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AIMA INNOVATION DAY 2024

Harnessing AI, data and technology for operational efficiency

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Message from AIMA's CEO

In anticipation of AIMA's first Innovation Day conference in London on 4 September, we are dedicating the first half of this edition of the AIMA Journal to pioneers within our industry, presenting a series of articles that explore novel solutions to the challenges of operating in today's market environment.

We start with a welcome contribution by AIMA's Global Head of Markets, Governance and Innovation, Adam Jacobs-Dean. Adam offers his view on how the increasing regulatory burden has increased the attractiveness of external solutions that can help stretched in-house legal, risk and compliance teams.

Next, we can learn about the efficiency gains that may be possible by applying artificial intelligence (AI) to compliance functions, a theme also identified in AIMA's recent research report on generative AI.

The merits of blockchain technology are also represented, with a compelling article on how it can improve the investment process through tokenising assets and funds.

There is also a meeting of new and old, as talk of innovative new technology is paired with a look back at the past decade since the EU's AIFMD went live and an assessment of how it has impacted the asset and fund management industry.

Looking ahead to AIFMD 2.0 – coming into force on 16 April 2026 – there are changes afoot for the rules governing EU AIFs that originate loans, such as private credit funds. This is an area that AIMA, through its private credit affiliate, the Alternative Credit Council, is highly active in engaging with policymakers at an EU and national level, and we will continue to represent our members' views on these changes and assist with implementation best practices ahead of the go-live date.

These are only some of the topical articles featured in this quarter's edition, with others offering timely explainers on tax, legal, regulatory and macroeconomic trends impacting our market today, all of which deserve your time.

My thanks go to all the contributors to the AIMA Journal this year, who ensure it will continue to be one of our most popular and widely read resources going forward.

Sincerely,

Jack Inglis
CEO, AIMA

Making the most of RegTech
an AIMA perspective

Adam Jacobs-Dean
Managing Director, Global Head of Markets, Governance and Innovation
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Hedge funds are famed for their lean operating models, which support their ability to deliver superior risk-adjusted returns to the investors that they serve. But this laser-sharp focus on overheads creates both challenges and opportunities for our members, particularly when it comes to dealing with the myriad and increasing regulatory requirements they are subject to. AIMA has been working with its manager members to explore how they are rising to meet these challenges and, in particular, the role played by regulatory technology (RegTech) in dealing with risk and compliance tasks.

To put into context the challenge, the typical headcount at an alternative investment manager in Europe is less than 20 people, an indication of the high level of operational efficiency that alternative asset managers seek to achieve. Inherent in this operating model is the need to outsource certain tasks or functions, relying on the skills and expertise of third-party service providers to ensure that fund managers can remain focused on managing investments and attracting new investors.

Regulatory compliance is, unsurprisingly, one of the key areas where hedge fund managers have a keen interest in third-party solutions to ensure that the costs associated with rules and regulations – including obligations to create and monitor records, report data or transactions to the regulator or market, and have particular trading or risks controls in place – do not become a drag on business strategy. The trend of **increasing regulatory prescription has greatly heightened the attractiveness of external solutions that can help reduce the burden on stretched in-house legal, risk and compliance teams**. We spoke to our members to find out more about their experiences of this growing area of the ecosystem.

The first key observation that we heard was an important one: that firms do not necessarily expect the typical RegTech solution to substantially reduce the amount of time that is devoted to compliance work. Instead, **the goal is often to focus existing resources in a better way**. For example, putting in place a third-party system that supports monitoring for potential market abuse might in all likelihood necessitate new ongoing workflow associated with reviewing the alerts that the system generates.

As such, it does not necessarily free up time for a legal or compliance officer, but does mean that they are using their time in a much more focused way, which is beneficial for the firm and its investors.

It is also worth noting that successful integration of an external product also requires an upfront time commitment – **firms that get it right are the ones that go beyond a mindset of 'what will the provider do for us?' and instead think in terms of 'what do we need to do to enable the provider to support us properly?'** The key dimension here is ensuring that in-house systems are properly configured to be able to provide the inputs necessary to allow a third-party solution to work effectively – most commonly this is a question of ensuring that the firm can feed the RegTech tool with the right information. As part of this, those taking a lead on putting in place new systems need to make sure they have got the necessary buy-in and input from their colleagues from across different functions to ensure the smooth implementation of a new solution.

A final theme that we have touched on in our discussions is that of system stability. Once an external system has been put in place it is important to ensure that systems and process changes – either on the part of the manager or the vendor – do not disrupt the proper functioning of the solution in question (which could potentially open the firm up to regulatory risk issues).

So ultimately **successful deployment of RegTech calls for a strong strategic approach, buy-in across teams and a laser-sharp focus on data and connectivity**. It can offer vast improvements over legacy approaches that might be heavily manual and based on less sophisticated approaches, but this does not necessarily imply significant time saving. The goal might in fact be more efficient risk reduction. For firms that can navigate this territory sensitively, the benefits can be tangible.

If this is a theme that you are interested in, we encourage you to take a look at the agenda for AIMA's Innovation Day, an all-day event taking place in London on 4 September 2024. Over the course of the day, we will shine a light on all aspects of how technology is impacting firms' operations, including the growing role of RegTech. Join us to be a part of the conversation.

For more information contact Adam Jacobs-Dean (ajacobs-dean@aima.org).

The rise of the machines

Fusing AI and legal contracts

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In the current legal environment, you can't have a conversation without mentioning the application of technology. In the world of contract management, software platforms can now create, search, and perform deep-dive analysis into even the most complex agreements. In this new reality, companies are beginning to see that "the old ways" of keeping contracts in PDF format in a folder somewhere or original hard copies in a drawer simply no longer work.

This article discusses Artificial Intelligence (AI), its application to contract management, and why it is in the interests of AIMA members to enhance their capabilities in this area.

A brief introduction to AI

Since the advent of Chat GPT in November 2022, entire industries have embraced the idea of using a machine to learn and streamline processes, optimise conditions, and generally make life easier for workers. The legal world is no different. However, it pays to take a moment to consider just what AI can really do, what it's good at, and where the potential pitfalls lie.

What is AI (in a nutshell)?

AI in the form that we know it today is effectively a very complicated decision-making algorithm. It is fed with data – a lot of data. At the time of writing, the biggest model, GPT 4 from OpenAI, consumed roughly 10 trillion words whilst being trained. Based on what was said before, an AI model predicts – as accurately as it can – what to say next. Therefore, to say that an AI model can 'think' is perhaps a misnomer, although it is easy to get muddied into definitions which this article aims to avoid.

What is AI good at?

AI models are typically brilliant as creative tools. They can write poetry, short stories, and summarise data very well. They can understand human written prompts and answer in a format a human would understand. They can be given context and can be asked to answer in a particular style. In all these aspects they usually do a convincing job. They are already causing headaches in the world of education, as they can answer essay questions – even with a condition of "this should be of a B grade standard".

What are the dangers of using AI?

In a legal context, detail and accuracy is paramount. Herein lies one of the risks. By their very design, AI models are creative. They actually hallucinate – which is to say that sometimes they might read things in a prompt that weren't there, go off on a tangent or, as a pertinent example, simply make up non-existent case law in support of an argument. Given this inherent creativity, asking an AI model to draft a negotiation – without a number of constraints and a human eye to exercise quality control – would be a recipe for disaster.

With AI being such a hot topic, it can also be difficult to determine if a Software as a Service (SAAS) solution advertising AI is simply dressing automation in the cloak of genuine machine learning. If a model is 100% accurate, chances are that it's a very involved bit of automation code, rather than a genuine utilisation of AI. In itself, this isn't necessarily a bad thing. However, being aware of the different limitations a system like this has (not being able to adapt to changes in the underlying data being of primary concern) is important for companies when deciding which SAAS solution to go for.

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Why is this relevant to you?

Time is money

Processes that are repeated multiple times, without the use of technology to speed them up and minimise human error, cost companies in a very real sense. Think about it in the context of contract management. How much time do you spend looking to find relevant agreements (and then understanding what they say), analysing risks every time an external event occurs or threatens, and drafting the same agreement or reviewing the same basic comments time and again? That time – that money – could have been put to better use.

Technology is rapidly addressing that problem. New SAAS solutions exist that can streamline the creation, amendment and negotiation of contracts, the digitisation of executed versions and the analysis of risks and commercial opportunities that can otherwise lie hidden within portfolios of documentation. This shift has happened relatively recently, but the rate of improvement is increasing all the time. Moreover, collaborative industry efforts to create common communication models between systems (such as ISDA's "Common Domain Model") will only further accelerate the process.

Data is king

Subject matter expertise and knowledge can only go as far as the data to which it is applied. Herein lies the nub of the problem – efficient acquisition of relevant data. High quality data is of paramount importance. Yet it remains one of the biggest hurdles faced in adopting new technology. On a micro level, understanding and communicating the obligations, risks and opportunities associated with a small set of contracts is a task that can be accomplished by a single qualified practitioner. However, even for those firms without budget or resource constraints (a unicorn indeed!) this is not a scalable approach. Absent technology, the problem becomes exponentially harder as you attempt to adopt a business-wide approach.

Fortunately, this is an area in which AI can really drive progress. Instead of dedicating teams to extract legacy data, it's entirely feasible to create a system that takes a document and extracts the data immediately and accurately, with little more than a cursory check from a human eye. The time savings – the cost savings – the benefits which naturally flow – are huge.

Once good quality data has been acquired, it becomes a relatively trivial exercise to generate a macro view of the contractual risks, obligations and opportunities facing the firm. What of the other benefits which naturally follow? Well, the burden associated with audits reduces. Levels of regulatory compliance increase. Looking above the line, the holy grail of understanding how to optimally allocate each asset of the firm at any point in time comes one step closer. More recently, the demonstrable power of data has even become a focal point for sales conversations.

In simple terms, when applied correctly, technology can help you to acquire information as a source of regulatory compliance and competitive advantage – providing insight, hindsight, and foresight into all of your commercial relationships. It's all there for any firm willing to take the plunge.

So, what's holding you back?

We've seen this movie before. Issues arise that could be solved by technology. Despite this, there remains a reluctance (a fear?) to change something that has worked for a long time – even though nobody is quite sure HOW it works. All that is known is that the current approach is far from optimal and getting worse all of the time. Tactical patches are applied to interim solutions sitting on top of strategic problems. Inertia rules.

But times are changing. If you don't want to adapt, at least know that someone else is – and they are gaining a competitive edge in the process. And size is no longer an excuse. For sure, larger institutions may have the budget and patience to create an in-house technology solution. However, history questions the wisdom of expending precious resource and even more precious time in building and maintaining solutions which are key, but not core, to the business. Far better, to acquire capabilities from suppliers who are invested in developing and supporting solutions for the long-term. Whisper it, but you no longer need the deepest of pockets to access game-changing technology. You just need the will to embrace it.

The future is now

The technological leaps over the last decade have been felt across every industry, including that of the legal documentation. The advent of AI and its mainstream use has turbocharged the rate of change. Companies that position themselves well in this ecosystem and adopt technological solutions to optimise processes, will have a distinct competitive advantage in the years to come. Those that do not will inevitably decline.

Visit DRS - Alternative Legal Solutions (drs-als.com) for more information.

Digital horizons: The future of real asset tokenisation

Elliot Refson
Head of Funds
Jersey Finance

Digitalisation is creating a more transparent, efficient and accessible investment environment that is rapidly transforming traditional finance - but just don't call it a revolution, writes Elliot Refson, Head of Funds, Jersey Finance.

There is no doubt that digitalisation is transforming the way in which we conduct business and the steady rise of tokenisation in the asset management space specifically is undeniable.

The rise of virtual assets, however, is an evolution not a revolution; in many ways it equates fundamentally to the unswerving drive of automation. If we consider that most investors are unfamiliar with the platforms their investments are held on currently, what digitalisation meaningfully brings to the table is efficiency - such as, for example, digital onboarding.

