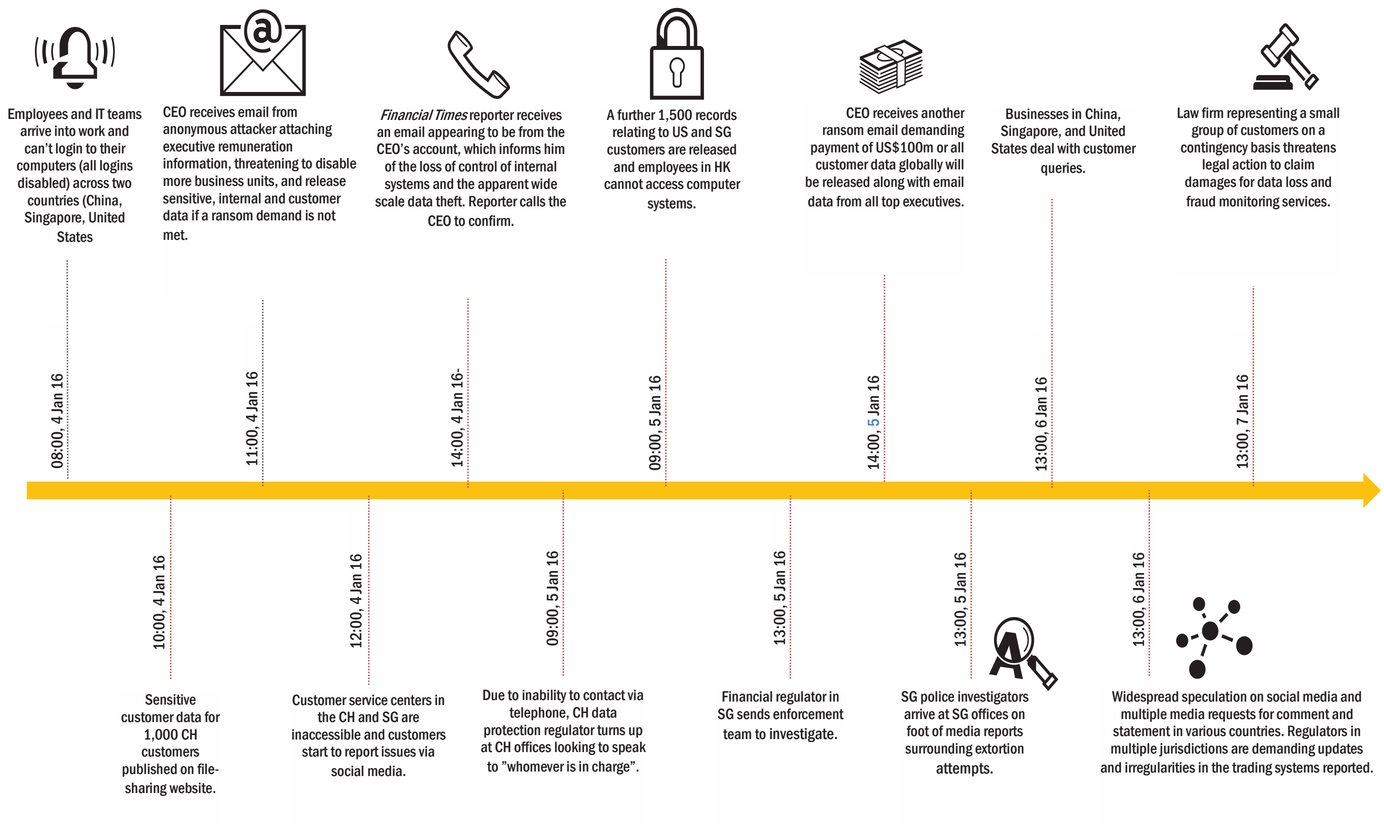
www.ey.com

The scenario outlined below provides an **example** of a cyber incident simulation that could cause catastrophic impact.



The Securities Financing Transactions Regulation - the EU seeks to shine a light on shadow banking

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MACFARLANES

By Robert Daniell, Senior Counsel, Will Sykes, Partner, Macfarlanes LLP

The European Union Securities Financing Transactions Regulation (SFTR) came into effect in January 2016. However, its implementation has been staggered over the coming months and years, with most of its more onerous obligations yet to come.

The SFTR is intended to create transparency for regulators and investors on the use of securities finance transactions (SFTs), and requires disclosures of risks associated with providing collateral.

The primary driver behind the SFTR has been a reaction to the bank-like credit intermediation known as "shadow banking". The opening words to the SFTR describe the scale of the shadow banking sector as "alarming", noting that it has been estimated as being half the size of the regulated banking system. One form of SFT, repurchase transactions (repos), is a core component of the shadow banking system. The SFT reporting requirement in particular is intended to give regulators a better understanding of the scope of the SFT market and its users. In addition to the reporting obligation, SFTR seeks to give retail investors transparency over the use of SFTR, as the use of SFTRs by apparently safe investments such as money market funds was a major source of instability in the financial crisis (see box "How the crisis in the shadow banking system has led to the SFTR"). Finally, SFTR seeks to ensure that risk disclosures are made for collateral for which legal ownership is passed, covering all financial transactions rather than just SFTs.

Which transactions are affected?

The SFTR affects the following SFTs:

- Repos, including reverse repos and buy-sell backs. Repos are a means of securing cash loans with bonds or shares as collateral.
- Securities lending, which involve shares or bonds being lent against cash collateral. Securities lending is frequently used in conjunction with short-selling of the lent securities.
- Commodities lending, which involve commodities being lent against cash, typically as a means of obtaining secured financing.
- Margin loans in connection with the purchase, sale, carrying or trading of securities, but excluding any other cash loans secured by securities.

The investor transparency obligations under the SFTR also apply to total return swaps (TRSs).

A recipient of collateral must give risk disclosures before receiving title transfer financial collateral or, for collateral held in custody, borrowing or otherwise reusing that collateral. Title transfer collateral is a means of passing collateral by transferring ownership of the collateral to the collateral recipient. Borrowing or reuse of collateral similarly involves the passing of the ownership of the collateral to the collateral recipient, and is often described as "rehypothecation"[1].

Which entities are affected?

- Any EU entity, including its non-EU branches.
- A non-EU entity if the SFT is entered into by an EU branch of that entity.
- UCITS and their management companies.
- Alternative investment funds (AIFs) and their managers (AIFMs) authorised or registered under the Alternative Investment Fund Manager Directive (AIFMD), irrespective of where the AIFM's fund is established.
- For reuse of collateral:
  - any EU collateral receiver (including its non-EU branches); and

1 Rehypothecation literally means re-pledging a pledged asset, so as a semantic point is used inaccurately to describe reuse of custody collateral. SFTR does not refer to "rehypothecation", instead preferring the word "reuse". It would be welcome if SFTR managed to displace in commercial parlance the word "rehypothecation" with the plain English term "reuse".

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- non-EU entities if:
  - the reuse is done by an EU branch; or
  - the collateral provider is (i) an EU entity or (ii) an EU branch of a non-EU entity.

What obligations are imposed?

The Reporting Obligation

Both counterparties must report details of each SFT to a trade repository within one business day of trading, modifying or terminating the SFT.

With regard to trading by a UCITS or an AIF, the obligation to report is placed on the manager, not the fund. Parties must also keep a record of any SFT they have concluded, modified or terminated for five years after termination of the SFT. A non-

How the crisis in the shadow banking system has led to the SFTR

The shadow banking system operates in parallel to the regular banking system, acting as a previously largely unregulated conduit between borrowers and providers of finance. Shadow banking typically involves non-bank firms using high leverage and short-term wholesale funding. Entities that are commonly seen as part of, or participating in, the shadow banking system are securitisation vehicles, asset-backed commercial paper conduits, money market funds, hedge funds, mortgage companies and investment banks.

As an example of one common route that cash flows through shadow banking, a mortgage lender may repackage its loans by creating a mortgage-backed security (MBS) issued by a special purpose vehicle. The MBS may then be bought by an investor (sometimes this is simply the mortgage lender that created the MBS) that then repos the MBS to a money market or other fixed income investment fund. The cash used by the fund in the repo comes from the retail public buying shares in the fund. In this way, money from retail customers is recycled to borrowers in a way that avoids the traditional, and heavily regulated, bank deposit route.

