AIMA Journal Edition 111

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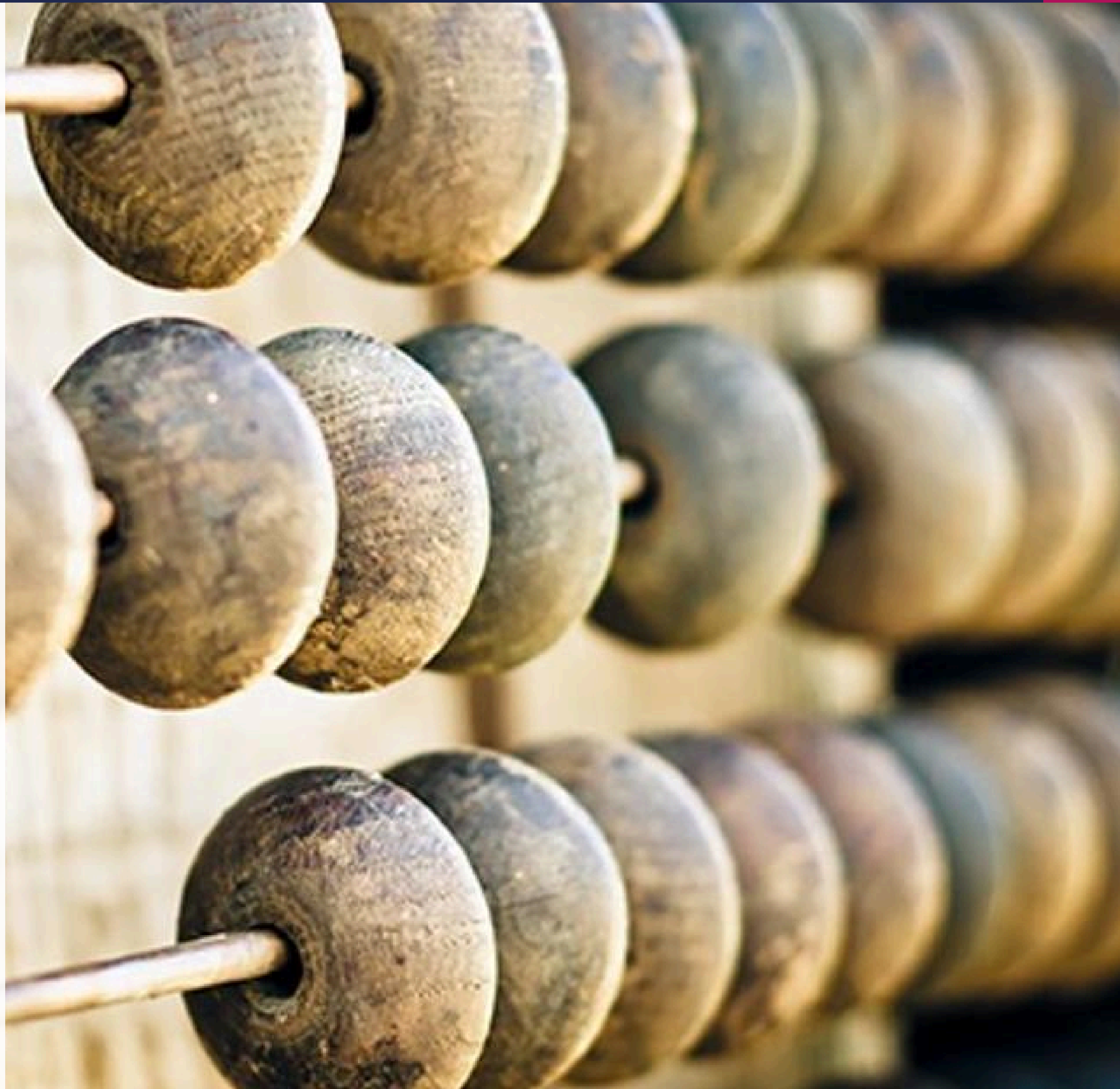

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Open Letter: Activist investors unlock value

By Jack Inglis, CEO, AIMA

Jack Inglis

On behalf of The Alternative Investment Management Association, which represents 1,850 investment firms that collectively manage more than $1.8 trillion in assets in 57 countries.

Following the March elections, the Dutch Employers' Association has made a number of suggestions to the political parties involved in the negotiations on the formation of the new government. There are some very sound and laudable suggestions proposing that the Dutch economy remains competitive in terms of tax and the overall business regulatory environment. However, there are also some troubling proposals that, if implemented, would move the Netherlands firmly into the camp of countries erecting new barriers to the movement of capital.