This is a sector that is rapidly evolving traditional finance in terms of both well-established 'vanilla' investment assets, as well as alternative assets, known in this new era as 'real-world' assets.
In essence, what digitalisation does is enable a world where investments are more accessible, transparent, and efficient.

It is a progression recently borne out in a survey by EY-Parthenon which found that more than a third of institutional investors in the US and almost two-thirds of high-net-worth investors plan to invest in tokenised assets by the end of 2024, evidencing the growing appetite for virtual assets within the investment community ('How tokenisation in asset management is driving meaningful opportunity', 2023).

A decade of growth

Virtual assets, of course, are not necessarily a new phenomenon. Some, such as crypto assets like Bitcoin, emerged more than a decade ago as a revolutionary concept, with these digital representations of value, stored on secure online ledgers, challenging the status quo of financial systems.

Like many a paradigm shift, initially at least, virtual assets faced scepticism. However, over time, their potential for innovation and disruption has become increasingly evident, with a 2023 report by Northern Trust and HSBC ('Beyond Asset Tokenisation', 2023) estimating that 5% to 10% of all assets will be digital by the turn of the decade.

Looking at the immediate future, another survey – this time from Calastone ('Tokenised Funds Go Mainstream', 2023) – has proved equally compelling, finding that 67% of US managers are expecting to have tokenised offerings available within the next 12 months, a further 22% expecting to do so within three years and an additional 11% within five years.

Meanwhile, major investment firms are also taking note and are launching money market, equity and bond tokenisation projects to improve efficiency and accessibility for investors. This growing adoption is fuelled by the benefits of tokenisation, such as increased liquidity, enhanced transparency, and faster transaction speeds.

Confidence in the sector is continually increasing - and within the last few months Blackrock has announced its first tokenised fund, as well as a strategy to digitalise US$10 trillion of its assets, which could prove a significant catalyst for others to follow suit.

There is significant scope to broaden and diversify investor access too - family offices and high-net worth investors, for instance, are seen as the investor class that is likeliest to be interested in tokenised options, particularly in illiquid alternative asset classes, something that was highlighted in a white paper Jersey Finance recently published in conjunction with IFI Global ('The Evolution of Virtual Assets', 2024).

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Supporting a burgeoning sector

It is clear that in today's market, the opportunities are now well understood and consequently there has been a concerted effort by service providers to support growth in the sector.

For instance, law firms are establishing specific digital funds groups, while administrators are appointing digital leads of innovation committees to ensure that they stay ahead of the curve.

Similarly, alternative investment managers are actively looking to be part of the conversation. The Bain Global Private Equity Report 2023 noted that individual investors hold roughly 50% of the estimated US$275 trillion to US$295 trillion of global AUM, but those same investors represent just 16% of AUM held by alternative investment funds.

This presents a genuine opportunity for alternative investment managers to adopt a more holistic approach to the market while, from an institutional investor perspective, there is clear potential for the high net worth and retail markets, with their associated capacity for expansion and additional avenues for fundraising.

Of course, this brings sizeable benefits for investors too, with the possibility for higher returns naturally proving attractive.

Democratising of private markets

Notably, one significant impact of digitalisation is the democratisation of historically private markets. But, while enhanced liquidity might have beneficial ramifications, for example in the commercial real estate space, it does not necessarily equate to increased demand, and poor investments will remain as such irrespective of how accessible they become.

Interestingly, we are also seeing a move towards the tokenisation of real assets – in particular in the private equity and real estate sectors – with the managers of such funds effectively forming the frontier of the industry's transformation and paving the way for fractional ownership.

Just as there are opportunities and challenges for managers and service providers, so too are they there for the fund domiciles that house them. From a jurisdictional perspective, the challenge has been, and always will be, to remain relevant. Those that do not evolve to serve the needs of managers and investors alike, in this new world of virtual assets, will simply die out.

The evolution of the regulatory landscape in particular is a case in point, where jurisdictions will need to strike a balance to support innovation while safeguarding investors, ensuring high standards of compliance and helping to combat the potential for anti-money laundering.

Jurisdictions will need to ensure that they have the sophisticated technical infrastructure to support this trend and there's no doubt that the industry as a whole can expect to see their tech spend increase in the coming years in blockchain and related technologies – which are in continual rapid development – if they are to align themselves with, and seize opportunities in, this space.
Crucially, as the virtual asset landscape evolves, the need for robust regulatory frameworks will become paramount and it will be those jurisdictions able to find the sweet spot between fostering innovation and protecting investors that will triumph.

The white paper recently published by IFI Global supports the notion that, while this sector is still very much unfolding, its potential for further long-term transformation is undeniable. It may not yet be clear exactly how the process of digitalising investment assets will impact the funds industry, but the potential is wide-ranging - and it could mean a period of greater change for the industry than it has experienced to date.

It remains, however, an evolution not a revolution. Jurisdictions, managers and service providers that can work symbiotically and keep pace with that evolution will be guaranteeing their position in a dynamic, and exciting, cross-border alternative funds landscape.

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Jersey Finance

Delivering Insight ▪ Driving Innovation

A Compelling Alternative

In the current climate, alternative fund managers are adopting global strategies and seeking to raise capital in growth markets around the world. Therefore, it is appealing to use a long-established jurisdiction that has expertise in handling alternative funds business. Jersey has carved a niche as a specialist centre in alternative funds, which now account for around 89% of the Island's overall funds business.

Jersey offers a range of benefits for alternative funds including:

- **A tax-neutral environment** to avoid double or triple taxation of funds and their investors
- **Alternative fund providers** of varying sizes and areas of specialisation
- **A regulatory framework** that has evolved specifically for alternative asset classes
- **A range of regulatory regimes** offering different levels of regulation depending on the investors' needs
- **Flexible fund structures** allowing for innovative investment strategies and bespoke investor protection mechanisms
- **Outstanding quality of life** for those managers looking to relocate

Get in touch with our Director of Funds and Corporate, Nicola Le Brocq.

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Jersey:

The compelling long-term and future-proof solution for funds and managers

US$574bn

net asset value

of all alternative funds administered in Jersey

Jersey Financial Services Commision, 31 December 2023

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Digital Operational Resilience Act: What it means for Alternative Investment Management Funds and Managers

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The EU's financial sector's digital regulatory landscape has undergone a significant shift with the recent enactment of the Digital Operational Resilience Act (DORA) on 17 January 2024. Recognising the growing dependency on Information and Communication Technology (ICT) in delivering financial services and the inherent risks, DORA was born, with the aim of harmonising the regulatory requirements and standards related to the use of ICT across the EU.

This article outlines what DORA is, the key requirements and then considers its application to asset management and investment funds and the common queries we are receiving from these financial entities in relation to DORA.

What is DORA?

DORA is a European regulation that was established with the primary objective of bolstering the digital operational resilience of the European Union's financial sector. It introduces uniform requirements for participants within the financial sector to prevent, respond to, and recover from disruptions. These requirements form part of a homogenous digital operational resilience strategy overseen by the EBA, EIOPA and ESMA – the European Supervisory Authorities (ESAs). ESAs are also responsible under DORA for developing regulatory technical standards (RTS), and implementing technical standards (ITS), which are used to further specify the practical and technical aspects of the regulation and ensure its uniform application across Member States. The first batch of final RTS' and ITS' were published on 17 January 2024.

Key Requirements

DORA is underpinned by six crucial pillars. We have set out the 6 pillars below and the key requirements of each.

(1) **ICT risk management:** Financial entities are required to implement a comprehensive ICT risk management framework. This includes the creation of policies and procedures to identify, assess, manage, and monitor ICT-related risks, along with a strategy for digital operational resilience. Entities are also required to establish internal governance and controls for ICT risk management, with a dedicated control function overseeing this risk. They must document all information and ICT assets, ICT-supported business functions, and sources of

ICT risk, conducting an annual review. Financial entities are obliged to maintain a comprehensive ICT business continuity policy, including response and recovery plans that are tested yearly, and implement policies and protocols for key aspects of ICT security. Finally, a crisis management function must be established, with clear procedures for managing crisis communications during the activation of ICT business continuity plans or ICT response and recovery plans.

(2) **Incident reporting**: Financial entities are mandated to set up a management procedure to track and record incidents, categorise them according to defined criteria, and report all "major" incidents to their respective supervisory authority. In the event of a "major" incident, financial entities must provide an initial notification, an interim report on progress towards resolution, and a final report analysing the incident's root causes. The competent authorities will provide supervisory feedback and guidance, and the potential for consolidating incident reporting at the EU level will be considered.

(3) **Testing:** Financial entities, excluding microenterprises, must create, maintain, and review a robust digital operational resilience testing programme as a key part of the ICT risk-management framework. Financial entities must conduct appropriate tests on all ICT systems and applications that support critical or important functions at least annually. These evaluations should include appropriate tests such as gap analyses and vulnerability assessments. Larger entities are also required to perform threat-led penetration testing (TLPT) on critical or important functions. While many financial entities may already conduct regular resilience testing, adjustments may be needed to comply with DORA's specific requirements.

(4) **ICT third-party risk management**: Financial entities must manage ICT third-party risk as a crucial part of their ICT risk management framework. This involves having a strategy for managing third-party risk, including a policy on using third-party ICT services that support critical functions. Entities must maintain a register of contractual arrangements with third-party ICT service providers, distinguishing between services that support critical functions and those that do not, and report to regulators annually on new ICT service arrangements. Before engaging a third-party ICT service provider, entities must conduct due diligence on the provider and assess the contractual setup. Additionally, entities must have exit strategies in place to ensure business continuity, regulatory compliance, and client service in the event of contract termination.

(5) **Information sharing:** DORA encourages (but does not mandate) information sharing, particularly in relation to cyber threat intelligence to enhance a firm's digital operational resilience. This exchange should take place within trusted communities via structured information-sharing arrangements. However, financial entities must notify the relevant supervisory authorities when such information is shared.

(6) **Governance** - This establishes effective governance arrangement obligations comprised of board members and senior management and outlines their respective responsibilities in furthering the digital operational resilience framework established in the 5 prior pillars.

Why should hedge fund managers, alternative credit managers and funds of funds take note?

DORA applies to most financial entities including but not limited to managers of alternative investment funds, and UCITs management companies, along with certain critical third-party ICT service providers. The exemptions that do exist may allow certain entities to establish a simplified ICT risk management framework, if it is proportionate to do so taking into account their size, nature, scale and complexity of their services, activities and operations and overall risk profile.

Competent authorities will have supervisory, investigatory and sanctioning powers necessary to fulfil their duties under DORA. This includes the ability to impose financial penalties, such as administrative fines and remedial measures, on financial entities for failure to comply with DORA. They also have discretion whether to impose criminal penalties for breaches of DORA under their national law. Therefore, it is crucial for the management bodies to understand how DORA impacts their entities, evaluate its implications, and adapt accordingly.

Common queries we are seeing from hedge fund managers, alternative credit managers and funds or funds and our response

Are they in scope?

As noted above, DORA applies to most financial entities within the financial sector. On its face, this looks to be straightforward as DORA gives a long list of financial entities that are in scope and defines what an in-scope entity is. However, this is not so straightforward when many of the definitions refer out to other EU legislation and have questionable outcomes. We have for example seen this play-out in the context of AIFMs.

Does DORA apply extraterritorially in relation to financial entities and managers?

At an entity level, the answer to this question is driven by how DORA defines the relevant financial entity or manager. We are seeing mixed views on whether financial entities or managers with no presence in the EU are in scope or not.

However, note also that DORA's reach can extend extraterritorially at an asset and service level e.g. in terms of a financial entity's or manager's ICT risk management framework.

What's the timeline for compliance?

DORA will generally become applicable as of **17 January 2025** and financial entities will need to have the necessary processes and documentation in place by then.

How can hedge fund managers, alternative credit managers and funds or funds prepare for DORA?