In the lead-up to the sub-prime mortgage crisis of 2007-8 money market funds were a popular means for US retail investors in particular to invest cash short-term, typically with little inkling that their funds were a key entry point for the shadow banking system. In consequence, at the time of the financial crisis the shadow banking system was a significant percentage of the financial system in the United States. As the prices for asset-backed securities linked to the US property market started to fall, lenders of cash under repos on those securities began to refuse to roll the repos over. The restriction to the flow of cash in the shadow banking system threatened the broader banking system, as many banks were reliant on repo funding for their holdings of asset-backed securities. The spread of the crisis has been described as “the silent bank run” or “the run on repo”, reflecting how the shadow banking system seized up due to the problems in the repo market. In an effort to put a floor under prices and so maintain the shadow banking repo market, the Troubled Assets Relief Program was implemented, which directly bought hundreds of billions of dollars of asset-backed securities at above-market prices. At the same time US money market funds were given government guarantees to try to maintain the flow of funds from retail investors. Government intervention prevented a complete collapse of the shadow banking system, but at considerable cost.

The crisis brought home the interconnectedness of the shadow banking system with the regulated sector. Regulators were conscious that their response to the crisis was hampered by a lack of a clear picture of the scale of the shadow banking system. In recognition of this, the Financial Stability Board (FSB) in 2013 made a number of recommendations with regard to SFTs, including collection of data, reducing pro-cyclical effects, promotion of central clearing and reform of bankruptcy law. The SFTR is among the EU’s first steps in response to these.

Although the EU shadow banking sector was smaller than the US shadow banking sector at the time of the crisis, unlike in the US the EU shadow banking sector has since grown, and at the end of 2015 the FSB reported data showing the US and EU shadow banking sectors as now roughly equal in size.

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financial counterparty[2] (NFC) trading with a financial counterparty[3] is exempted from the reporting obligation if the NFC does not exceed more than two of (i) a balance sheet of 20 million euros, (ii) turnover of 40 million euros, and (iii) 250 employees. Further, the parties to an SFT can delegate one party to report for both, and we expect dealers will agree to report for clients, as commonly occurs for derivatives.

Although the SFTR sets out the principal information that must be reported, the European Securities and Markets Authority (ESMA) has been delegated with the responsibility to determine the specifics of what is to be reported, and has recently taken public comments on the scope of the obligation. As with reporting of derivatives under EMIR, a contentious point has been the requirement that both parties to the SFT must report the transaction, with many submissions to ESMA recommending that one dealer counterparty to an SFT should be obliged to report on behalf of the dealer's counterparty as a single-sided report.

The Transparency Obligation

UCITS funds and AIFMs must disclose their use of SFTs and TRSs in prospectuses and periodic reports to investors. The required disclosures for prospectuses and reports are each specified in an annex to the SFTR.

The Reuse Obligation

Any recipient of title transfer collateral, or custody collateral on which it wants to exercise a re-use right, must:

i. obtain from the collateral provider written consent to do so, and
ii. disclose to the collateral provider the credit and other risks caused by title transfer and reuse.

As well as SFTs using financial collateral, also covered are securities under collateral agreements that rely on transfer of title, such as the English law ISDA Credit Support Annex.

Notably, existing collateral arrangements must meet this requirement. To assist in the meeting the requirement, a number of industry bodies have recently jointly published a standard risk disclosure document to assist users of collateral in this[4].

Entities must have policies for reporting to regulators any breaches of the reporting and reuse obligations.

What are the penalties for breach?

Member states must set their own penalties for breaches, which include possible bans and suspensions, and in financial terms must include a maximum penalty of at least:

- €5 million or 10% of annual turnover for breaches of transaction reporting requirements.
- €15 million or 10% of annual turnover for breaches of collateral reuse requirements.

What do fund managers need to do?

For those entities that are one of the affected entities listed above, the obligations that currently apply are:

- Record-keeping, for SFTs entered into or existing on or after 12 January 2016; and
- Prospectus disclosure, for UCITS and funds of AIFMs incorporated on or after 12 January 2016.

Obligations that will apply in the future are:

- From 12 July 2016, the reuse obligation.
- From 12 January 2017, periodic reports to investors for UCITS and AIFMs.
- From 12 July 2017, prospectus disclosure for UCITS and funds of AIFMs incorporated before 12 January 2016.
- The reporting obligation implementation is not yet fixed. ESMA must submit draft reporting Regulatory Technical Standards (RTS) by 12 January 2017, and a few months after submission the finalised RTS should come into force (the date of coming into force, the RTS Date). The time reporting then starts is:

2 An NFC is an entity that isn't a Financial Counterparty (see next footnote).

3 A Financial Counterparty includes any of (i) an investment firm authorised under MiFID II, (ii) a credit institution authorised under CRD IV, (iii) an insurance undertaking authorised under Solvency II, (iv) a UCITS (or, where relevant, its manager) authorised under the UCITS Directive, (v) an AIF that is managed by an AIFM authorised or registered under AIFMD, and (vi) an institution for occupational retirement provision under the IORP Directive.

4 Available at http://www.icmagroup.org/News/news-in-brief/five-industry-associations-publish-sftr-information-statement/

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- 12 months after the RTS Date for investment firms and credit institutions;
- 15 months after the RTS Date for clearing houses and central securities depositories;
- 18 months after the RTS Date for insurance undertakings, AIFMs, UCITS and pension schemes; and
- 21 months after the RTS Date for non-financial counterparties.

All SFTs entered into from the relevant reporting start date must be reported by the entity to which the reporting start date applies. As a retrospective reporting obligation, within 190 days of reporting start date the affected entity must report any SFTs existing at the reporting start date that (i) had a fixed period of at least 180 days to run, or (ii) didn't have a fixed period left to run but remained open for at least 180 days after the reporting start date.

Future developments

In addition to ESMA's recommendations with regard the reporting of SFTs, there are a number of other current or potential EU regulatory developments regarding SFTs and shadow banking. These include:

- SFTs with financial firms have, along with other financial contracts, become subject to a temporary stay on counterparties' ability to terminate, and the possibility of bail-in, under the EU Banking Recovery and Resolution Directive.
- The Financial Stability Board in November 2015 published a framework of minimum haircuts for non-centrally cleared SFTs. The FSB has mandated that these be introduced by regulators in jurisdictions of the largest levels of SFT activity by the end of 2018.
- In September 2013 the EU published a proposed regulation on money market funds with the intention of improving resilience in a future crisis. If adopted, the regulation would mandate minimum levels of liquid assets and limiting concentration risks.

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Shoot, aim, fire – another blow for hedge fund managers! Determining whether carried interest is still viable for hedge fund managers

AIMA SPONSORING PARTNER

By Rob Mellor, Partner, and Diya Wilson, Partner, Asset Management Tax Group, PricewaterhouseCoopers LLP

Hedge fund managers have been directly affected by many of the changes to UK tax legislation in recent years. The latest of these have been targeted at determining how both management and performance fees / carried interest ("carry") for investment managers should be taxed. As a result, hedge fund managers will need to consider more carefully the tax consequences of their fee arrangements going forward.

The first of these changes was the introduction of the disguised investment management fee (DIMF) rules that apply from April 2015. These rules intended to ensure that management fees were treated as income (and not capital) on the basis they were paid for the provision of investment management services. Genuine carry arrangements, co-investment and performance linked returns were specifically excluded from the scope of the DIMF rules.

In July 2015, only three months later, further changes fundamentally changed how UK tax resident non-domiciled individuals were taxed in respect of carry. As a result of these changes, the remittance basis of taxation is only now available in respect of carry to the extent that the individual, in question, performs services outside the UK.

At the same time a new special capital gains tax (CGT) was introduced in relation to carry which removed the benefits of "base cost shift" to ensure that, at a minimum, a UK tax resident individual was subject to 28% CGT on the amount of gain made.

Further changes were introduced in October 2015 which aimed to expand the application of both the DIMF and new carry rules where the individual has the "power to enjoy" the carry or DIMF sum.

The last of the trilogy of new rules affecting investment managers, and in particular hedge fund managers with carry arrangements, is the "income-based carried interest" (IBCI) rules within Finance Bill 2016. The rules which are effective from April 2016, have the effect that certain carry amounts may be subject to income tax & NICs (47% in aggregate) rather than CGT at 28% (the reduction in CGT to 20% from April 2016 does not apply to carry).

The HMRC's consultation document on the IBCI regime referred to HMRC's awareness of some hedge fund managers seeking to restructure their arrangements so that performance fees previously taxed as income are instead received as performance linked interests in the underlying funds i.e. carried interest. HMRC then conceded that applying the typical (and quite complex) trading / investing principles to determine income or capital treatment was difficult in such cases and led to inconsistencies in the industry. As such HMRC wanted to ensure such inconsistencies could not be exploited in relation to taxation of such performance linked rewards.