The proposals suggest that because the Euro and, by extension, Dutch assets and companies will remain cheap and because some other countries around the world are becoming more protectionist, the government should consider legal remedies to ward against unhelpful hostile takeovers and active investors.

This is nothing new. We have seen before that companies argued that active investing could be harmful for the long term strategic prospects of companies that are their targets. These often self-serving arguments are usually based on a very few highly publicised examples which do not reflect the role and the value of active investing in an economy. Also, these arguments are often strategically used to promote and support a position in a concrete situation.

We at The Alternative Investment Management Association have undertaken comprehensive research to assess the development and current state of shareholder activism by alternative investors, investigated the impact of such activism and identified certain trends and implications for future developments. We analysed a unique dataset compiled with assistance from databases that record campaigns, reviewed the empirical research to date, and consulted both active and passive investment managers.

The data shows a clear picture: active shareholders produce long-term improvements in companies' performance. The empirical evidence to date indicates that, on average, engagement by active investors is correlated to improvements in the share price, operating performance and productivity of targeted companies for several years following the engagement, including after the investor exits.[1]

Similar findings have been replicated by a great number of studies across different regions in the world. Most recently, a study conducted by Bloomberg in early 2014 found that stocks of companies with active shareholder groups in the period 2009 to 2013 – a period of 48 months – gained 48% on average, beating the S&P index by approximately 17 percentage points.[2]

Active investors are relatively longer-term investors and are frequently structured to provide ‘patient capital’. Large institutional shareholders such as pension funds are also becoming increasingly supportive of active investors by: investing ever greater sums in active funds; supporting shareholder proposals; and, in some cases, joining forces with active shareholders.

According to our data, proposals to improve governance of companies globally account for more than half of the objectives of active alternative investors. This suggests the concerns that activism is primarily about short term goals and “financial engineering” and therefore not in the benefit of long term strategic performance are not well-founded.

By seeking higher standards of corporate governance these investors improve the alignment of interest between management, shareholders and all other stakeholders. This ultimately leads to improvements in the efficient allocation of capital and resources in the economy overall. Governments should therefore be wary of proposals that could restrict the manner in which shareholders exercise their rights as the evidence suggests this ultimately leads to bad results.

[1] The AIMA study is available at https://www.aima.org/educate/aima-resear...

[2] https://www.bloomberg.com/graphics/info
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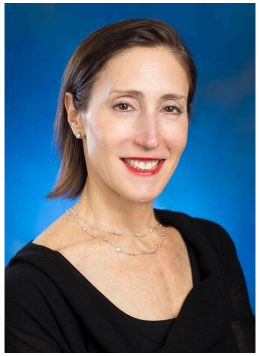
[3] A Dutch version of this letter was originally published in Het Financieele Dagblad on April 25, 2017.

Beyond the Fees: Key Considerations

By Wendy Beer, Director, Head of Business Consulting; William Saltus, Director, Business Consulting, and Jasmaer Sandhu, Analyst, Business Consulting at Wells Fargo



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Bill Saltus

Jasmaer Sandhu

Intro

The Wells Fargo Business Consulting group spoke to industry experts, investors, and managers this year, and has noticed an uptick of more complex term structures to better align the interests between managers and investors. Analysis of these recent discussions indicates that an increasing number of existing and new hedge funds are being pushed to explore such structures. The past three years of challenged hedge fund performance and muted capital flows seems to have shifted the balance of power in negotiations to investors. As a result, it appears a growing number of investors have been pushing managers to implement tools to ensure that fees are paid based on alpha generation. In addition to reducing fees, negotiated investment terms include performance hurdles, multi-year performance crystallization periods (multi-year crystallization) and claw-backs. Even though a manager may be incented to agree to some of these terms in order to attract capital, they should be well-informed of the tax ramifications and any other implications of such terms.

Trends

Based on our discussions, hurdle rates are becoming one of the most discussed topics during term structure negotiations. The process of choosing an appropriate hurdle rate is complicated by the difficulty of separating alpha from beta. Historically, investors were content with either a fixed hurdle rate or a variable hurdle rate tied LIBOR. More recently, however, there has been a push to selecting a benchmark that more closely matches the strategy of the fund. An AIMA survey taken in early 2016 showed that a third of respondents employ hurdles within their funds – noting that, in comparison to recent years, this was a significant increase.[1] Brian Lahart, Head of Manager Research for Abbot Downing notes, "Hurdle rates tied to alpha generation would be more transformative to the industry."[2] Investors view managers' acceptance of hurdles tied to a benchmark as a vote of confidence by the manager in their ability to generate alpha.