Hedge fund managers, alternative credit managers and funds or funds can prepare for DORA implementation by:

1. **Establish your perimeter:** Identify which entities are in scope and what the key terms under DORA such as 'critical or important function' mean to you.
2. **Conduct a gap analysis:** Evaluate current governance, risk management and policies and standards against the requirements of DORA.
3. **Create a roadmap:** Determine the necessary priorities and efforts to close the gaps identified in the gap analysis thus meeting DORA requirements.
4. **Remediate contracts:** Identify which ICT third party contracts fall within the scope of DORA and need remediation. Prepare contractual addenda to those third-party contracts and conduct a project to remediate those agreements so that they are DORA-compliant.
5. **Track regulatory updates:** Look out for the new RTS' in July this year and any further national competent authority guidance or requirements.

What is coming next?

On 8 December 2023, the ESAs initiated a public consultation on the second batch of technical standards under DORA. This batch comprises four sets of RTS', one ITS and two sets of guidelines (GL). The content of the second batch of technical standards includes content, timelines and templates for ICT-related incident reporting; conditions for sub-contracting of ICT services supporting critical or important functions; and criteria used for identifying financial entities required to perform TLPT. The ESAs plan to submit the draft technical standards to the European Commission and publish the final guidelines by 17 July 2024.

Honey, I shrunk the trend-following

Yash Panjabi
Client Portfolio Management Analyst
Man AHL

Graham Robertson
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Man AHL

Readers who are familiar with trend-following will recall its desirable properties: comparable long-term returns to equities, zero long-term correlation to traditional assets, and historically-observed strong performance in crisis periods. Many readers may even be investors in trend-following programmes for these exact reasons. But a natural next question, and indeed one that we have been increasingly fielding, is 'how much trend-following should I hold in my portfolio?'

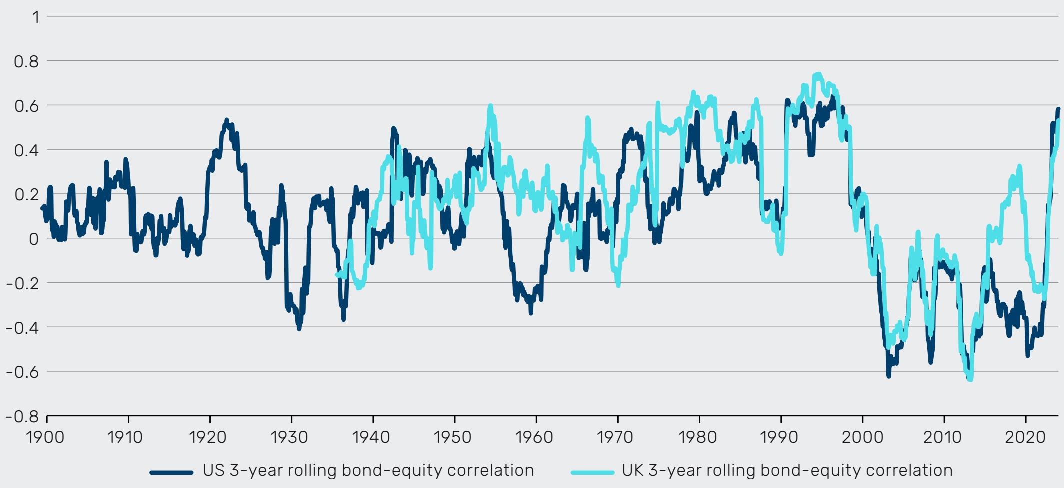
The textbook answer, in the absence of any constraints, would be the proportion that generates the optimal risk-adjusted reward, or Sharpe ratio. However, there are often some real-world constraints – investor preferences, lookback window, and tracking error – that come into play and may shrink a trend-following allocation. We investigate each of these in this paper.

Trend-following with long-only multi-asset portfolio

We are cognisant that a large proportion of investors' portfolios typically comprise a long-only multi-asset (LOMA) allocation. The most common example is the 60/40 portfolio: 60% global equities and 40% global bonds, notionally allocated. There may be regional or slight differences in the ratio of stocks to bonds, but for the scope of this paper, we will focus on a global version.

For most of the 21st century, 60/40 has been the hallmark of multi-asset investing, driven by the twin tailwinds of rising bond and equity prices, while being negatively correlated with each other. However, as we illustrate in Figure 1 (page 20), an excerpt from a previous paper, the correlation between bonds and equities has recently trickled into positive territory, a reversion to what was seemingly the status quo for most periods before the turn of the century.

Figure 1. Rolling 3Y Bond and Equity Correlation

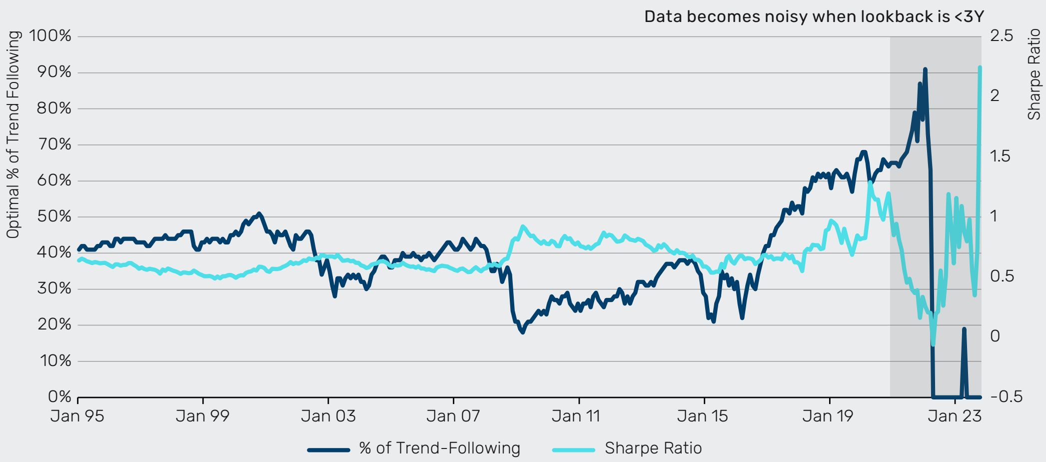


Source: Bloomberg, Man Group Database. Date range: 1 January 1900 to 31 December 2023.

Thus, it may be that traditional portfolios, such as 60/40, need additional sources of diversification more than they have done in this century. Trend-following, we believe, fits the bill nicely, but how much do investors need?

In Figure 2 below we analyse the optimal combination, as defined by Sharpe ratio, of trend-following, proxied by the BTOP50 Index, and 60/40, proxied by 60% MSCI World USD Hedged Index and 40% Bloomberg Global Aggregate USD Hedged Index, through time. The different points on the x-axis of the chart refer to the different lookback windows used when ascertaining the optimal combination but all running through to December 2023. For example, the point in January 1995 computes the optimal combination using a start date of January 1995 up to December 2023, whereas a point in January 2015 determines the optimal combination using data from that point up until December 2023.

Figure 2. Optimal Combination of 60/40 and Trend-Following Using Sharpe Ratio, with Different Lookback Windows (x-axis represents starting dates) to December 2023



Source: Bloomberg, Backstop Solutions Group, LLC – BarclayHedge (www.barclayhedge.com), Man Group, as of 31 December 2023.

The swings of the optimal percentage of trend-following (dark blue) curve in Figure 2 (page 20) illustrate its strongly time-varying nature. With that said, these oscillations are relatively intuitive. Trend-following has a relatively higher optimal weight in the early period of the sample given its outperformance, and on a relatively lower level of volatility, throughout the dot-com bubble burst and the Global Financial Crisis (GFC), periods where traditional assets struggled. However, following the GFC, trend-following entered what many regard as the 'CTA winter', where returns were broadly flat, which leads to a drop in optimal weight. From 2022 onwards, the ratio oscillates wildly given stark performance differences between trend-following (+14.9%) and 60/40 (-13.5%) during 2022's inflationary burst.

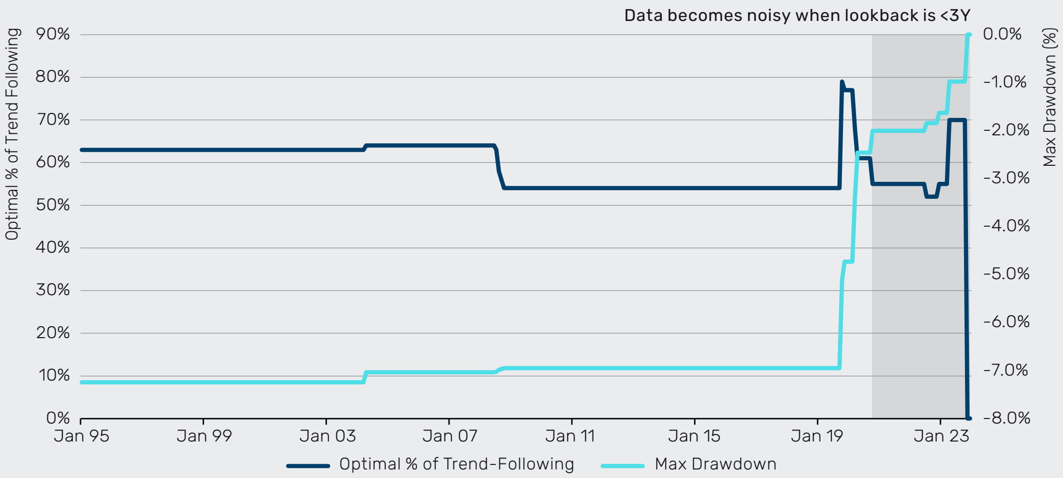
To most credibly determine the optimal combination, and to overcome the outsized effect of 'noise', statistics suggest that we should refer to the longest sample available.

To most credibly determine the optimal combination, and to overcome the outsized effect of 'noise', statistics suggest that we should refer to the longest sample available. Looking at the full sample, this indicates an optimal **40%** allocation to trend-following and 60% to 60/40.

We do, however, appreciate that 'optimal' is in the eye of the beholder. Some investors, such as those who are expressly interested in trend-following's defensiveness may consider drawdown to be the most pertinent measure of optimal.

In Figure 3 below we plot the percentage of trend-following (when combined with 60/40) that yields the smallest maximum drawdown. Trend-following's positive return skew, which we discuss in greater detail in this paper, means its drawdowns are relatively muted through time, leading it to have a relatively higher weight when optimising for the lowest maximum drawdown. Again, looking at the full sample from January 1995 to December 2023 indicates the optimal percentage of trend-following to yield the lowest maximum drawdown when combined with 60/40 is **63%**.

Figure 3. Optimal Combination of 60/40 and Trend-Following through Using Max Drawdown with Different Lookback Windows (x-axis represents starting dates) to December 2023



Source: Bloomberg, Backstop Solutions Group, LLC – BarclayHedge (www.barclayhedge.com), Man Group, as of 31 December 2023.

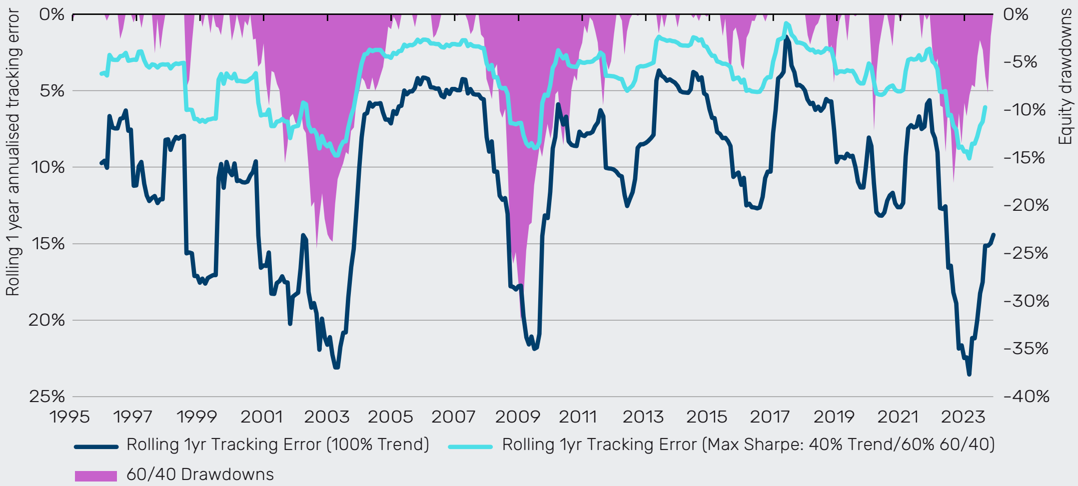
Tracking in the right (or wrong) direction?