The IBCI rules state that if the weighted average holding period is greater than 40 months, it is taxed at the 28% CGT rate. However, if it is less than 36 months, then it is taxed under income tax. A tapering applies between 36 and 40 months. Depending on the fund strategy, the weighted average holding period calculations can create some difficulties. As a consequence there are a number of special computational rules that provide the opportunity to adopt a "simplified approach" to calculating the average holding period. For example, for private equity funds which invest in trading companies and/or trading groups there are rules for "significant interests", rules for "controlling equity stake funds" and rules for "significant equity stake funds". There are also further simplified weighted average holding period calculation provisions rules for venture capital funds, real estate funds, fund of funds and secondary funds. For qualifying fund of funds, the calculation can be done by reference to the holding period of the investments in the underlying funds rather than the ultimate underlying portfolio investments of those funds.

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In relation to debt funds, there are special rules for direct lending funds under which carry is taxed as income under IBCI unless the fund can fall within specific originating debt funds rules.

There are no provisions dealing with secondary debt funds or for strategies that might be considered the more typical hedge fund strategies.

Given the 36-month threshold, it is likely that many hedge fund strategies will not be able to avail themselves of the capital gains tax rates from April 2016 where they have carry arrangements already in place. As such it will be important for hedge fund managers who have not already done so to review their arrangements and consider how the new rules may affect their senior executives. In particular, the interaction of these UK rules changes with US taxation, for US nationals who are tax resident in the UK, is a very messy and complex area in its own right.

It should be noted that where hedge fund managers are already subject to the employment related securities rules, the IBCI rules do not apply to carry arising to such individuals. Since the partnership tax changes in 2014, depending on the specific facts, some hedge fund managers have been considering whether to move to a limited company structure in the UK as opposed to trading through a UK LLP. These changes could add weight to that view.

In summary, it is another complex issue that hedge fund managers may need to consider. Managers will need to understand the rules and decide if they apply to their arrangements and if so what the UK tax consequences might be for some of their senior executives.

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Survival of the fittest for emerging managers

By Sean Scott, Partner, Ian Gobin, Partner, Harneys

The regulatory and operational hurdles

So you want to be a hedge fund manager? Perhaps the better question is not whether but what kind of hedge fund manager you want to be. It certainly is no easy feat to survive, let alone thrive, in an increasingly complex industry. Complexity continues to drive up costs and is creating ever higher barriers to entry for so-called start-up or "emerging" managers. Form PF reporting obligations required under Dodd-Frank in the US, the EU's Alternative Investment Fund Managers Directive (AIFMD), European Market Infrastructure Regulation (EMIR), short-selling rules, the Markets in Financial Instruments Directive II (MIFID II) and Solvency II are all increasing the workloads and operational requirements for fund managers at a time when raising steady long-term capital from investors is equally challenging.

If the intention is to build a profitable asset management business, then a core ingredient has to be a commitment to a solid operational infrastructure conducive to institutional investment. Emerging managers are likely to find that in order to attract and retain the type of long term capital needed to build a profitable asset management business, they need to demonstrate the type of long term thinking and institutional mind-set of these investors. To an institutional investor, this often will mean internal and external infrastructure which will allows scalability.

Many of the surveys published by larger institutional investors frequently cite the need for hundreds of millions of dollars in assets under management (AuM) in order to be viable. While there is some merit to that position, taken in the context of the current market these numbers appear excessive. The reality is that an emerging manager will likely struggle to raise the first $100 million and indeed may launch with considerably less. The ability to quickly grow AuM to the types of levels which supposedly makes the fund attractive to larger institutional investors is a factor of whether or not the emerging manager has built the right infrastructure.

While it may be difficult, it is not impossible. The problem is that too often attention to building something properly is sacrificed for building something quickly.

Demonstrating institutional qualities

Hedge funds traditionally obtained early-stage investments from family offices, private banks and high-net-worth individuals, but these allocators have withdrawn somewhat since the financial crisis. Public and private sector pension funds now account for a significant chunk of hedge fund AuM. These investors are often contractually prevented from investing into hedge funds below a certain AuM threshold. The J.P. Morgan Capital Introductions Group survey of institutional investors in 2015 found that pensions and insurance companies were the investors most likely to require a hedge fund to have a minimum AuM of $500 million given their concentration risk guidelines and exposure limits.

Implicit in this approach is the expectation that any emerging manager who has not achieved this level of AuM probably does not have the relevant infrastructure, systems and processes to meet institutional expectations. Funds operated by managers who fail to meet these expectations will usually be rejected for investment by the operational due diligence processes of such investors early on.

The Deutsche Bank Global Prime Finance Group's 2014 Operational Due Diligence survey polled investors with more than $2.72 trillion in assets and identified the five most frequently cited red flags. These were (i) a lack of transparency by managers; (ii) inadequate compliance policies; (iii) poor segregation of duties; (iv) lack of experienced personnel in critical roles; and (v) inappropriate or substandard valuation policies. So although AuM is a persuasive factor in deciding whether or not to allocate, it clearly isn't the sole determining factor.

Undoubtedly one of the biggest challenges facing emerging managers is to create institutionally attractive infrastructure in a cost effective manner. Without this, emerging managers may face an uphill struggle convincing investors that they merit attention and allocations. Prioritising speed to market over care, time and attention to systems, quality control, service provider selection and due diligence may prove cost efficient at the outset but it is likely to be a false economy in the long run.

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In practice, a large part of the infrastructure required (certainly most if not all of the red flags in (i) to (v) above) can be managed by prudent and well-judged delegation and outsourcing to key functionaries. A carefully considered due diligence and vender selection process should form part of any critical path to launch, but emerging managers should expect to be ably assisted by a robust corporate governance framework, which should include independent, experienced directors, auditors and legal counsel.

The future?

Investor money is smarter than it has ever been and it is looking to trade up. It is also looking to pick a manager who has the best chance of long term survival. Emerging managers who want not just to survive but to thrive must demonstrate to the institutional investor marketplace that they possess the right type of infrastructure, long term strategic decision making and the standard of service providers necessary to ensure longevity.

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The Reserved Alternative Investment Fund (RAIF)

By Camille Bourke, Partner, and Jérôme Lasserre, Senior Associate, Arendt & Medernach

In the rapidly shifting, legal, regulatory and fiscal environments affecting the international investment funds industry, providing a stable and reliable structuring framework while keeping up with the pace of innovation is a delicate balancing act. In order to achieve this, Luxembourg has readily embraced the paradigm shift towards ever-more harmonised regulation in the alternative investment funds industry, precipitated by the G20 in the aftermath of the 2008 financial crisis. The Luxembourg investment funds model has traditionally been based on sound regulation at product level; prior to the 2013 implementation of the Alternative Investment Fund Managers Directive (AIFMD), all Luxembourg investment funds were subject to the prior authorisation and ongoing supervision of the financial sector supervisory authority (the CSSF). The AIFMD introduced regulatory supervision at the fund manager level, as well as certain product regulation features.

In a first step towards the new European approach for regulation of the alternative investment fund (AIF) sector, the Luxembourg legislator implemented the new manager-level regulation, modernised the outdated and unwieldy Luxembourg common limited partnership – *société en commandite simple* (SCS or CLP), and made an innovative advance by introducing the special limited partnership – *société en commandite spéciale* (SCSp or SLP), inspired by the Anglo-Saxon limited partnership model. Two years and almost 1,000 new limited partnership launches later, the Luxembourg unregulated limited partnership has become a new norm for the launch of AIFs. It would however be incorrect to state that the modernised limited partnership regimes have entirely replaced the tried and tested investment company in risk capital (SICAR) introduced in 2004 or the specialised investment fund (SIF) introduced in 2007.

While the launch of new SICARs and SIFs has dwindled in comparison to the launch of CLPs and SLPs, there is no one-size-fits-all solution. The unprecedented rise of the limited partnership did however signal to the Luxembourg legislator that the market participants no longer perceived product supervision as a must have. Instead, markets participants prioritised speed to market and structuring flexibility (in the context of regional, international or global offerings).

Two years into the new investment funds landscape created by the AIFMD, the Luxembourg fund structuring toolbox is ready for one further evolution. Shortly before the end of 2015, a bill of law was tabled to the Luxembourg *Conseil d'État* with the aim to introduce into Luxembourg law a new investment fund framework combining the strengths of the SIF and SICAR regimes with the flexibility of the modernised limited partnership forms under a new acronym: the RAIF (the "reserved alternative investment fund" regime) or FIAR (*fonds d'investissement alternatif réservé*). The availability of the RAIF will be reserved for authorised AIFMs, which may be based in Luxembourg, any other EU Member State or, if and when the AIFM management passport is introduced, for third country AIFMs.

The new regime will allow fund initiators and sponsors to set up a new type of Luxembourg AIF, allowing efficient access to the pan-European marketing passport of the AIFMD and which provides for the legal and tax features of the well-known, established SIF or SICAR regimes, but without the regulatory supervision of the CSSF. Rather than being directly supervised by the CSSF, RAIFs will be managed and monitored by fully authorised AIFMs subject to the supervision of their competent national authority.