In addition to considering how the benchmark matches up with the manager's strategy, the manager should back-test to determine how the hurdle would have affected compensation in prior periods. "If a manager believes in its ability to perform, it may not negatively impact the economics of the manager," notes Benson Cohen, a partner at Sidley Austin LLP's Investment Funds, Advisers and Derivatives practice. As managers look to better align their incentive structures with investors' interests, hurdles pegged to benchmarks that are aligned with the investment strategy may become more prevalent.

Less frequently employed than hurdles, multi-year crystallization and claw-backs of performance fees are another method investors are using to increase investor/ manager interest alignment. Anecdotally, looking back at our investor and manager discussions as recent as a year ago, little was spoken about multi-year crystallization. Based on dialogue with legal practitioners and the results of the AIMA survey, we infer that while multi-year crystallization adoption rates remain low, discussions including it are on the rise. Indeed, hedge fund lawyers we spoke with acknowledge an increase in conversations involving hurdles and multi-year crystallization calculations. "Given the tough performance environment, managers have been more willing to work with their investors over the last few months on implementing innovative commercial terms. Funds that employ longer-term strategies are beginning to incorporate multi-year crystallization, while an even greater number of managers are implementing benchmark-based hurdles," notes Kelli Moll, a partner with Akin Gump Strauss Hauer & Feld LLP.

Performance crystallization periods delay the payment of incentive allocations by a time length often influenced by both the lock-up period and the investment strategy. For example, some investors may request for managers to implement a three-year performance calculation period, over which the investor would be able to "claw back" any accrued performance-related allocation during a year of under-performance. The implementation of these terms can take place through the creation of new share classes, separately managed accounts (SMAs), or funds- of-one. These can be created for both new and existing investors. During the formation phase of new hedge fund launches, investors may engage managers to consider these terms as part of either a founders share class or as part of the standard terms.

The 1 or 30 model is an example of a newer investment structure which employs hurdle rates. Developed by Albourne and popularized by a leading allocator, the model is designed to ensure that over the long run the investor will receive a greater share of alpha. In this model, the 1% management fee is an advance against the 30% incentive allocation. At the end of the year managers will receive their 30%incentive allocation, less the 1% management fee, if they beat their benchmark hurdle. If that hurdle is not reached, they only collect the 1% management fee. Making the management fee an advance against the incentive fee creates an inherent hurdle on a gross performance basis of (1%/30%), or 3.33%. This implied hurdle is on top of the benchmark hurdle that is used to ensure the 30% incentive allocation is only paid for alpha generation.[3]

Considerations

Though these terms can be effective in promoting investor alignment, there are a plethora of considerations that need to be vetted. Implementing any of these terms, whether in an SMA, funds-of-one, or new share class, can trigger Most Favored Nations (MFN) clauses. As Cohen from Sidley Austin LLP points out, once a manager commits to such an arrangement, existing investors may need to be offered access to the same terms. The manager may either be legally required to extend these terms to existing investors because of an MFN or otherwise feel compelled to extend the terms to existing investors. The potentially broad reach of a poorly drafted or insufficiently understood MFN provision can have unexpected consequences. Underscoring the importance of drafting, Cohen notes that an MFN clause agreed to in a specific feeder fund "may apply not only to new share classes of that feeder fund, but to SMAs and funds-of -0ne that pursue similar investment objectives." Therefore, when agreeing to MFN clauses, managers should work closely with experienced counsel to draft the MFN as narrowly as possible to avoid it being applied beyond the specific circumstances that a manager would expect.

Tax implications also need to be considered. For example, a scenario that could trigger tax questions is when manager performance is benchmarked to an index, but the index is negative for the performance period being measured. In this situation there is a possibility that the manager will beat the benchmark but still have negative absolute performance. Because the incentive that is calculated is based on negative absolute performance, it may not be a profit allocation. A couple of different ways this can be approached include: classify the incentive as a guaranteed payment or delay taking the incentive until the manager generates profits. With a guaranteed payment classification, the manager may receive the revenue immediately but it could be taxed at the higher ordinary income tax rate. In the case of delaying the earning of the incentive, the revenue will be classified as an allocation of profits and potentially taxed at the lower long-term capital gain rates, but the manager will have to wait until a year with positive absolute performance to receive this allocation[4]; this approach is not without its risks. "This method creates an economic risk because the manager will forfeit the incentive if the fund shuts down before the manager is able to create positive absolute performance," notes Joseph Heavey, Partner, of KPMG.