Admittedly, an investor or allocator looking at the aforementioned optimal figures may be gawking at the sizes of the proposed trend-following allocations. And there is some justification in that reaction.

While trend-following is an active, absolute return strategy and therefore not managed to a benchmark, 60/40 or equities are the industry gold standard for performance evaluation. There is some merit to this. Equities, and by association, 60/40, have been one of the best performing asset classes of the last 20 years, earning it the TINA – 'There is No Alternative' – title. Therefore, the risk of underperforming (i.e., downside tracking error) equities or a 60/40 for a sustained period may invite challenging questions from clients and investment committees, making it a real-world constraint for investors to consider when designing asset allocations.

However, trend-following's convexity means that this tracking error to 60/40 is generally at its greatest when we need it most, in other words, when 60/40 is at its worst. In Figure 4 below, we plot the rolling 12-month tracking error of a 100% trend-following portfolio and the Sharpe-optimal combination (40% Trend and 60% 60/40) to 60/40. The spikes in the tracking error curves are contemporaneous to drawdowns for 60/40, while the curves taper towards their lows when 60/40 rallies.

Figure 4. Rolling 1Y Annualised Tracking Error between Trend-Following and Global Equities



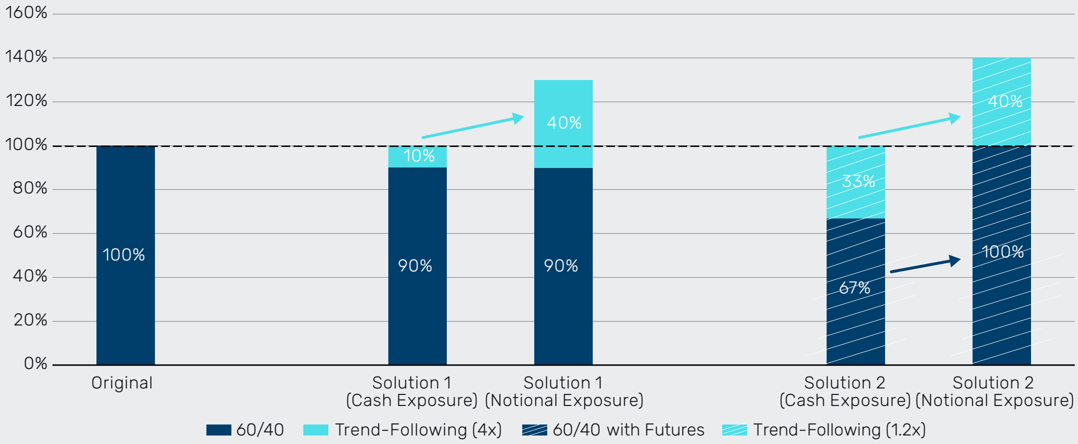
Source: Bloomberg, Backstop Solutions Group, LLC – BarclayHedge (www.barclayhedge.com), Man Group, as of 31 December 2023.

If it moves, monetise it!

The point of this paper is not to say investors should significantly down weight the LOMA component of their portfolio and replace it with trend-following. Equities and bonds have accrued significant historical gains, and justifiably make up a meaningful portion of strategic asset allocations. As discussed in Trend-Following: If it Moves, Monetise it!, the cash efficiency of instruments traded by trend-following strategies means that little additional cash is needed to fund an allocation.

Let us take the following example. Allocating 90% of cash to the LOMA and 10% to trend-following, with the latter levered up by 4x, leads to roughly 40% trend-following, 90% LOMA, or 30% trend-following and 70% LOMA in normalised notional allocation terms. See Solution 1 in Figure 5 (page 23). But this is just one of many implementation options. Another approach, that preserves 100% of the LOMA, would be to replicate the LOMA using a swap or futures, with the cash-efficiency creating excess cash to allocate to the trend-following component – Solution 2 in Figure 5, page 20. Both options also facilitate customisation in terms of the amount of leverage desired.

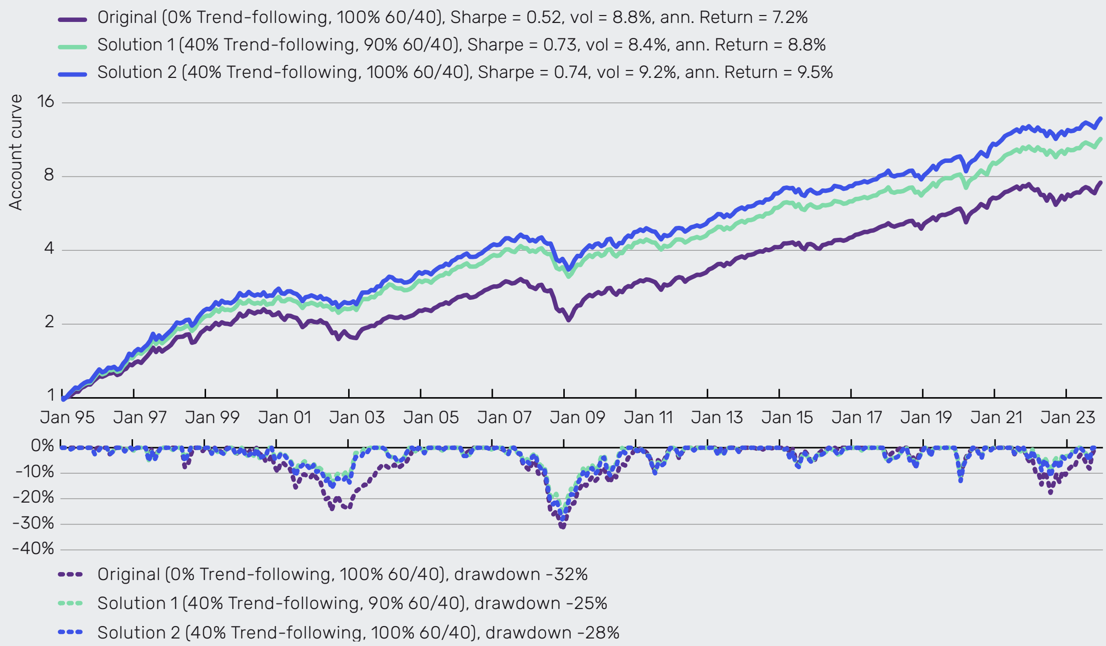
Figure 5. Cash-Efficient Implementations of 60/40 and Trend-Following



Source: Man Group, as of 31 December 2023. Number in brackets represents leverage on trend-following allocation.

Account curves and drawdown profiles of these three potential solutions are illustrated in Figure 6 below. Note how Solution 2, with the same amount of 60/40 as our original 60/40 portfolio, enhances the return of 60/40 by 2.3% per annum on similar volatility and drawdown.

Figure 6. Account Curves of Combinations of Solutions Presented in Figure 5



Source: Bloomberg, Backstop Solutions Group, LLC – BarclayHedge (www.barclayhedge.com), Man Group. Trend-following represented by BTOP50. Date range: 1 January 1995 to 31 December 2023.

Concluding Thoughts

Real-world constraints often predicate that trend-following may not get the allocations our two measures of optimal, namely Sharpe ratio and drawdown mitigation, might suggest. And we are not advocating that it should either. Instead, we hope the takeaway of this paper is that investors and allocators give trend-following serious consideration for inclusion in portfolios in more meaningful quantities than it historically has been. Aside from its desirable crisis alpha and risk-management properties, it generates attractive long-term risk-adjusted returns while being diversified to traditional assets. Cash efficiency also means that it need not precipitate abandoning a traditional LOMA approach to accommodate more trend-following, but instead combined in a robust framework that uses leverage to monetise the diversification.

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Buying and selling regulated businesses – Key factors to ensure a successful transaction

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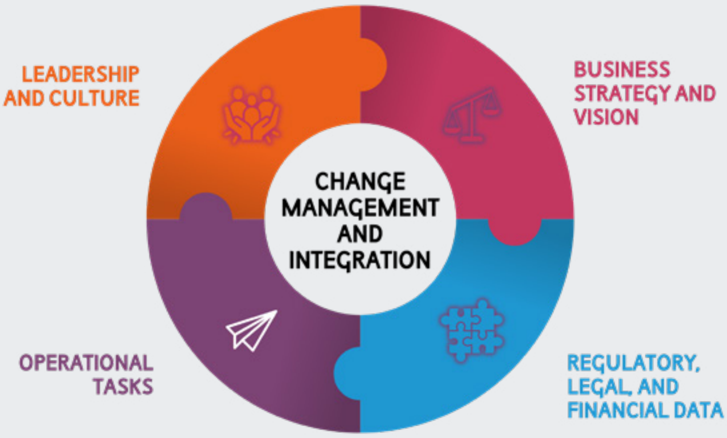
The asset management industry has seen numerous mergers, acquisitions, and consolidations in recent years. The complexities of these transactions can provide a myriad of challenges, not least, the requirement for regulatory approval.

A ‘change in control’ application is thorough and demands considerable resource and time. Incomplete, or inaccurate, applications can delay the entire process, highlighting just how important it is to get everything lined up from the outset. In this article, we explore how utilising ‘change management practices’, ‘strategic planning’, and ‘proactive measures’ can help you manage, as well as mitigate, risks and unlock the full potential of the combined businesses through a smooth regulatory integration.

Essential to the smooth completion of a transaction are preparation and planning, execution and measurement, and communication and feedback. It is also key to understand how the Financial Conduct Authority (FCA) approaches a change of control application and what information they need before approving. When the above considerations are applied to the tasks at hand, challenges can be addressed thoroughly and greater outcomes can be achieved.

The below diagram outlines the four key considerations for successful change management and integration.



Below, we explore how the regulatory landscape should be considered for each of these areas in more detail.

Business strategy and vision

The foundation of a successful application to the FCA is the clarity and completeness of the regulatory business plan. The plan should articulate details of the target firm as well as the acquiring firm and, as a minimum, should cover the following key points:

- Background of the target firm in terms of description of business activities, prudential classification, and regulatory permissions.
- Background of the proposed controllers with a detailed history of previous acquisitions, as well as explaining how the target firm would fit in and enhance the acquiring firm's business.
- Augmentation of the new investment process, long-term aims in relation to the target firm, and anticipated changes in global regulatory footprint focusing on the overall aim of the proposed acquisition.
- Financial goals of the proposed acquisition (i.e., return on equity, cost-benefit ratio, earnings per share or in other terms).
- Possible redirection of activities, products, targeted customers, as well as possible reallocation of funds or resources expected to impact the target firm.
- The integration plans for the target firm within the proposed acquirer's group structure.
- Information about the impact of the acquisition on the target firm's corporate governance and general organisational structure.

A clear, well-thought-through business strategy is not just essential for a successful application however, it will also ensure long-term success for the integration. Having a clear vision will ensure that the goals and measures of success are clear and will act as a guiding north star for those in the business.

Regulatory, legal, and financial data

Demonstrating prudential regulatory compliance over capital adequacy and liquidity requirements through comprehensive and well-integrated financial data is vital for the FCA's approval. You should include the following:

- Transparency of information flow between the balance-sheet, profit and loss account, and cashflow statements of all entities, ironing out any anomalies potentially caused by different accounting conventions or generally accepted accounting principles (GAAPs).
- The firm's assessment of its capital and liquidity thresholds, and evidence that the business will have sufficient financial resources to meet these requirements going forward.
- The preparation of the post-acquisition Internal Capital Adequacy and Risk Assessment (ICARA) process and wind-down planning documentation.
- Financial and capital projections, including stress- and reverse stress-testing.
- Establishment of processes relating to financial planning and analysis, financial reporting, regulatory monitoring, treasury and liquidity management, and group structure impact.
- Incorporation of the applicable local laws, tax planning, licencing, and registrations.