Legal structuring flexibility

Like the SIF and SICAR, the RAIF may be formed under any of the well-known Luxembourg partnership, corporate and contractual legal forms:

- Partnership forms: common (CLP), special (SLP) or corporate (*société en commandite par actions* - SCA);
- Corporate forms: public limited company (*société anonyme* - SA), private limited company (*société à responsabilité limitée* - S.à.r.l.), cooperative company organised as a public limited company (*société coopérative organisée comme une* SA - SCOSA);
- Contractual form: common fund (*fonds commun de placement* - FCP).

A RAIF may adopt a variable (e.g., SICAV) or fixed capital (e.g., SICAF) structure and can operate as either

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an open-ended or a closed-ended fund. The RAIF may also adopt an umbrella structure with fully segregated compartments provided by law and have any number of classes of securities or interests, each with discrete characteristics.

The establishment of a RAIF will need to be performed before of a Luxembourg notary and recorded in a notarial deed. The notary must ensure that the RAIF is then registered with the Luxembourg Trade and Companies' Register within 10 days of its formation.

Investment strategy

The RAIF regime allows full flexibility with respect to the assets in which a RAIF may invest and the investment policies that a RAIF may implement. If the RAIF elects to avail itself of the legal and tax benefits available to a SIF, it will be subject to a minimum risk-spreading requirement (i.e., with a 30% counterparty exposure limit of its aggregate committed capital or NAV). If, however, the RAIF elects to only invest in qualifying risk capital investments (just like a SICAR does), the risk-spreading requirement will not apply.

Eligible investors

The RAIF will be available to "well-informed investors". This category includes institutional investors, professional investors and investors investing a certain minimum amount (EUR 125,000) further accepting a self-certification as to their financial knowledgeability and experience. Persons involved in the management of a RAIF will *a priori* be considered to be well-informed investors.

Management

The naming convention of the RAIF stems from the legal requirement that a RAIF must be managed by and is thus reserved for fully authorised AIFMs. Each Luxembourg AIF which elects to be treated as a RAIF must therefore appoint a duly authorised external AIFM, whether established in Luxembourg, in another EU Member State or, upon and subject to the implementation of the third-country management passport, a third-country authorised AIFM.

The assets of a RAIF must be entrusted to a depositary for safe-keeping and its central administration must be located in Luxembourg. The annual accounts of a RAIF must be audited by a Luxembourg approved statutory auditor.

Regulatory supervision

With the introduction of fund manager-level regulation via the AIFMD, the Luxembourg legislator identified an opportunity to revise its long standing strategy: continue the strong and recognised regulatory framework applicable to Luxembourg fund products and the Luxembourg service providers surrounding it but replacing the authorisation and supervision by the CSSF at product level with the authorisation and supervision of the product through the authorised AIFM. The CSSF will therefore not have to authorise the launch of a new RAIF or any changes thereto, thereby reducing the time to market for managers and initiators. The outcome will be absolute planning certainty, which will probably be recognised as the most welcome feature of the new regime.

Marketing

The RAIF will benefit from all EU AIFM's passporting advantages and can therefore be marketed to professional investors (as defined in the AIFMD) across Europe through a regulator-to-regulator procedure. The marketing of a RAIF to well-informed investors that do not qualify as professional investors within Europe, or to investors outside of Europe, will be subject to local placement rules.

Tax features

The RAIF will either be subject to an annual subscription tax (taxe d'abonnement) at a rate of 0.01%, like the SIF, with various exemptions, or be subject to the tax regime applicable to SICARs, i.e., be fully subject to tax save for qualifying risk capital income and gains. The VAT exemption applicable to AIF management services will also apply. The RAIF regime therefore merely continues two well-established tax regimes and does not introduce any new tax features.

Conversions

Existing SIFs, SICARs and unregulated AIFs may elect for the RAIF regime subject to securing the relevant approvals from investors and, where applicable, the CSSF. Under the same conditions, the RAIF could be used in a phased approach to organise a first closing rapidly with investors that do not require direct product supervision, with a transition into another regime, such as the SIF, to follow at a later stage to permit other investors that prefer or are limited to investing in directly supervised products.

Outlook

The bill of law is expected to enter fully into force in the summer / fall 2016.

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Trend following in crisis periods – January and February 2016 as a case study

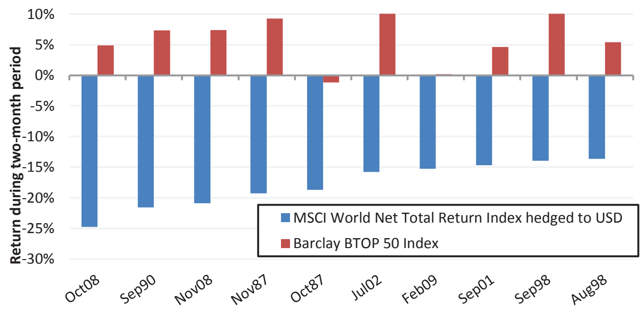
AIMA SPONSORING PARTNER

By Graham Robertson, Head of Client Portfolio Management, Man AHL

January and February 2016 were tumultuous months in financial markets. MSCI World Equities were down 6.8%, WTI crude oil was down 8.9%, and money flocked to the safe haven of fixed income, pushing the Citigroup World Government Bond Index up 3.3%.

Hedge funds were also caught out. The HFRI Fund Weighted Composite Index was down 2.4%, and 4 out of the 5 sub-indices were in the red. One notable exception was CTAs, or strategies which have trend-following at their core. The Barclay BTOP50 index and SG CTA Index were up 5.4% and 7.3% respectively for the two-month period. The intuition for this strong performance is fairly straightforward. Markets trended strongly throughout most of January and February -- stocks down, energies down, fixed income up, for example -- and many trend-following algorithms were able to profit through appropriate positioning in the futures instruments they typically trade.

Figure 1[2]: Performance of Barclay BTOP50 during worst ten two-month periods for MSCI World Equities, 31 December 1986 to 29 February 2016. Generally trend-following returns have been stronger in periods when equities were weaker.

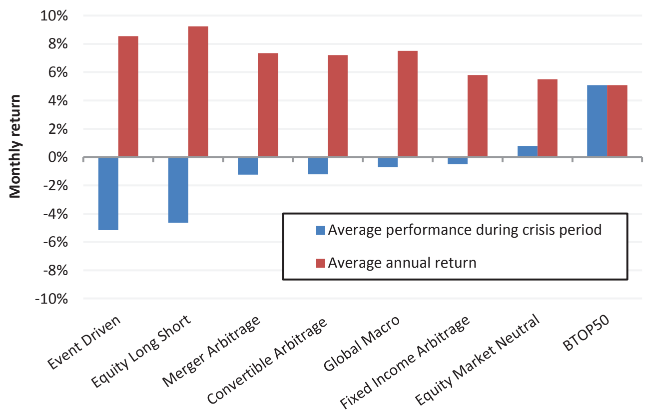


Past performance is not indicative of future results.
Source: Bloomberg and BarclayHedge.

Clearly trend-following strategies have worked well year-to-date, and performance has come at a time when many equity investors in particular needed it most. But is this behaviour typical? Can trend-followers deliver performance when equity markets are weak?

To answer this question, in Figure 1[1] we examine the performance of the BTOP50 index during the worst two-month periods for equities over the last three decades. In general, it does seem that trend-following

Figure 2[1]: Long-term performance of typical hedge fund strategies, and performance when equity markets are weak, defined as S&P down more than 10% in a two month period. 1 January 1997 to 31 December 2015. Trend following is one of the few investment strategies that can potentially profit significantly in crisis periods and in the long term.



Past performance is not indicative of future results.
Source: CME Group, and BarclayHedge.

strategies have exhibited positive performance when equity markets were weak. Just how diversifying CTAs have been from other hedge fund investments shines through in Figure 2[2], which considers performance of

1 MSCI World Net Total Return Index hedged to USD

2 The periods selected are exceptional and the results do not reflect typical performance. To a certain extent, the start and end dates of such events are subjective and different sources may suggest different date ranges, leading to different performance fi gures. As a consequence, they give no indication of likely performance.

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various strategies[3] (on average (red) and during two-month periods in which equities have been down at least 10% (blue). Several well known strategies, such as Equity Long/Short and Global Macro offered little diversification to equities when equities were suffering, despite being profitable in the long term. Others, such as Equity Market Neutral, performed better in the long term, but only marginally positively when equities were weak.Trend-followers, on the other hand, exhibited positive performance both in the long-term and in bad times. In other words, they performed well when many equity investors needed performance the most.