Likewise, there are tax considerations when implementing a multi-year performance crystallization period. From the perspective of generally accepted accounting principles (GAAP), a performance allocation needs to be made to the general partner (GP) on an annual basis, and will appear as accrued incentive to the GP on the financial statements even though it has not been earned. Furthermore, the GP may receive an allocation of taxable income and have to pay taxes on that income on an annual basis based on this accrued amount, even though the GP hasn't earned a dollar within the structure of a multi-year performance crystallization period. If that performance accrual needs to be clawed back in a subsequent year of under-performance, it could be difficult for the GP to recover the amount of any taxes paid immediately because any losses allocated would generally be capital in nature, and capital losses can only be utilized to offset other capital gains and generally cannot be carried back. Any unutilized capital loss could be carried forward into future years, so the GP should not lose the benefit.[5]

In an era of challenging market conditions, investors are continuously pushing for a greater alignment of interests. Based on Wells Fargo's discussions with its managers and investors which highlight the increasing adoption of hurdles, this indicates that managers are buying into this notion. As discussed, multi-year crystallization, a tool designed to align liquidity of underlying investments and investor lock-up agreements with manager performance allocations, is another tool being discussed as a way to way to better align manager's and investor's interests . Today's managers are designing terms to better align their funds with their investors, while remaining vigilant regarding all possible tax implications of these structures. Investors are always willing to pay managers for alpha.

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Footnotes:

[1] AIMA paper "In Concert", p. 9

[2] Abbot Downing, a Wells Fargo owned company, is a wealth management company

[3] Albourne "Case Study: The Texas Teachers' "1 or 30 Fee Structure", December 2016

[4] Note: Each situation may differ and you should consult your tax expert.

[5] For illustrative purposes only. Each situation may differ and you should contact your tax expert.

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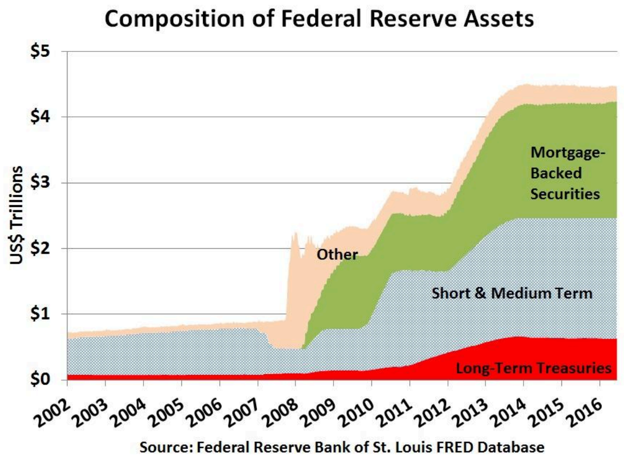
Federal Reserve may shrink its balance sheet gradually

By Blu Putnam, Chief Economist, CME Group

Blu Putnam

With U.S. unemployment at 4.3%, the Federal Reserve (Fed) remains on track for more rate increases in 2017 despite sluggish labor force expansion and wage growth barely staying ahead of inflation. And, the Fed now appears ready to start a long and drawn out process to reduce the size of its massive balance sheet. A bloated balance sheet is inconsistent with raising rates, but fears of possible market impacts have made the Fed very cautious. The Fed's total assets are now $4.5 trillion, including portfolio holdings of $2.5 trillion of U.S. Treasury securities and $1.8 trillion in mortgage-backed securities (MBS). The reinvestment activity implies the Fed is currently a buyer of about $1 of every $2 of new Treasury debt, and remains a huge player in the mortgage market. We anticipate that the Fed will stop reinvesting 100% of the principal received from maturing investments and switch to a staged policy of putting a cap on reinvestment activity. The cap would be adjusted periodically over the next few years until the balance sheet had been reduced to roughly 12%-15% of GDP from about 25% currently.

Because the Fed anchors the short end of the yield curve with its target federal funds rate policy and the interest it pays on excess reserves, the market impact of maturing Treasury securities not being reinvested will probably be very small, although it does imply less buying by the Fed at Treasury auctions. If the Fed also steps back from reinvesting in the MBS market, the impact might be a little larger, in the range of 0.25% to 0.50% in terms of possible mortgage rate increases along the maturity curve, especially centered on the 15-year and 30-year mortgages that the Fed buys.