Operational tasks

Implementing robust processes, enabling flexible ways of working and planning, and empowering people across the organisation are crucial elements of successful integrations. A resilient operating model not only sets the future organisation up for success, but it also ensures that the organisation complies with regulatory requirements across a variety of business units. Various functions across the business have the potential to impact operational efficiency in differing ways during a merger or acquisition:

- **Business-as-usual processes:** Ensuring that investment processes, portfolio management, trade execution, asset administration, and investment performance and risk measurement continue in an unaffected way is key. Other activities such as product management and brand and marketing can also be impacted by a merger or acquisition and will need to be managed effectively, so as not to have a negative impact.
- **Systems and technology**: From a business continuity and future growth perspective, it is hugely important to get the right systems and technology in place. This could be anything from IT support, data integrity management, agile ways of working, change management & BAU conflict, third-party contingency & exit, vendor and service provider change, and business continuity & crisis management.
- **People:** This is one of the most crucial elements to get right in any merger or acquisition, because while processes and technology can help a business, it's the people that power change. Strategic workforce planning – which is the act of truly understanding what skills and people are needed to deliver on the business strategy – is an important activity to undertake. From there, you'll also need to consider activities such as recruitment, training, employer brand, HR and employee relationships, and how to manage changes in reporting lines.
- **Finance:** To ensure operational efficiency, it is important to get the finance function up and running; considering new accounting systems and data mapping, management information systems, and various other activities is key.

Leadership and culture

Finally, firms will also need to prioritise their leadership and culture to support a merger or an acquisition. It is essential to increase synergy between the two firms, but also to create an organisation that people want to work for and with.

Focusing on future-focused leadership capabilities will ensure a more successful experience post-integration. Senior members of staff should be able to not only successfully execute and deliver the earlier mentioned business strategies, but they should also be able to meet the SM&CR requirements of the FCA.

In addition, they should also be able to lead with empathy and create adaptive and blended cultures. Communication is a big part of this – breaking down barriers of communication between the target and acquiring firm, and between various vendors and service providers is crucial. Alongside this, being able to communicate the new vision and strategy for the firm will ensure that everyone knows what they are working towards. It's important to remember that for global asset managers, there may be a difference in geographical locations. If this is the case, combatting and embracing any cultural difference is another important point to note in order to contribute to a healthy working relationship.

In summary

The FCA's stamp of approval over a transaction is a game changer. It generates momentum and introduces unique challenges for each subsequent action upon which other tasks rely. However, as mentioned earlier, if the application is incomplete or inaccurate, the FCA can delay the process. Identifying the additional or differing reporting requirements of the new market, firm, or merger will help ensure an efficient FCA approval process.

A personalised checklist can be created by working with your network of advisors. Creating a checklist can ensure all considerations are covered, and then, through ample communication, each task can be assigned to employees, and roles can be discussed. This will be an efficient method of creating employee synergy while meeting deadlines.

From a regulatory compliance standpoint, it is also important to consider immediate priorities post-acquisition. In our experience, those are:

1. New entity names, a new website, and any redirection from old ones
2. Novation of agreements
3. Public disclosures
4. Sufficient capital and liquidity
5. Remuneration policies in line with the legislation
6. Procedures or governance for monitoring requirements and collecting the relevant data
7. Ensuring that you have employees with the relevant knowledge or experience
8. Combined ICARA and wind-down process
9. Risk assessment considering the new control environment
10. Understanding and rightsizing the network of advisors and service providers – ensuring there are no gaps or duplication

If you are going through a merger or acquisition, or working with an organisation that is, and these points resonate, don't hesitate to get in touch.

AIFMD at 10 – How has this regulation impacted the asset and fund management industry?

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A decade after its inception, the Alternative Investment Fund Managers Directive (AIFMD) stands as a transformative force, significantly influencing the landscape of the asset management industry by establishing an abundance of transparent fund structures. Enacted in the aftermath of the 2008-09 global financial crisis, the AIFMD addressed the need for increased oversight and regulation of alternative investment funds, a sector which national regulations were often not harmonised or in some case, barely regulated.

As we assess the impact of AIFMD over the past ten years, it's crucial to examine how it has moulded the industry and consider the ongoing challenges and opportunities it presents today AIFMD was given the task of streamlining regulations across Europe for non-undertaking for collective investment in transferable securities (UCITS) funds. It played a role in overseeing the less regulated sector, specifically closed-end funds that fell under the alternative investment funds category. Some regulations, like those governing German Spezialfonds primarily dealing with securities funds, were already in place in various instances.

However, the financial crisis in 2008 exposed vulnerabilities within the financial system, prompting regulators to fortify regulations to prevent a recurrence of such systemic shocks.

In this context, the AIFMD emerged as a crucial regulatory response aimed at mitigating risks associated with the affected funds and investment structures. It is also important to remember that AIFMD's regulatory scope goes beyond alternative investments, impacting any fund which exists outside of the UCITS framework and therefore harmonised European regulation.

While AIFMD's multifaced presence is crystal-clear, it's important to ask, what has *actually* changed?

Introducing a comprehensive regulatory framework that AIFMs had to comply with

The inception of AIFMD marked a paradigm shift, ushering in a new era of heightened regulatory compliance and standardisation within the affected investment industry. AIFMD compelled fund managers to adapt to a comprehensive regulatory framework, triggering a substantial increase in transparency, stringent reporting requirements, and the widespread adoption of robust risk management practices.

Beyond the immediate regulatory impact, AIFMD played a pivotal role in elevating the profile of alternative investments. Investors, previously hesitant due to the unregulated nature of certain vehicles, found assurance in the newfound oversight of risks. This paradigm shift empowered managers and investors alike, fostering an environment conducive to outsourcing oversight and, consequently, fuelling a surge in the popularity of alternative investments - By coincidence, the timing aligned seamlessly with the ascent of alternative investments driven by the prevailing low interest rates.

The introduction of a marketing passport

One of the hallmark features of AIFMD was the introduction of the marketing passport, a mechanism that streamlined the process for EU-based alternative investment fund managers (AIFMs) to market their funds to professional investors across the European Union. This innovative approach significantly facilitated cross-border fund distribution, providing fund managers with unprecedented opportunities to tap into a broader and more diverse investor base.

This ease of distribution also presented a double-edged sword as it inadvertently created a barrier for non-European entities. Despite this, the overall effect was a simplification of the flow of capital within the alternative business. The harmonisation within Europe emerged as a game-changer, propelling Luxembourg and Ireland into the spotlight as competitive global centres for pan-European access. In addition to the streamlined cross-border fund distribution facilitated by the marketing passport under AIFMD, another noteworthy consequence emerged from increased regulatory requirements. Market participants found themselves grappling with crucial decisions, often pondering the “make or buy” question. In response, a notable trend emerged where many leaned towards engaging Third-Party AIFMs.

This strategic shift in reliance on third-party AIFMs was a direct response to the challenges posed by heightened regulatory demands. While the marketing passport simplified capital flow within the alternative business, the surge in third-party AIFM adoption highlighted a pragmatic approach adopted by market participants to navigate the evolving regulatory landscape. This strategic shift not only addressed the challenges faced by market participants but also contributed to reshaping the dynamics of fund management in Luxembourg and Ireland. [1]

The evolution of fund structures

AIFMD not only catalysed regulatory changes but also spurred the development of novel fund structures, notably European Long-Term Investment Funds (ELTIFs) and European Venture Capital Funds. These structures were designed to cater to specific types of investments and investors within the EU, showcasing the directive’s nuanced approach to fostering a dynamic and adaptive market. The standardisation of fund structures triggered a consequential shift in competition dynamics. With uniform structures, market players found themselves competing not merely based on the fund’s nature but on the quality of service. This shift propelled the industry into an era where the distinguishing factor was the stringent and high-quality approach to service delivery. Simultaneously, structural changes, including a reduction in time to market for fund launches, played a pivotal role in shaping the industry. Exemplifying this evolution are Berenberg and ABN AMRO, benchmarking the success of highly specialised structures.

1 Observatory for Management Companies, PWC, 2023

Global impact

While AIFMD was crafted with a primary focus on EU-based AIFMs, its influence transcended European borders, echoing in global discussions on hedge fund and alternative investment regulation, working in tandem with the UCITS framework. The directive became a catalyst, prompting other jurisdictions to consider analogous regulatory reforms. The global impact of AIFMD underscored its significance in shaping regulatory discussions and practices worldwide, transforming it from a regional directive into a blueprint for global regulatory evolution.

The AIF Market Continues to Prosper

Amid heightened safeguards for investors, the landscape for alternative investment managers seeking capital in Europe has witnessed a notable expansion. Those aligning with AIFMD regulations find themselves at the forefront, poised for substantial increases in capital inflows. In the year 2021, fundraising activities for alternative assets, spanning private equity, real estate, infrastructure, private debt, and natural resources, exceeded the 1.1 trillion USD mark. According to Moody's 2022 asset management outlook, the total assets under management in the alternative sector have now eclipsed the US$9 trillion milestone.

Conclusion

As the alternative investment industry continues its dynamic evolution, AIFMD remains a cornerstone of regulatory frameworks. Industry participants must remain vigilant, adapting to the evolving landscape of AIFMD rules. The directive has not only successfully increased regulation, transparency, and investor protections within the EU's alternative investment landscape but has also left an indelible mark on global regulatory discussions.

Even as the industry charts its course forward, AIFMD's enduring influence is palpable. In the UK, the decision to retain the core framework of AIFMD while tailoring it to the unique characteristics of the UK market showcases its adaptability and enduring impact. AIFMD, a regulatory force that has not merely weathered the past decade but has actively shaped its contours, continues to guide the industry toward stability, transparency, and investor-friendly environments for alternative investments.

Changes to the EU landscape for private credit funds in the EU

In a notable change of policy direction, EU legislators have introduced specific rules to regulate alternative investment funds (**AIFs**) that originate loans by way of amendments to the alternative investment fund managers directive (the amended directive commonly referred to as **AIFMD 2.0**). The intention behind the policy move is to protect investors and to ensure financial stability of the EU financial markets. AIFMD 2.0 entered into force on 15 April 2024 and will come into effect on 16 April 2026. AIFMD 2.0 provides transitional provisions and exemptions from certain rules applicable to funds existing before the 15 April 2024 and/or to the loans in their portfolios.

AIFMD 2.0 contains general rules applicable to EU AIFs that originate loans. The rules prohibit “originate to distribute” strategies, essentially preventing funds from originating loans with the sole purpose of selling them to third parties. The recast directive also introduces a new risk retention requirement, meaning that an AIF must retain at least 5% of the notional value of the loan that it subsequently sells, unless the sale is made in one of certain permitted scenarios (e.g., liquidation of the fund or if the quality of the loan deteriorates). AIFs must retain the 5% amount until the loan matures or, for at least eight years if the maturity of the loan is longer. AIFMD 2.0 also introduces additional reporting, disclosure and diversification requirements and certain conflict-of-interest safeguards for any AIFs that engage in loan origination activities.

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The recitals to AIFMD 2.0 lay down basis for the so called “cross border loan origination passport” for the EU Alternative Investment Fund Managers (**AIFMs**), which should allow EU AIFs, irrespective of where in the EU the AIFM or the AIF is based, to lend on cross-border basis into any other EU jurisdiction. However, due to a lack of precise operative provisions in the text of AIFMD 2.0 itself, the reality of cross-border lending within the EU will largely depend on the national implementation of AIFMD 2.0 by the EU Member States.

AIFs that originate loans as their main strategy, or if they invest 50% or more of their NAV into loans that they originate, (so called **loan originating funds**), will be subject to additional requirements under AIFMD 2.0.