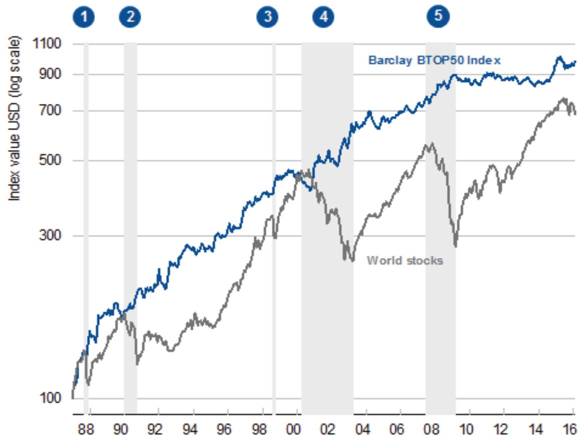
So it appears the positive performance by trend-followers relative to both equities and hedge funds so far in 2016 may be more than coincidence. To see what the strategy really has done in crisis periods, however, it is best to look over longer periods. Although previous analysis in this short note has looked at two-month intervals, holding periods for trend followers is typically around three months, and hence the strategy would be expected to get into its stride when intervals this length or greater are considered.

Figure 3 shows that trend-followers have historically shown the ability to perform positively during periods of well-known equity market weakness. When the dot-com bubble burst in 2000, for example, world stocks lost nearly half their value, whereas trend-following strategies returned over 35%.

In summary, it appears the strong performance of trend-following strategies during the equity market stress of January and February 2016 was no fluke. They have demonsrated this characteristic regularly over time.

Timescale is important, however. We have concentrated on two-month and longer horizons. Shorter than than this -- a sudden market move, for example – and performance will depend on positioning at the time of the event. It could be positive or negative. On the other hand, when moves in markets become sustained,

Figure 3[2]: Performance during extended periods of equity market stress. 1 January 1987 to 29 February 2016



	Total return over the period	Barclay BTOP50 Index	World stocks[1]
1	1 Sep 1987 to 30 Nov 1987	8.5%	-20.8%
2	1 Jan 1990 to 30 Sep 1990	13.1%	-29.0%
3	Russian crisis and LTCM difficulty 1 Aug 1998 to 30 Sep 1998	10.9%	-14.0%
4	Equity bear market 1 Apr 2000 to 31 Mar 2003	36.8%	-45.7%
5	Credit crisis 1 Jul 2007 to 28 Feb 2009	16.5%	-49.3%

Source: CME Group, and BarclayHedge.

Past performance is not indicative of futre results.

trend-following strategies have historically fallen into their stride. We believe this is why they have historically tended to exhibit positive performance during crisis periods.

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3 Index definitions (Figure 2) Event Driven: Barclays Hedge Fund Event Driven; Equity Long Short: Barclays Hedge Fund Equity Long Short; Merger Arbitrage: BarclaysHedge Fund Merger Arbitrage; Covertible Arbitrage: Barclays Hedge Fund Convertible Arbitrage; Global Macro: Barclays Hedge Fund Global Marco; Fixed Income Arbitrage: Barclays Hedge Fund Fixed Income Arbitrage; Equity Market Neutral: Barclays Hege Fund Equity Market Neutral

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Extension of the Senior Managers and Certification Regime: Impact on asset managers

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By Alistair Woodland, Partner, Dorian Drew, Partner, and Chinwe Odimba-Chapman, Senior Associate, Clifford Chance

On 4 May 2016, the Bank of England and Financial Services Act received Royal Assent. The Act will extend the Senior Managers and Certification Regime (SMCR) - which already applies to banks and insurers - to all financial services firms. Around 60,000 additional firms will be brought into scope of the regime when it comes into force (expected to be early 2018). Detailed regulations from the PRA/FCA are expected later this year, but experience drawn from the banking sector suggests that the changes required by the regime are extensive and will take a substantial amount of time to implement, and that early engagement by firms with affected individuals is vital.

Background

The extended SMCR will come into effect in 2018. Although the regulators are expected to consult on the proposed rules in 2016 and 2017, lessons can be learned from the implementation of the regime in the banking sector. In our experience the extended SMCR is likely to require substantial changes to training, employment documents and compliance policies and procedures and senior individuals will need to understand the possible impact on them personally. Firms will need to consider:

- Who will be a Senior Manager
- How to allocate key responsibilities between the Senior Managers. What processes they will adopt for agreeing statements of responsibility (SORs) with Senior Managers
- Whether existing governance and committee arrangements continue to be appropriate
- What arrangements will be made to reflect increased personal accountability for Senior Managers (for example, in relation to legal expenses and/or indemnification)
- How Certified Persons will be identified and certified annually
- How to ensure uncertified staff are not inadvertently performing certified functions
- Which staff will be covered by the Conduct Rules
- How training should be updated and delivered
- Whether changes to employment documents and processes will be required
- If changes to regulatory references and personal data retention are necessary
- What changes to settlement agreements and termination processes should be implemented
- The potential impact on remuneration arrangements
- Which individuals will be covered in other group entities
- The practical implementation of the regime in relation to in-scope employees based overseas

What is proposed?

On 7 March 2016, the new Senior Managers (SM) and Certification Regime (CR) applicable to many banks and insurers in the UK came into force. Its purpose is to ensure that individuals who run, or perform important functions in, banks and insurers have clear lines of responsibility, and are accountable to the regulator for their actions. The Government now proposes to extend this regime to all sectors of the financial services industry, including FSMA "authorised" firms in 2018.

Is my firm affected?

Yes if your firm is regulated by the Financial Services and Markets Act 2000 and meets the definition of an 'Authorised Person'. About 60,000 firms will be affected including investment firms, private equity firms, asset managers, mortgage brokers and consumer credit firms.

What are the key elements of the extended SMCR?

The extended SMCR will replace the current Approved Persons Regime for affected firms. The final rules will be subject to consultation, but key elements will be:

- The most Senior Managers in firms will be subject to pre-approval and supervision by the FCA or PRA. Certain responsibilities prescribed by the FCA or

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PRA will be allocated to the Senior Managers and their individual responsibilities will need to be set out in a "statement of responsibilities" (SORs) which must be submitted to the regulator with the Senior Manager's approval application.

- Firms will have to prepare and maintain a Governance or Responsibilities Map showing the key roles within the firm, the people responsible for them, their responsibilities and lines of accountability.
- Senior Managers will be accountable to the regulator if they breach Conduct Rules prescribed by the FCA or PRA, are knowingly concerned in a breach by a firm of a regulatory requirement, or fail to take reasonable steps to prevent such a breach by a firm in their area of responsibility, as set out in their Statement of Responsibilities and the Responsibilities Map.
- Senior Managers will have a statutory duty of responsibility to take reasonable steps to avoid the firm breaching a regulatory requirement in the Senior Manager's area of responsibility.
- Firms must ensure that Senior Managers and other staff who could cause significant harm to the firm or its customers are at all times fit and proper, and must certify them as such at least annually.
- Firms must also ensure that employees comply with certain Conduct Rules, in respect of which firms will have notification, training and record keeping obligations.
- The criminal offence applied to banks of recklessly causing a financial institution to fail will not be applied under the Extended SMCR.

Who will be a Senior Manager, who will be a Certified Person and who will be covered by the new Conduct Rules?

The Senior Managers Regime is intended to cover the top level of decision makers within an institution. This could cover individuals who are based outside the UK and some non-executive directors. Experience demonstrates the importance of involving Senior Managers in the process (and in particular the Governance Map and Statement of Responsibilities) at an early stage. Equally important is the provision of advice and re-assurance to Senior Managers through the development of appropriate policies (for example, we have assisted a number of Banks by producing a bespoke "Senior Managers' Handbook") and processes relating to decision making. Most current Approved Persons below senior management level are expected to become Certified Persons. In addition some roles that are currently not subject to approval may require certification.

New Conduct Rules will apply to Senior Managers, Certified Persons, directors and other employees. For institutions regulated by the FCA the staff population subject to the Conduct Rules may be extensive (under the banking regime only ancillary staff such as security, catering and cleaning staff are exempt). Firms will be expected to embed the Conduct Rules in their employment documentation and to provide firms with appropriate training.

When will the extended SMCR be implemented?

The extended SMCR will come is expected to come into effect in (early) 2018 and the regulators are expected to consult on the proposed rules later this year.