I. Inconsistency of Rising Rates and a Massive Balance Sheet

The asset purchase programs (aka Quantitative Easing or QE) were instituted during a period of near zero short-term rates while the Fed was targeting the federal funds rate at between 0.00% and 0.25%. Before the financial panic of 2008 and the institution of QE, the Fed's balance sheet was about $800 billion, or 6% of GDP. Moreover, the mix of reserves held at the Fed was roughly 80% required reserves and 20% excess reserves. The massive asset purchases created a huge overhang of excess reserves – those deposits held by banks at the Fed and not needed to meet reserve requirements. Total bank reserves are now $2.2 trillion (end-May 2017), of which 5% is required reserves and 95% excess reserves.

To provide a return to banks, the Fed instituted a policy of paying interest on reserves, set at the top end of the target federal funds rate range. As the Fed raises its target federal funds rate range, it also raises the interest rate it pays on reserves, and this means the interest expense bill rises by $5.6 billion annually for each 25-basis-point rise in the target federal funds rate range, eating into the Fed's annual portfolio earnings. To be clear, raising rates means raising the costs of funding the Fed's massive balance sheet and creates an incentive for the Fed to reduce the size of its balance sheet, in part to protect its portfolio earnings that are running close to $100 billion annually over the last few years. [Note: After some accounting adjustments, the Fed contributes the bulk of its net portfolio earnings to the U.S. Treasury.]

There is another challenge created by the size of the Fed's massive balance sheet – namely, the process by which the Fed controls the federal funds rate so it stays within its target range. Prior to the financial crisis and QE, with excess reserves representing about 20% of total reserves, and amounting to only $2 billion, the Fed was able to use security repurchase agreements (i.e., repo and reverse repo operations) to add or drain reserves on a temporary basis to keep the federal funds rate at its desired level. While the Fed still does some repo and reverse repo operations, with over $2 trillion of excess reserves, the size of potential reverse repo operations needed to keep the federal funds rate in its target range is overwhelming. Consequently, the Fed now has a dependency on paying interest on excess reserves at the top of the target rate range as the primary method of enforcing its desired federal funds rate range. This dependency on paying interest on reserves is likely to remain even as the Fed moves to shrink its balance sheet. Over the long term, though, reductions in the level of excess reserves will give repo activities a little more influence, although not remotely as much in the old, pre-QE days.

II. Gradual Pullback from Reinvesting Principal

The reinvestment of principal makes the Fed a very big player in the market for U.S. Treasury securities and for 15-year and 30-year mortgage-backed securities. We estimate that over the next 12 months the Fed will see about $300 billion of its U.S. Treasury securities mature. This represents about half the U.S. budget deficit, or put another way, about $1 of every $2 of net new debt the U.S. Treasury issues. MBS are self-amortizing, so principal is received every month, and some mortgages are paid off as homes are sold or refinanced. Given the $1.8 trillion of MBS the Fed holds, as much as $400 billion in principal might be received over the next 12 months; which compares to the overall outstanding mortgage debt of U.S. households and nonprofit organizations of about $10 billion. Estimating the size of the new issue mortgage market is complex, and not just about rates. People pay off mortgages for a variety of reasons. While refinancing is usually about rates, sales can be driven by divorce, transferring to a different location for a new job, desire to downsize by retirees, and death. The Fed's appetite for 15-year and 30-year mortgages makes it the elephant in the room for the new issue market for home mortgages as well as the secondary market.

The Fed's plan to shrink its balance sheet is going to occur in very drawn out stages, mainly because the Fed does not want to disturb the Treasury or MBS markets. The plan is to put a cap on reinvestment activity that initially makes only a small dent in the reinvestment activity. Over time, as economic conditions allow, the Fed would adjust the cap and reduce reinvestment activity. Our estimate is that the Fed would like to reduce its portfolio holdings of Treasuries and MBS from $4.2 trillion in mid-2017, to around $2.8-$3.0 trillion by the end of 2021, with a target to get the balance sheet in line with about 12% of nominal GDP. This estimated long-term objective for the size of the Fed's balance sheet is about half of what it is now and about twice what it was before the financial crisis and when QE was instituted.