Firstly, leverage caps – calculated in accordance with the commitment method – are introduced:

- open-ended loan originating funds may be leveraged up to 175% of the NAV; and
- closed-ended loan originating funds may be leveraged up to 300% of the NAV.

Secondly, loan originating funds must be operated as closed-ended unless the AIFM that manages the loan originating fund is able to demonstrate to the competent authorities of the home Member State of the AIFM that the fund's liquidity risk management system is compatible with the investment strategy and redemption policy, in which case the fund can remain open-ended.

AIFMD 2.0 also regulates the open-ended AIFs more generally, whether they originate loans or not, by extending the existing liquidity management provisions in AIFMD to provide new obligations and powers for AIFMs that manage open-ended AIFs. Under AIFMD 2.0, an AIFM that manages an open-ended AIF is to select at least two "appropriate" liquidity management tools (**LMTs**) from a list of seven LMTs included in a new annex to AIFMD 2.0 (in addition to the suspension of subscriptions and redemptions and the creation of the side pockets which are to only be used in exceptional circumstances and where justified having regard to the interests of the AIF's investors). The selection of the LMT must be based on an assessment of the suitability of those tools to its investment strategy, the liquidity profile and the redemption policy of the AIF.

AIFMD 2.0 also regulates the open-ended AIFs more generally, whether they originate loans or not, by extending the existing liquidity management provisions in AIFMD to provide new obligations and powers for AIFMs that manage open-ended AIFs.

The European Securities and Markets Authority (**ESMA**) is due to issue detailed regulatory technical standards (**RTS**) on both of these critical topics - placing existing and future open-ended loan originating funds in an uncertain position until the finalised RTS are available.

AIFMD 2.0 also amends the information that must be disclosed to investors both before investment and periodically thereafter. For AIFs that engage in loan origination, the information to be provided periodically post investment has been amended and now includes details of the composition of the originated loan portfolio (this requirement applies to all AIFs, not only loan originating funds) and, on an annual basis, (i) all fees, charges and expenses that were directly or indirectly borne by investors and (ii) any parent company, subsidiary or special purpose entity utilised in relation to the AIF's investments by or on behalf of the AIFM.

To conclude, EU Member States' have until 16 April 2026 to adopt and publish the national laws, regulations and administrative provisions necessary to implement AIFMD 2.0 in their respective jurisdictions. While 'goldplating' of the primary rules is not necessarily expected, especially in the areas where detailed RTS will be published by ESMA, some EU Member States may see implementation as an opportunity to regulate other issues related to the topic, such as lending to consumers. The EU direct lending landscape will no doubt change during the course of the next two years and beyond.

Meeting the operational challenges of SFDR: The time to act is now

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We recently launched the second edition of our Sustainable Finance Disclosure Regulation (SFDR) Impact Analysis, the aim of which is to provide asset managers with a practically focused assessment on the current state of sustainable investing in Europe. The analysis, based on a review of over 26,000 funds across the two largest fund domiciles in the EU, Ireland and Luxembourg, shows a 20% growth year-on-year in the number of European sustainability funds.

Europe is at the forefront of sustainable investment globally with assets in sustainability focused funds now exceeding €5.5 trillion. We are only in the second full year of SFDR implementation and its impact on the European funds space has been immense.

In 2023, more than half of new funds were categorised as either Article 8 or 9 under SFDR and already more than 40% of European AUM sits within such funds.

Asset managers are structuring sustainable funds across all asset classes demonstrating that the Article 8 and Article 9 SFDR categorisations are not constraining managers in terms of sustainable product design. In short, SFDR is working and is achieving its key objective, namely the redeployment of capital sustainably across a broad spectrum of asset and fund types.

However, despite the significant success that SFDR has had in reorientating private capital towards sustainable investments and the growing numbers of Article 8 and 9 funds, from a legal and regulatory perspective there remains the risk for compliance gaps - particularly in ensuring an operational model that can achieve and support continued compliance.

Operational compliance under SFDR

SFDR entity level and fund level compliance sit with the asset manager of the relevant fund, (e.g., Undertakings for the Collective Investment in Transferable Securities (UCITS) management company, Alternative Investment Fund Managers (AIFM) or investment manager (ManCo)). Broadly speaking, the entity level requirements apply to the ManCo itself, how it has integrated sustainability into its operational and organisational framework, with the fund level requirements applying to the funds under its management.

Understandably, the greater attention of SFDR compliance to date has tended to focus on the fund level disclosures, (i.e. the pre-contractual templates and the periodic reports, etc). Increasingly however, the supervisory focus of European National Competent Authorities (NCAs) has been on how ManCos are complying with the operational obligations imposed by SFDR and supporting legislation as indicated through various questionnaires and thematic reviews issued by both the Central Bank of Ireland and the *Commission de Surveillance du Secteur Financier*.

As such, compliance with SFDR extends beyond disclosure requirements and the impact at the operational level should not be overlooked.

Policies, procedures and resources

ManCos are required to ensure that their overall policy and procedures frameworks (i) integrate sustainability risks in the management of all funds; (ii) include conflicts of interest procedures which consider conflicts that may arise as a result of the integration of sustainability risks; (iii) take into account sustainability risks (and, if relevant, take into account the principal adverse impacts of investment decisions on sustainability factors) as part of the due diligence in the selection and ongoing monitoring of investments; (iv) capture details of procedures to manage sustainability risks in the risk management policy and (v) integrate the consideration of sustainability risks into their remuneration policies.

Areas like websites are just one of the heightened SFDR compliance risks that European NCAs are already focusing on.

In addition to this enhanced policy and procedural framework, SFDR also obligates ManCos to retain the necessary resources and expertise for the effective integration of sustainability risks, (i.e., dedicated members of staff). It then falls on the board / senior management of each ManCo to ensure that those people are retained and that the integration of sustainability at the operational and organisational framework occurs and is effective.

This can be challenging for ManCos to demonstrate, particularly where they have placed a significant reliance on delegate investment managers for compliance with some of these SFDR obligations. While this approach is understandable given the inherent link between SFDR requirements and the day-to-day management of a given fund, it is crucial for ManCos and their boards to design and consistently apply a SFDR compliance model which is appropriate given the nature, scale and complexity of their business as well as one which is adequately contracted and documented.

A prime example of this is meeting the SFDR website disclosure requirements, which include ManCos ensuring that the information contained on the websites is up to date, and that it is prominent and easily accessible.

When SFDR websites first went live (in advance of 1 January 2023 implementation date) these aspects may have been taken as read, but as funds are updated and change throughout their lifecycles, and the bank of SFDR periodic reporting increases, ensuring there is both the resources and oversight to meet the website requirements becomes a more onerous task. As part of our SFDR Impact Analysis, we found these requirements were not always being met. This demonstrated a basic failure to comply with the prescriptive website requirements of SFDR, but also a lack of operational oversight by the ManCos.

Areas like websites are just one of the heightened SFDR compliance risks that European NCAs are already focusing on. Therefore, having documented policy and procedural frameworks, coupled with adequate and frequent reporting, is essential in demonstrating that appropriate oversight is in place.

EMIR - a cautionary tale for SFDR

European NCAs remain in information gathering mode and are establishing baselines as to suitable and appropriate SFDR disclosure and compliance models.

It will take time before the SFDR supervisory framework takes shape.

However, ManCos should not take this as an indication that compliance was addressed when they filed their pre-contractual documents in late 2022 and merely take a watching brief.

The regulatory supervisory approach to the European Market Infrastructure Regulation (EMIR) is instructive on how European NCAs are likely to approach SFDR compliance.

EMIR was introduced in 2012 (also on a phased basis) and imposed ongoing reporting obligations on ManCos with respect to the derivative trading activities of their funds under management. ManCos designed EMIR compliance frameworks largely reliant on a delegation model.

Between 2012 – 2015, European NCAs engaged in an information gathering phase to ascertain how industry was adhering to its EMIR reporting obligations. By 2016, European NCAs set out their baseline expectations to EMIR compliance and were voicing their concerns over the prevailing delegation model, warning industry that the regulatory buck stopped with the ManCo and for them not to assume their delegate was properly discharging their EMIR obligations. Unfortunately, these warning shots were not heeded (in all cases), and what followed has been a series of EU-wide regulatory enforcement actions, sanctions and fines for ManCos resulting from EMIR non-compliance.

EMIR is the cautionary tale for SFDR. European NCAs no more than industry, have been challenged by the pace of SFDR's implementation and the new concepts it introduced to the regulatory supervisory framework.

The time to act is now

EMIR is the cautionary tale for SFDR. European NCAs no more than industry, have been challenged by the pace of SFDR's implementation and the new concepts it introduced to the regulatory supervisory framework.

What is clear is that European NCAs are working in lockstep with regards to SFDR compliance. And once they have established their baseline expectations as to what represents appropriate SFDR disclosure and compliance models, this will be articulated to industry.

It will then be down to ManCos and their boards to implement and adhere to those expectations. Failure to do so will undoubtedly result in regulatory enforcement actions and fines for bad actors.

The average fine levied to date by European NCAs for EMIR non-compliance has been approx. €150,000. These fines were largely for lack of oversight and/or failure to meet ongoing reporting obligations. In most cases, investors were not impacted or did not suffer a loss. The same will not be the case for SFDR. Compliance failures under SFDR create the very real risk of greenwashing and direct adverse outcomes for investors so regulatory fines will in all likelihood be significantly higher.

So how can ManCos ensure they are meeting all of their SFDR obligations? Well simply put, they should be assessing their contractual arrangements, stress testing their policy and procedural frameworks to ensure there aren't any SFDR compliance gaps and ensuring adequate and frequent reporting is in place. It's too late to do so when an issue emerges, especially in the face of potential regulatory interventions.

The tax alpha advantage: A competitive edge for fund managers

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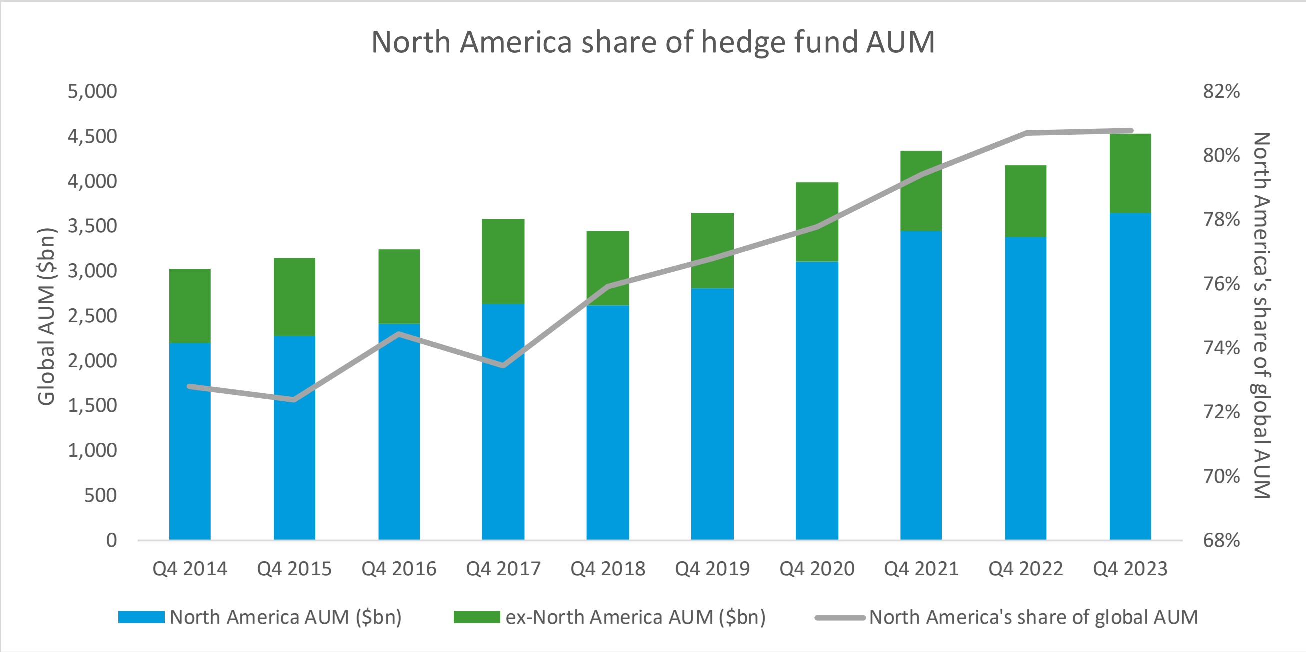
The asset management sector has experienced notable capital consolidation in recent years. Large managers continue to outcompete their smaller peers for capital as a result of economies of scale, technological advancements, regulatory pressures and changing investor preferences. Across all alternative asset classes, investors are committing more capital to fewer funds. Of the US$4.5 trillion in hedge fund assets under management at the end of Q4 2023, 80% of those assets, or US$3.7 trillion, were managed by North America-based funds, according to Preqin. This share has grown by about 7% since 2017 as the mega funds continued to gain market share, notably at the expense of European hedge funds whose share of global AUM has dwindled rapidly.