Key features of the extended SMCR

- Regulatory pre-approval for specified "Senior Managers"
- Statements of responsibility (a form of regulatory job profile) for Senior Managers
- Enhanced individual accountability
- Firm required to identify and certify the fitness and propriety of individuals with the potential to pose significant harm to the firm or customers (known as "Certified Persons")
- New Conduct Rules
- New notification, training and record-keeping obligations

It is anticipated that the extended SMCR regime will also include:

- Governance and responsibilities map requirements
- Enhanced "handover" requirements for departing Senior Managers
- A requirement to obtain and provide regulatory references
- New whistleblowing requirements

Key dates

- 4 May 2016: The Bank of England and Financial Services Act received Royal Assent
- Q3 2016 to Q4 2017: FCA and PRA consultation in relation to proposed rules
- Early 2018: New extended SMCR rules likely to be implemented

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Finally the EU clearing obligation for interest swaps begins

By Kate Wormald, Owner and Founder, Oesa Partners

The European Markets Infrastructure Regulation (EMIR) implements, within Europe, the mandatory clearing of certain OTC derivative contracts through a framework of central counterparties (CCPs), and establishes a requirement for all non-cleared OTC derivative contracts to be subject to more stringent risk mitigation requirements. The regulations for risk mitigation have mostly been implemented; but we do have what is expected to be the final rules for margining un-cleared swaps. Although this starts for some counterparts in September 2016, most alternative funds will not be caught until later in 2017 or even 2108, as these rules are also being phased in. So there is time to consider these rules.

The delegated regulation that imposes the mandatory clearing obligation for certain interest rate swap contracts entered into with any European counterparty has finally been published and comes into force in June 2016. The regulations are being phased in over the course of 2016-2018, so market counterparties including UCITS, AIF and non-EU AIF who trade OTC IRS derivatives should consider how they are categorised to enable them to declare their status, in order to clear these products and consequently be able to start clearing IRS at the relevant time.

This article focuses on who will be subject to the clearing obligation, the assets classes that must be cleared via a CCP and the relevant implementation dates, and new trading documentation requirements.

Scope and application

The application of certain parts of EMIR is dependent on the classification of an entity as set out below. The risk mitigation and transaction reporting requirements are applicable to anyone trading OTC derivatives within the EU. But the clearing obligation is dependent on the type of entity and some exemptions apply if the entity does not exceed certain clearing thresholds. The entity classifications are as follows:

- Financial counterparties (broadly; banks, insurers, investment firms, pension schemes, alternative investment funds and UCITS funds) established in the EU (FCs);
- Non-financial counterparties (NFCs) established in the EU whose aggregate positions exceed the clearing thresholds (NFC+s); and
- NFCs established in the EU whose aggregate positions are below the clearing threshold (NFC-).

Prima facie non EU funds are outside the application of EMIR. However, if the investment manager of a non EU fund is or becomes an AIFM then the non EU fund is captured and then falls within the definition of FC.

The determination of which category a NFC falls within depends on a threshold measured against the gross notional value of positions of:

- EUR 1 billion - credit derivative and equity derivative contracts; and
- EUR 3 billion - interest rate derivative, foreign exchange derivative and commodity derivative contracts and other derivatives.

In order to calculate whether the NFCs exceeds the threshold it must aggregate positions across non-

Category	Counterparty	Date
1	Clearing members for at least one class of the relevant classes of IRS of at least one CCP authorized or recognized to clear	21 June 2016
2	FCs and alternative investment funds (“AIFs’) belonging to a group whose group aggregate month-end average of outstanding notional amount of non-centrally cleared derivatives for the three months following the Delegated Regulation entering into force is above EUR 8 billion	21 Dec 2016
3	FCs and AIFs not in either category 1 or 2 above	21 June 2017
4	NFC+s not in either category 1,2 or 3 above	21 Dec 2018

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financial entities in their group but may exclude, subject to certain conditions.

All FCs and NFCs that exceed the applicable clearing threshold (NFC+) will be required to clear certain classes of IRS. The delegated regulation further divides these categories into four types of counterparty, so as to phase in compliance over the next couple of years. A contract between two counterparties in different categories would be subject to the clearing obligation from the later of the two dates specified above.

ISDA has designed a classification letter that is effectively a series of questions to help counterparties determine their own classification and those of their trading counterparts. ISDA have also helpfully produced a guidance note. Both are available on the ISDA website for free and if FC or NFC are in doubt about their status these documents are useful tools to use.

IRS subject to the mandatory clearing

The classes of IRS that must be cleared are:

- Float-to-Float (basis) IRS that reference the Euro Interbank Offered Rate (EURIBOR) or the London Interbank Offered Rate (LIBOR), have a maturity of 28 days to 50 years and are settled in either euro, pounds sterling, Japanese yen or US dollars;
- Fixed-to-Float (plain vanilla) IRS that reference the EURIBOR or LIBOR, have a maturity of 28 days to 50 years and are settled in either euro, pounds sterling, Japanese yen or US dollars;
- Forward Rate Agreements that reference EURIBOR or LIBOR, have a maturity of three days to three years and are settled in either euro, pounds sterling or US dollars; and
- Overnight Index Swaps that Reference Euro OverNight Index Average, FedFunds or the Sterling OverNight Index Average, have a maturity of seven days to three years and are settled in either euro, pounds sterling or US dollars.

There are specific exemptions for covered bonds but we have not detailed them here.

ESMA recently proposed extending the scope of the clearing obligation for IRS to include fixed-to-float IRS denominated in Czech koruna, Danish krone, Hungarian forint, Norwegian krone, Swedish krona and Polish zloty to forward rate agreements denominated in Norwegian krone, Swedish krona and Polish zloty. The Commission has not yet adopted the proposed final draft RTS.

How a CCP works and related documentation

The centrally cleared model closely mirrors how clearing houses operate for exchange traded derivatives. Most hedge funds will not have direct access to the CCP, as this it is not commercially viable to be a clearing member, so the majority of funds will have to gain access indirectly via a clearing member. In effect they will still face their clearing member, often their prime broker, and have counterparty risk exposure to the clearing member, even though some of the collateral will be held at a CCP. Some clearers will allow any excess margin to also be held at the CCP and this then eliminates the counterparty risk exposure to that counterpart in most circumstances.

The main benefit of the CCP model is that the collateral is held in either a fully segregated account in the client's name or a client omnibus account. However, it should be noted that the excess margin held by the clearing member and is not automatically held at the CCP. Consequently, one has to consider the agreements very carefully and assess the counterparty risk exposure accordingly.

In the event of clearing member bankruptcy, the amount of the excess collateral is unsecured and the fund would have to make a claim in the bankruptcy for this sum. Whilst the CCP would look to port the transactions and corresponding collateral it held to a new clearing member, it cannot transfer collateral that it does not hold. Therefore, if the excess margin is effectively lost or locked up in the bankruptcy, a counterparty would have to post more collateral to the new clearing member. So the benefit of this model would be lost to some degree.

Due to this risk a new clearing model is currently being developed to address this but the details are not available at this time.

Standard documentation has been developed by the ISDA/FOA for OTC clearing and can be used under either the ISDA Master Agreement or a Futures and Options agreement. Most clearing members have established it under the latter. The problem is most clearing members have varied the Addendum. So there is not really a standard market agreement as such and these agreements can take a while to negotiate.

Suggested plan of action

1. Consider whether you trade the relevant classes of OTC swaps.
2. Determine your counterparty classification to be

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able to declare your status for clearing purposes. We suggest you use the ISDA letter if you need assistance in the first instance and seek advice if anything is unclear.

3. Work out the deadline which applies to you. Although we have seen some bank counterpart insisting to start clearing straight away.
4. Negotiate the relevant documents with your prime broker or other indirect clearing member to enable clearing to occur.
5. Start to clear by the relevant deadline.

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Asset managers must focus on long term to justify their existence

By Fiona Frick, CEO, Unigestion

Ensuring financial markets function as an efficient transmission mechanism

The finance industry provides the flow of capital necessary for the economy to grow. Within this system, asset management companies have a vital role to play – European asset managers alone hold equities equivalent to around 40% of the free float of European listed companies. One of the key jobs of the asset management industry is to make sure that the financial markets function as smoothly as possible. How exactly do we do this?

Ensuring appropriate liquidity

First, we must ensure that there is no mismatch between the liquidity of the securities we hold in our investment solutions and the redemption conditions we promise to investors – in other words, our investment funds must not provide more attractive liquidity terms than that of the underlying investments those vehicles allocate to.

If there is a liquidity mismatch and a fund cannot meet redemption demand in a down market, there can be major implications for the markets as prices will diverge from the value of the underlying assets. This was strikingly the case in 2008 when hedge funds could not cope with the redemptions that investors were trying to make.

More recently the rapid rise in flows into and out of exchange-traded funds (ETFs) has also raised some concerns, with two worrying incidents taking place in 2015. First, US shares were sold off sharply at the opening of the market on 24 August 2015, and US equity ETFs saw their prices plunge far below the values of the indices they were designed to track. Second, a gradual sell-off in high-yield bonds in December 2015 turned into a rout for ETFs investing in this asset class. In short, ETFs are an untested market force that may increase selling pressure in a market downturn.

Focusing on the long term to prevent excessive market volatility

Second, asset managers need to play the role of long-term buy-and-hold investors, basing their decisions on their confidence in a company's valuation and growth potential. Today, an alarming proportion of financial market participants do not invest for the long term, but trade in the hope that they can jump off a profitable bandwagon in as little time as possible.

The danger of this short-termism is that it creates volatility in the stock price, which represents a risk for investors. What's more, it doesn't incentivise asset managers or the companies they invest in to adopt long-term strategies as they will not be judged on their success. Instead of encouraging our institutions and leaders to overcome complex, long-term challenges, we're actually rewarding them to do the opposite. Often, there seems to be a great deal more upside to placing a simple bet for a quick win than in staying the course through difficult times with the aim of creating sustainable gains that can be widely shared across society.

So asset manager incentives should be based on long-term return metrics that incorporate measures of risk. Investors, for their part, must act as the long-term owner of a stock and not as a mere renter who will trade the stock as soon as they can pocket a quick gain – or sooner if there's no such gain to be made.

In fact, there is far too much short-termism throughout the economy. Companies are judged based not on their long-term financial performance and future potential, but on what happened over the last quarter. Asset managers are assessed by their clients in large part on their year-to-date performance rather than their long-term returns.

But it doesn't have to be this way, and indeed it wasn't in the past. It is only in the last 10 years or so that this focus on the short term has become so prevalent – previously, a 3-5-year horizon was much more common. And going further back in time to the very beginnings of the stock market, the whole idea of investing in a share was to benefit from the issuing company's long-term growth.

So it is important that asset managers invest with the long term in mind and do not pay too much attention to short-term noise. Institutional investors also have a role to play in this respect, as they have long-term liabilities and must move towards assessing their asset managers over a similar horizon, not just on the last few months. We elaborate on this point later on.

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Contributing to price discovery and avoiding bubbles

A third way in which asset managers ensure that the markets are efficient is their role in price discovery. But it is only active managers that can perform this role, and it is one of their most important functions.

A decade ago, passive funds accounted for around 5% of global assets invested in public equity. Today, this figure is around 20%. Passive investments provide a great service in terms of keeping a lid on management fees and ensuring liquidity in the markets, but they cannot match the role of active managers in terms of price discovery.

What does this mean in practice? In simple terms, active managers aim to uncover as much information as possible about a stock and these details are incorporated in the share price, which represents the sum of all of their views. Without active managers, no one would have an accurate idea of what the price of a security should be.

Passive investors, in contrast, act as free riders in that they only have to pay the marginal cost of participating in the markets rather than the high costs of a research process whose aim is to accurately assess prices.

What's more, in general they allocate capital based on the composition of a market index rather than in the belief that a company will grow or that it is an attractive investment. This means a passive approach is like investing by looking in the rear-view mirror. If a company is in the index, passive investors are forced to continue investing even when a company's valuation has become disconnected from its fundamentals. The result is that the greater the proportion of capital invested in passive strategies, the more likely it is that bubbles will form and that investors will be exposed to sharp reversals in performance.

The purpose of passive investment is not in question but its rapid growth raises the question of whether it has come to lead the market rather than follow it. The cost to society of passive management is a more volatile and less efficient stock market. If all investments were managed passively, the main function of the market – to provide pricing – would cease to exist. Passive investments can also expose investors to undue risk: an investor allocating to a passive fund in 2008 would have been taking exposure to some very risky sectors (such as financials) that were about to collapse and that many active managers avoided entirely. Active management based on exposure to a set of proven risk factors provides the most scope for producing attractive long-term risk-adjusted returns.

Long-term financing of the economy

Asset managers are ideally placed to provide long-term funding

Asset managers should increase their involvement in the long-term financing of the economy, and there could be some considerable advantages to them doing so. Unlike banks, which use short-term funding to allocate capital, asset managers use the long-term funding provided by institutional investors (with the caveat that those investors must remain invested), so they provide a crucial link between investors and the financing needs of the real economy. What's more, history shows that very few of them have gone bust or needed state bail-outs in order to survive. Active asset managers allocate capital among competing uses so, if they do so properly, economic growth will be enhanced as those activities that generate the best risk-adjusted returns should attract the most investment.

So asset managers have an important role to play in society in terms of channelling capital to finance growth. But not any kind of growth. The real end goal should be sustainable economic expansion that minimises the risk of another major financial crisis.

How can we achieve this goal? Again, institutional investors and asset managers must work together to allocate to companies with a sustainable growth model rather than looking for a short-term jump in price. Institutional investors (mainly pension funds and insurance companies) account for around 75% of the asset management client base in Europe, so they have a major role to play in ensuring the companies they invest in act responsibly and implement good corporate governance practices.

Given that the liabilities of our biggest clients – pension funds and insurance companies – are rather long term in nature, asset managers are well placed to act as a source of long-term finance to the economy, mainly by investing in equity and debt securities issued by companies and governments.

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This holds true for investments in private as well as public equity. The idea of private equity is to inject working capital into a promising business and help refine its products, operations or management, while suitably compensating shareholders for the risk this involves. As private equity investments are long term in nature, investors have even more time to make sure the strategy of the underlying companies meet a relevant societal purpose.

A change in mind-set

But at the moment, adopting a long-term approach is easier said than done because of the current focus on short-termism, which we discussed above. For example, the average holding period of a stock has fallen from eight years in the 1960s to around one year today. Meanwhile, the tenure of the average CEO is just three years. Under these circumstances, what kind of motivation do company managers have to put forward a long-term strategy? As it stands, they will just be judged on day-to-day events.

We see evidence of this in the financial news on a regular basis. Short-term financial engineering efforts, such as buybacks, dividends, spin-offs and sales, are increasing in frequency, and they generally cause shares to spike in the short term. But such activities can have unwanted effects over the longer term, leaving a company's finances more vulnerable, especially if it uses borrowed money to buy its own shares. This is harming the long-term creation of value and may ultimately be doing companies and their investors a disservice, even if stock prices rise impressively temporarily.

We can see this in a 2015 report published by McKinsey Global Institute, which showed that the average variance in return on capital for North American companies is over 60% higher today than it was between 1965–1980. What's more, a focus on short-termism could see public companies lose ground to other kinds of firm, compelling some to move back to private ownership so they can implement a long-term strategy without worrying too much about quarterly earnings. In the US, the number of listed shares has fallen from 8000 in 1996 to half that number now.

To avoid this kind of situation, asset managers must act as long-term investors who make sure that companies do not focus too much on the daily fluctuations of their stock prices and that they plan for and invest enough in their long-term futures. Meanwhile, company CEOs must be incentivised to invest in research, innovation, and training their staff, and to make the capital expenditure that is vital to ensure long-term growth and ongoing relevance of the company as the needs of its customers evolve.

Investors need to be on board

The caveat of all this is that institutional investors must also take a long-term view when they choose their asset managers and evaluate their investment performance. This could be achieved by setting out a fee structure based on long-term performance objectives – we believe that a horizon of five years is appropriate given that this is approximately the length of an investment cycle.

Internal managers working at institutional investors must also be judged over the long term. If they are assessed on their one-year performance, even though the goal of the pension fund is to meet its long-term liabilities, there is no way they will judge their asset manager based on long-term returns.

While a shift to a long-term focus would represent a big change from much current practice, it would be in the interests of investors themselves. As most institutional investors themselves have long-term horizons, ensuring the sustainable long-term growth of the companies they invest in is clearly in their benefit.

In conclusion

With the fallout from the 2008 crisis still affecting the lives of millions of people across the world, it is unsurprising that the financial industry is still viewed with considerable suspicion by much of the general public. But we believe it can be a powerful force for good.

Asset managers in particular have a major role to play in helping solve some of the most pressing problems that the world currently faces, and we must demonstrate our capacity to develop meaningful investment solutions that meet today's challenges and help finance sustainable economic growth.

We are in a privileged position in terms of our position as a link between the providers of and those who need funding, and we must make the most of the opportunity we have to improve the world we live in as well as grow the value of our clients' assets. If we do so successfully, we will once more be able to justify our existence as an industry to a sceptical public.

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MiFID II… Prepare to record all mobile communications

By Lee Stonehouse, Chief Executive Officer, Venncomm

Dubbed the most ambitious and contentious set of reforms introduced by the European Union in the wake of the 2008/09 financial crisis, the Markets in Financial Instruments Directive (MiFID II) is proving to be a big thorn in the side of many across the broad spectrum of market participants.