Looking to the future, the trend toward capital consolidation within this sector is likely to continue. Preqin's latest Future of Alternatives 2028 report projects that hedge fund assets will grow 3.6% yearly, reaching US$5.2 trillion by 2028, with North America keeping a tight grasp on much of that AUM. Fund managers will need to focus on differentiating themselves to attract and retain capital and position themselves for success.

In this environment, the importance of tax-efficient investing is rising to the fore. Managing investments in a tax-efficient manner can enable fund managers to potentially enhance their investors' after-tax returns and improve their overall return on investment. The key to effectively optimising tax alpha is the ability to access near-real-time insights to make better, quicker investment decisions.



Source: Preqin Pro. Data as of February 2024

Optimising tax alpha

The ability to optimise tax alpha can be a significant differentiator for fund managers in the competitive landscape of attracting capital. The impact of taxes on investment returns can be detrimental if not properly managed and planned for.

Too often, tax is viewed strictly as a compliance function. Tax departments are stretched thin by increasingly complex reporting requirements, higher expectations from investors, and outdated processes and technology. To become a value-creating function rather than a cost center, tax departments need to lean on automation and data analytics to provide enhanced insights. The right technology can enable fund managers to effectively manage their tax compliance function and reporting obligations while also gaining insights to guide investment strategies and transactions. To do so successfully, there are certain features that fund managers should look for in potential technology solutions:

1. A single, integrated approach

With securities trading specifically, a single transaction may be subject to overlapping tax rules. This can make the analysis of all potential tax ramifications a bit challenging if traders are relying on manual processes to piece together their full tax picture. By using a single, integrated platform, portfolio managers can get a holistic look at the tax implications of their trades with a fully tax-sensitised view of the portfolio.

This clearer picture can enable fund managers to effectively analyse all tax implications of their trades, allowing them to more accurately plan for long-term capital gains and qualified dividend income, expedite or conserve short-term capital losses, and mitigate the potential for loss disallowances under the loss deferral rules.

2. Prioritisation of timely insights and modeling

Tax data is often provided after a trade has been executed, rendering it useless as a modeling tool. By leveraging advanced technology and the latest data, fund managers can rapidly analyse the tax consequences of various “what-if” trading scenarios. This includes assessing the impact of various trading strategies on the overall tax liability of the portfolio. Near-real-time modeling paves the way for identification of opportunities such as tax-loss harvesting and enhancement of the timing of trades to minimise tax exposure.

Timely modeling also allows fund managers to be more responsive to rapidly changing market conditions and investor needs. For example, if a geopolitical event or new policy initiative significantly affects an investment, managers can quickly assess the tax implications and adjust their portfolio accordingly. This level of agility is essential in today’s fast-paced and ever-changing operating landscape.

3. Synergy throughout the entire tax function

Employing systems that do not communicate with each other is a common barrier to effective automation within compliance functions. Having easy data flow between various functions in the asset management business is essential to automate certain processes. A fully integrated and transparent tax compliance system allows for seamless collaboration between various departments, including trading, operations, back-office and compliance teams. This can lead to improved efficiency overall, lower costs, and ultimately better returns for investors.

The long view

Tax considerations can be an essential part of the formula for an asset managers’ success. Those who prioritise tax efficiency and actively work to minimise the tax burden for their investors can provide significant value and help investors achieve superior long-term outcomes. As the importance of tax-efficient investing continues to grow, fund managers who can consistently generate tax alpha will be well-positioned to succeed in the competitive world of asset management.

Higher ground: How the new rate regime impacts allocators

For most people in the business of fund allocation, the higher interest rate environment has meant taking a new approach.

In the era of tighter credit, risk-reward calculations have shifted. This is true across the market spectrum, regardless of geography, asset class or investment approach. Higher interest rates may provide a common backdrop, but they also create a slew of new push-pull relationships as they impact different market segments, affect specific industry sectors and the broader economy, put additional pressures on hedge funds to perform, and inflate the costs of portfolio financing.

Jack Seibald, Global Co-Head of Prime Services and Outsourced Trading at Marex is constantly talking to people who need to weigh these push-pull factors and decide on allocations themselves or advise clients on such decisions. Here, he shares his insight on allocator views for the months ahead.

Jack Seibald
Global Co-Head of Prime Services and Outsourced Trading
Marex

Cash is not necessarily king

Cash may be more attractive, but assets are proving more so. For cash-heavy macro funds and commodity trading advisors, higher rates provide a base, on top of which there can be opportunities for alpha. This puts the onus on advisors to find managers who are able to generate alpha, because clearly not enough funds have been doing that. Hedge funds need to be making double-digit returns or very close to that to justify investor interest in this environment.

Think diversity

Given everything that has happened in the past few years, it should not come as a surprise that what may have worked well one year has not always continued to do so the next. Certain strategies that performed in 2022 struggled in 2023 and last year was notable for how often many managers found themselves having to make abrupt changes pertaining to fundraising strategies. With that in mind, it makes sense not to focus on a single strategy but to aim for diversity.

Credit complications

Long-short credit strategies could offer opportunities, especially considering dispersion and differentiation of returns.

Underlying that view are the competing forces at play in credit. Investors have been moving more into credit in the past six to nine months, but the higher rate environment also raises the prospect of more defaults. What is clear is that people are not used to thinking about dispersion when it comes to credit because they have seen so little of it in the past seven or eight years.

Focus on flexibility

Anyone looking broadly at credit will want a broad portfolio of credit managers focusing on stressed, distressed and performing credit, rather than a single manager rotating. The market moves quickly. In 2020, as COVID hit, the window of opportunity for some distressed credit could be months long. Fast forward a couple of years and such windows may open and close at lightning speed. Managers who have experience dealing with both stressed and performing credit should expect to be popular.

Mileage in long-short equity

When rates were near zero, it was not conducive to outperformance against exchange-traded funds or passive investing in general. But if we assume higher rates will be around for a while, long-short investing could become more attractive. Is the goal of hedge funds to outperform Exchange Traded Funds (ETFs)? The after-effects of excess liquidity from the COVID years have been benefiting the market, but that is changing. Short strategies could offer more opportunities, particularly once delinquencies finally start to happen. It's worth noting that the long-short space has improved but some of that was driven by beta as the equity market rebounded.

Manager selection is key

Higher interest rates are a double-edged sword. They can make short-selling more expensive, but they create opportunities because of their effect on underlying companies. At the same time, dispersion in the long-short space has been so great that allocators will need to focus on manager selection. It's been popular to buy-the-dip, making life more difficult for short sellers. It is therefore key to look for managers who are resilient in such an environment.

The FOMO factor

One positive side-effect from the rally in equities has been that it generated a dose of FOMO (fear of missing out) in people's minds. In other words, it provided yet another argument against sitting on cash. But that does not mean investors need to rush into equities. Relative value may be less exciting but it can generate solid returns. One possible approach is to use relative value and multi-strategy to create a strong core and then add diversity on top of that.

Final thoughts

It has been almost a generation since interest rates have been this significant for institutional allocators and investment managers. The impact of higher interest rates – on trading strategies, underlying assets and the macroeconomic environment – adds fresh complications. But from speaking to fund managers and allocators, it is clear that there is tremendous opportunity to be had for those investors prepared to delve deeply and identify the right managers. All things being equal, that's a pretty good position to be in.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Hurricane season: Practical solutions for Cayman Islands funds in respect of sanctions and CIMA notifications


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Residents in Cayman know, when the summer months are coming, to prepare for the effects of strong storms and hurricanes. Similarly after several particularly tumultuous years leading to the current economic environment, a number of Cayman funds and their investors are managing situations involving (i) sanctioned investors; and (ii) CIMA notifications following regulatory or other administrative action by foreign regulators.

This Article discusses these matters and offers practical guidance.

Sanctioned investments and investors

Sanctions are used as a foreign policy tool as part of a broader political and diplomatic strategy to achieve a desired outcome from a target country or regime, most recently including Russian sanctions.

The Cayman Islands is a British Overseas Territory and, as such, takes its sanctions regime from the United Kingdom (**UK**). The UK sanctions regime is governed by the *Sanctions and Anti-Money Laundering Act 2018* (**Act**) and its regulations. Corresponding sanctions are applied in the Cayman Islands by a number of Orders in Council (**Orders**).

These sanctions are implemented by designating particular nations, entities or individuals, or categories of entities or individuals, as "designated persons". The UK maintains a list of those entities and individuals which it has sanctioned (and which by extension are sanctioned in the Cayman Islands).

The Act defines six types of sanctions, including financial sanctions.

The most common financial sanction is an asset freeze. This prohibits dealing with the funds or economic resources of a designated person, including by that person, and also making funds or economic resources available to or for the benefit of the designated person. The funds and economic resources subject to the sanction are to be frozen immediately by the person in possession or control of them. These sanctions are broadly drafted, and capture any entities which a designated person controls or holds a majority interest in.

Where an investor in a fund or its beneficial owners, controllers or authorised persons are named on an applicable sanctions list, the fund is required to immediately and without notice to the investor cease any further dealings with the investor and/or the investor's interest in the fund until the investor (or its beneficial owners, controllers or authorised persons (as applicable)) ceases to be named on an applicable sanctions list, or a licence is obtained to continue such dealings. In addition, should any investment made by the fund subsequently become subject to sanctions, the fund shall immediately and without notice to any relevant investor cease any further dealings with that investment until the sanctions are lifted or a licence is obtained to continue such dealings.

If a fund knows or has reasonable cause to suspect that the fund is in possession or control or is otherwise dealing with the funds or economic resources of an investor named in a sanctions list, the fund must:

(a) immediately freeze the funds, or economic resources of that investor;
(b) not enter into financial transactions or provide financial assistance or services to that investor unless there is an exemption in the legislation that can be relied on or the fund holds a licence from the Cayman Governor;
(c) immediately report that investor to the Cayman Financial Reporting Authority (**FRA**); and
(d) complete and submit a Compliance Reporting Form to the FRA as soon as practicable.

Applicable penalties are set out in the relevant Order but in general, the maximum penalties are a fine at the discretion of the Grand Court of the Cayman Islands (which may be unlimited but cannot be excessive) and up to seven years' imprisonment. These penalties are specifically extended to the directors or controllers of a fund that has breached the sanctions regulations and also apply to any conduct which circumvents or is intended to circumvent the applicable regulations.

In light of the above, funds should be extremely cautious when proposing any course of action relating to sanctions, and as a first step, we recommend that funds confer with Cayman Islands counsel for advice on sanctions related matters.

Some Cayman funds may have recently encountered either the fund's investments or the ultimate beneficial owner of an investor being designated as a "designated person" under *The Russia (Sanctions) (Overseas Territories) Order 2020*, which will have required the fund to incur time and expense in managing the associated difficulties with holding and divesting from such investment or investor. Funds may be forced to incur significant holding costs associated with frozen assets, as any divestment of any kind is strictly prohibited and would constitute "dealing with" (as broadly defined in *The Russia (Sanctions) (EU Exit) Regulations 2019*) that asset and/or "making funds or economic resources available to a designated person".