With a go-live date of January 2018, the beast of MIFID II and its accompanying regulation (MiFIR) has four key objectives: (a) strengthening investor protection; (b) improving market surveillance through more transparency; (c) keeping pace with technological innovations that could result in financial arbitrage; and (d) enhanced overall supervision and enforcement.

One particular facet which should not be treated lightly is the recording of mobile communications as prescribed under 'Organisation Requirements' (MiFID II article 16). As part of the overall drive towards preventing, detecting and deterring market abuse, recording of voice and electronic communications is, by the regulators' own admission, the most difficult offence to investigate and prosecute. As a result, obligations under MiFID II have been refined in the hope of increasing legal certainty between investment firms and their clients.

It is important that investment firms fully understand how MiFID II will impact their business models and the operational frameworks that will have to be created. Workstreams should now be mobilised and tasked with delivering compliant solutions, whilst allowing ample time for test phases. From a mobile communications perspective, at the highest level, firms will have to review their compliance policies and assess the appropriate technology to meet the legislation.

By providing a one-year implementation delay[1], regulators will expect full compliance and as such, expectation is that a zero tolerance policy will be applied post-January 2018.

1 Agreed in principle at time of writing between the European Commission, Parliament and Council

Flying under the radar?

One can form a variety of credible arguments on which specific aspects of MiFID II are the most significant and far-reaching. For example, the expansion of pre- and post-trade transparency to non-equity instruments that brings into scope bonds and derivatives. From a post-trade perspective, certain instruments will have to be publicly reported within 15 minutes for the first three years post go-live and then within five minutes.

Other examples include reporting nearly triple the number of fields (65) for transaction reporting compared to MiFID I (2007), double volume caps on the use of the reference price waiver, the effective elimination of broker crossing networks, a ban on inducements and research unbundling. Whilst it may not pose the greatest impact on an investment firms' business model, the recording of voice and electronic communications will require careful attention.

The original MIFID I framework[2] did not mandate the recording of telephone conversations or electronic communications. Instead, it provided member states with discretion to adopt taping requirements involving client orders if required.

The Financial Services Authority[3] enacted new rules (COBS 11.8[4]) in 2009 that meant firms dealing in an agency or principal basis covering a range of 'qualifying investments' (equity, bond and derivatives) were required to record telephone lines used for voice conversations along with electronic communications

2 MiFID I (2004/39/EC) – Article 50: Powers to be made available to competent authorities

3 Predecessor to the Financial Conduct Authority

4 Conduct of Business Sourcebook

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relating to these activities. Interestingly, discretionary investment managers were exempt on the basis relevant taping would be captured by the sell-side firms. The other important point to note here and one of industry contention was centred on the recording of mobile phone conversations. Bowing to concerns that technology was not advanced enough to enable banks to record mobile conversations, the FSA postponed this particular element of the regulation until 2011.

Tightening the scope

As a means of creating a level playing field and harmonisation across member states, MiFID II eradicates any elements of discretion. Article 16 (6)(7) mandates that records be kept of all services, activities and transactions including the recording of telephone and electronic communications regardless of whether these conversations or communications lead to the conclusion of a transaction.

The term ‘mobile phone’ is not explicitly stated but like with many aspects of the legislation, the devil is in the detail. Article 16(7) further states that reasonable steps must be taken in terms of recordings and communications “made with, sent from, or received by equipment provided by the investment firm”. Provided the investment firm is able to record and/or copy the devices they issue, mobile phones would be captured within the scope. In the event recording functionality is not possible, mobile phone usage will be prohibited from use.

A couple of key contrasts to COBS 11.8 need to be called out here. Article 16 will claw buy-side firms into the net and where under COBS 11.8 taping and communications records are to be kept for a minimum 6 months, under Article 16 they will be have to be kept for a minimum of five years. National Competent Authorities will have the option to request an additional two years on top of this.

Global focus

Recording of conversations and communications over various mediums is not a requirement specific to MiFID II. Heightened global regulatory focus can be seen in the US, which implemented similar legislation under the Title VII Dodd-Frank Wall Street Reform and Consumer Protection Act (2010). CFTC regulation §23.202 (daily trading records) and §23.203 (location of records) require swap dealers and major swap participants to record ‘all’ pre-execution (quotes, solicitations, bids, offers, instructions, trading) communication (including mobile) in a form that is identifiable and searchable by counterparty. Records must be kept for a minimum of one year.

Estimating progress

According to a Reuters article[5] titled “Banks ignore UK’s mobile phone regulations”, analysts have estimated that as few as 33% of firms are in compliance with the mobile phone recording rules published under the FSA. Similarly, an informal Bloomberg survey[6] revealed only 7% of firms felt confident meeting CFTC trade reconstruction requirements.

Whilst neither a formal exemption has been granted nor a fine levied for non-compliance against an institution, there is no doubt shortcomings in this area will have to be rectified and proven well before January 2018. Detecting improper conduct and honing in on individual culpability is part of the overall MiFID II design framework. This is further evidenced by obligations under MiFIR article 26 (transaction reporting) which requires investment firms to populate for each reportable transaction the personnel responsible for ‘investment within firm’ and ‘execution within firm’. In the UK this will translate to providing a national insurance number.

Demonstrating compliance

It is critical that investment firms adopt long-term strategic solutions, as opposed to ad-hoc tactical ones, which enable them to seamlessly meet variations in cross-jurisdictional requirements. Given the regulatory drivers behind such measures include increasing the probability of successful enforcement in the event of an incident, investment firms should look to have solutions and internal testing models which will withstand regulatory scrutiny and support investigations. Alongside being able to capture and store data in readily accessible format that is configurable, such models should encapsulate a comprehensive, accurate and timely trade reconstruction that can be plotted against the various mediums of communication. As a standard of principle, all copies should be secure and unaltered with functionality built out to make available to regulators the raw data. Potentially even direct access should be offered if they so wish.

5 http://uk.reuters.com/article/uk-britain-banks-phones-ifr-idUKBREA2G0VH20140317

6 http://uk.reuters.com/article/uk-britain-banks-phones-ifr-idUKBREA2G0VH20140317

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The use of third party solutions would be a viable option and one that may be cost effective. However, internal controls aligned to the compliance policy must prevent undue operational risk (MiFID II Article 16(5)) arising from any outsourced technology. An updated policy will also need to be rolled out to employees taking into account any material shifts in monitoring[7]. In summary, working in tandem, compliance and technology will need to solve for[8]:

- Capturing and recording voice, mobile and electronic communications (FCA COBS 11.8; MiFID II Article 16; CFTC regulation §23.202)
- Appropriate security and authentication (FCA COBS 11.8)
- Record retention for a minimum of five years (MiFID II Article 16)
- Readily accessible full trade reconstruction. Within 72 hours in the case of CFTC (CFTC regulation §23.203)
- Configurable file and data formats (FCA COBS 11.8). For example, date and time in UTC (CFTC regulation §23.202)
- Data search functionality (CFTC regulation §23.202)
- Transmission and regulatory access to data

The industry successfully argued in 2009 that technologically it was not feasible to record mobile phone conversations. MiFID II to a large extent seeks to curb dangers arising from the financial sectors' very own proliferation of technology and innovation. Regulators will expect investment firms to exhibit equal wisdom when meeting obligations to record across all mediums.

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7 Certain policies may have been updated upon the inception of COBS 11.8 and CFTC regulation §23.202, CFTC regulation §23.203

8 Overlaps will exist between jurisdictions. The points listed aim to give a view on some of the explicitly stated regulatory requirements

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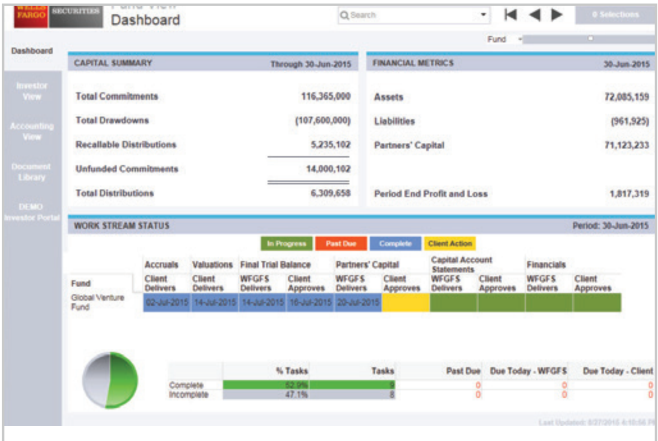

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- **Accounting View:** activities related to NAV calculation and financial statement processing
- **Investor View:** subscription/redemption and capital call/distribution, KYC/AML, and investor accounting and servicing activities

Wells Fargo Global Fund Services offers comprehensive fund administration and operations outsourcing services for investment managers, family offices, endowments and foundations, and pension funds worldwide.

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