Funds may be able to take advantage of some of the limited exceptions to sanctions prohibitions that have been introduced by the UK, principally to allow provision of services in order to comply with statutory or regulatory obligations (such as the provision of statutory audits to Cayman Islands entities which may be ultimately held by a person connected with Russia).

The UK has also introduced specific divestment licensing grounds which might assist affected funds. In the context of sanctions imposed against Russian individuals and entities, the UK introduced licensing grounds to enable a fund to apply for a specific license from the Cayman Governor to either (i) undertake a transfer of funds or economic resources located in Russia and owned, held or controlled by the Cayman fund, in order to enable that fund to divest itself of those funds/economic resources, where the funds or resources are transferred to the Government of Russia or a designated person; or (ii) acquire an interest in that Cayman Islands entity from a designated person or the Government of Russia. This is subject to the condition that the only consideration for the acquisition is a transfer of funds and the funds are credited to a frozen account in the Cayman Islands or a jurisdiction with similar sanctions against Russia.

Such measures may provide welcome relief for funds confronting issues relating to sanctions, and we encourage such funds to seek specific advice from Cayman Islands counsel about how best to navigate the safest path forward.

CIMA notifications

On occasion, funds, their service providers and employees may be subject to non-Cayman regulatory or legal proceedings which obliges a fund and its directors to communicate certain information to the Cayman Islands Monetary Authority (**CIMA**). For example, a fund has CIMA disclosure obligations under the *Mutual Funds Act* or the *Private Funds Act*, and their related policies, procedures, rules and guidance notes issued by CIMA.

A few key disclosure obligations are outlined below, though these may differ depending on the type of fund and its circumstances:

- A fund must notify CIMA **within twenty-one (21) days** after any material change to the information in its offering document, of any information submitted to CIMA under the *Private Funds Act* or the *Mutual Funds Act*, as applicable. CIMA will likely regard any changes to the following in respect of a fund as being material: the investment objectives and strategies, investment managers/advisors, investment risks, operators, service providers, registered office, change of name, change in administrator and the creation of a segregated portfolio (as applicable);
- Under CIMA's regulatory measures introduced in April and October 2023, a fund must ensure that CIMA is notified by email, **within ten (10) days**, of any substantive issues which could materially affect the fund, in line with applicable acts, rules, regulations and regulatory measures;
- Directors of certain funds will also have a personal obligation under the *Directors Registration and Licensing Act* to notify CIMA of any change in the information provided to CIMA for the registration of a director, **within twenty-one (21) days** of such change. This includes any changes to probity statements and confirmations made in the director's personal questionnaire submitted to CIMA, such as where a director serves as director of an entity that has been the subject of an investigation, anywhere, by a governmental, professional or other regulatory body. A Cayman fund must at all times have directors, senior officers, managers or persons who have acquired ownership or control that are "fit and proper persons". The fit and proper person test focuses on (a) honesty, integrity, reputation; (b) competence and capability; and (c) financial soundness.

CIMA has the power under the *Monetary Authority (Administrative Fines) Regulations* to impose administrative penalties for breaches of regulatory laws, including the *Mutual Funds Act* and the *Private Funds Act*. These regulations classify breaches of certain sections of applicable regulatory laws as either minor, serious or very serious. Minor breaches can result in a US$6,000 fine, while serious and very serious breaches can result in discretionary fines of up to US$120,000 and US$1,200,000 respectively. A Cayman fund's directors, officers or managers who are complicit in any breach may also be liable to fines of up to US$120,000.

Funds and their directors should therefore remain mindful of their obligations to notify CIMA in the event that a fund, its service providers or directors becomes the subject of any material change or regulatory action, and should seek Cayman Islands legal advice in the event of any doubt.

Changes to beneficial ownership reporting: What funds and managers need to know

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What is the beneficial ownership regime?

To comply with international standards and commitments to combat money laundering, tax evasion and terrorist financing, the Cayman Islands implemented a beneficial ownership reporting regime (BORR) in 2017 which required each in-scope entity to instruct its corporate service provider (CSP) to establish and maintain a register of beneficial ownership information and file it with the Registrar of Companies (the Registrar). The Registrar maintains a search platform that enables specified persons to access information on beneficial ownership registers.

Background

The Cayman Islands has grown to around 30,000 regulated open-ended and closed-ended alternative investment funds. The Cayman Islands and the US each have between 30% and 40% of the world's alternative investment funds, with the next largest domicile having less than 10%. The Cayman Islands' appeal includes a legislative and regulatory framework designed for investment funds, continuously evolving to meet global standards. This framework focusses on financial crime prevention, corporate governance and international transparency but is highly flexible in terms of the operational requirements of funds, with no restrictions on investment strategies, short-selling or leverage, and no need for investment funds to have local bank accounts or local directors, managers, administrators, custodians, or other fund service providers – although hedge funds typically appoint local independent directors.

The OECD's Financial Action Task Force (FATF) and the European Union have meticulously reviewed the Cayman Islands' financial crime prevention framework and confirmed it meets global standards for transparency, anti-money laundering, and tax good governance on par with, or better than, most major economies. Over 170 countries have been assessed by the FATF and its network of regional bodies for compliance with the FATF Recommendations. Of these, the Cayman Islands is one of only a handful assessed by the FATF as compliant with all 40 of its Recommendations, a level of compliance which no G20 members or key EU member states meet. The Cayman Islands is committed to international transparency and is now updating its BORR.

What is changing?

Following industry consultation, the Beneficial Ownership Transparency Act, 2023 (the BOTA) was gazetted on 15 December 2023, to update the BORR in line with evolving international standards. The BOTA expands the scope of the BORR, meaning that many entities which previously had few or no obligations under this regime will have to take steps to comply.

Expansion of scope: Cayman Islands companies, limited liability companies, limited liability partnerships, foundation companies and, for the first time, exempted limited partnerships and limited partnerships (together Legal Persons) will be in scope of the BOTA. Trusts and registered foreign companies remain out of scope. Several exemptions available under the current BORR are to be removed.

Streamlining of legislation: Currently the BORR is set out across numerous pieces of primary legislation and accompanying regulations, which can make it hard to navigate. The BOTA consolidates the provisions of the Cayman Islands' beneficial ownership regime in one single act.

Alignment of definition of "beneficial owner": The BOTA aligns the definition of "beneficial owner" with the Cayman Islands Anti-Money Laundering Regulations (the AML Regulations), save that the relevant percentage for determining "control" under the BORR remains at 25% or more (not 10% or more, which is the threshold under the AML Regulations).

Data requirements: The BOTA requires marginally more information (as compared to currently) on registrable beneficial owners (RBOs) to be provided, particularly the nature of ownership or control held and, for individuals, their nationality. Currently a RBO's name, address and (in the case of an individual) date of birth and details from the individual's unexpired and valid government-issued document or (in the case of an entity) legal form and registration number need to be provided, along with the date of becoming or ceasing to be a RBO.

What action do entities need to take?

Many Legal Persons that were previously out of scope or exempt (such as local general partners, carry vehicles, debt issuance vehicles, special purpose vehicles, blockers, trading subsidiaries, entities registered under the Securities Investment Business Act and others) will now need to identify their RBOs and provide details to their CSP.

However, Legal Persons which are registered with the Cayman Islands Monetary Authority (CIMA) as mutual funds or private funds will not need to maintain a beneficial ownership register. Instead, they need only provide their CSP with details of an entity (Contact Person) which is able to provide details of the fund's RBOs if ever requested. Legal Persons licensed by CIMA or listed on the Cayman Islands Stock Exchange (the CSX) or an approved stock exchange (or subsidiaries of such listed entities) also need not maintain beneficial ownership registers. Instead, they need only provide their CSP with details of their licensed or listed status." CIMA registered investment funds, licensees and listed entities may opt in to establishing maintaining a beneficial ownership register if they wish.

A brief summary of initial actions is below.

Type of entity	Initial action required
Trust	Out of scope - no action required
Registered foreign company or other non-Cayman entity	Out of scope - no action required
CIMA registered mutual fund or private fund	Legal Person must provide its CSP with details of a Contact Person (or opt in to having a register)
CIMA licensed Legal Person	Legal Person must provide details of its licence to its CSP (or opt in to having a register)
Legal Person listed on the CSX or an approved stock exchange	Legal Person must provide details of its listing to its CSP (or opt in to having a register)
Legal Person owned 75% or more by an entity listed on the CSX or an approved stock exchange	Legal Person must provide details of its parent's listing to its CSP (or opt in to having a register)
Legal Person being wound up	Legal Person's liquidator or CSP must provide details of the liquidator and the Legal Person's RBOs at the time of the liquidator's appointment to the Registrar
Legal Person not falling under any of the above which already reports its RBOs	Legal Person must identify its RBOs under the new definition and provide its RBOs' details to its CSP
Legal Person not falling under any of the above	Legal Person must identify its RBOs and provide its RBOs' details to its CSP

What type of entity can a CIMA registered mutual fund or private fund appoint as Contact Person?

Only an entity licensed or registered with CIMA for providing beneficial ownership information (typically a CSP) or a fund administrator licensed under the Mutual Funds Act is eligible to be appointed as Contact Person.

What are RBOs?

A Legal Person which is neither a CIMA registered investment fund nor licenced or listed or the subsidiary of a listed entity will need to identify and provide details of its RBOs to its CSP, so the CSP can establish and maintain the Legal Person's beneficial ownership register. RBOs include individual "beneficial owners" and "reportable legal entities" as defined in the BOTA. However, entities within fund structures are frequently institutionally and / or widely owned, meaning there may be no individual beneficial owner who ultimately owns or controls, directly or indirectly, 25% or more of the shares, voting rights or partnership interests in the Legal Person. In this case, an individual beneficial owner may be an individual who otherwise exercises ultimate effective control over the management of the Legal Person or who exercises control of the Legal Person through other means. A trustee may be deemed an individual beneficial owner in certain circumstances. There is a carve out for individuals operating solely in the capacity of lawyer, accountant, financial advisor or of liquidator, receiver or restructuring officer exercising a statutory function. If there is no such individual, a senior managing official, for example a director or chief executive officer of the Legal Person, will need to be identified. Reportable legal entities are, essentially, Cayman Islands entities which would be individual beneficial owners of a Legal Person if they were individuals.

Are Legal Entities required to implement any special reporting software?

No. Legal Entities can provide information to their CSP in whatever form is required by their CSP, which may include an online portal or via legal counsel. As the BORR has been in place since 2017, CSPs are familiar with their obligations.

Are there ongoing obligations?

There are ongoing obligations on Legal Persons, including but not only to ensure the information reported to their CSP is kept up to date. As under the existing BORR, the BOTA provides for restriction notices and penalties for non-compliance.

What is the timing?

The BOTA is expected to come into force in the near future, along with regulations and guidance, subject to a grace period meaning no enforcement action will be taken until 1 January 2025.

Next steps

Funds and managers should monitor further developments and be ready to take the necessary steps to comply.

This article does not cover every aspect of this topic and is not designed to provide legal advice. Further information and assistance is available on request, including advisories, decision trees and FAQs.

Thank you for reading the Edition 138 of the AIMA Journal.

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

PUBLICATION PLAN 2024

- **Q3 Edition 139**
  Deadline for submission 5pm UK time Monday 29 July | Publication Monday 23 September

  Please note the deadline to reserve a spot for the Q3 edition of the AIMA Journal is 5pm UK time Friday 12 July.

- **Q4 Edition 140**
  Deadline for submission 5pm UK time Monday 21 October | Publication Monday 18 November

  Please note the deadline to reserve a spot for the Q4 edition of the AIMA Journal is 5pm UK time Friday 4 October.

Please note that availability is limited, and we cannot accept any additional contributions once all the spots have been filled.

We kindly advise all contributors to email us prior to submitting to make sure we can include the contribution. We can't guarantee the inclusion of any last-minute submissions.

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