Federal Reserve Balance Sheet

Wednesday, May 31, 2017

		US Dollar Trillions	
Total Assets			**$4.460**
US Treasuries			**$2.465**
	Maturing within One Year (<1yr)	**$0.304**	
	Short & Medium-Term (1yr - 10yr)	**$1.528**	
	10-Year or Longer Maturities (>10yr	**$0.633**	
Mortgage-Backed Securities			**$1.771**
Other Items			**$0.224**

Source: Federal Reserve Bank of St. Louis FRED database.

III. Market Impact

The market impact of the Fed slowly starting to reduce in reinvestment activity will affect the Treasury market differently from the MBS market.

The short end of the U.S. Treasury yield curve is anchored by the Fed's target federal funds rate range. So, the maturing of Treasuries is unlikely to have any impact at all on short-term rates.

The impact on longer-term rates depends on how the Fed targets its asset allocation along the yield curve, especially for the 10-year plus maturities. Since the Fed's maturity extension program was announce in 2011 and implemented in 2012, the Fed has been holding about 22%-25% of its Treasury portfolio in longer-dated securities. If this asset allocation percentage is held constant, then there may be some incremental upward impact of a few basis points on 10-year or longer yields, as the portfolio shrinks. The Fed could decide to increase its asset allocation to longer-dated securities to offset this small impact. We believe changing the asset allocation is unlikely, however, since other influences on longer-term Treasury yields are expected to swamp the tiny impact of the slow pace of balance sheet shrinkage. We particularly expect the U.S. federal budget deficit to rise over the next several years as interest expense rises with rising rates. And, if the Republican Administration is able to enact a tax cut as we expect it will eventually, deficits are likely to rise even further. And, another big influence over the trend in Treasury yields will be inflation, which is currently well anchored at around 2%. A rise in inflation expectation, should it occur, would tend to push yields higher.

The impact on the MBS market of shrinking the balance sheet is much more complex. When the Fed does decide to taper its buying of 15-year and 30-year MBS, we estimate that mortgage rates might rise about 0.25% to 0.50% relative to the Treasury yield curve. We note, though, that the Fed may decide to set a different time table for shrinking mortgages versus Treasuries, and may be particularly sensitive to its impact on mortgage rates.

On net, we are expecting that as the balance sheet shrinkage process is implemented, an incremental upward increase in long-term mortgage rates of up to 25 basis points seems likely, while the impact on Treasuries will be very hard to find. In addition, Fed Watchers will now have to think about the pace of balance sheet shrinkage as the Fed will periodically adjust its cap on reinvestment activity. Changes in the reinvestment cap may not be one-for-one aligned with rate increases, and may cause some confusion along the LIBOR yield curve while markets and analysts come to terms with the pace of balance sheet shrinkage.

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Dreams of white picket fences: the investment potential of US single-family real estate

By Petteri Barman, Co-Head of Real Assets at Man GPM and a member of the Man Group Executive Committee

Petteri Barman

As returns across asset classes become ever more elusive, we believe it's increasingly important for investors to consider a wider range of opportunities. Real estate investment is an established part of many investors' alternative portfolios, but single-family residences (SFR) have received limited attention since the Global Financial Crisis (GFC). Whilst US commercial property has risen 157% since its crisis nadir – putting it 23% above its previous cycle peak – US SFR is still 7% below its 2006 highs[1]. Currently, the ratio of house prices against average income within the US market are in line with historical averages, in contrast to the UK (where they are 30% higher versus long-term averages), Canada (+46%), Australia (+50%) and Hong Kong (+50%).[2]

Moreover, the US has one of the biggest and most liquid residential property markets in the world, with more than 5.4 million transactions every year[3]. As a core tenet of 'the American dream', we believe that the persistent trends of home ownership may be a compelling investment story, and that single-family residences could offer interesting opportunities.

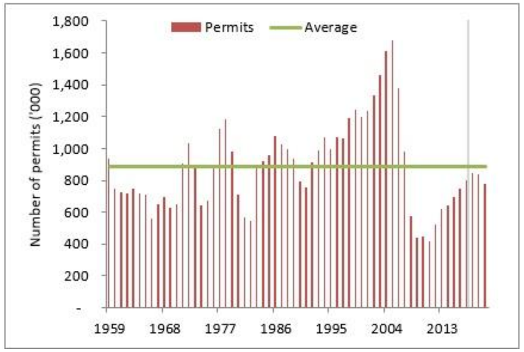
SFR supply and demand dynamics look attractive

America is a relatively youthful nation. Its 15-34 age bracket represents 27% of the total population. This is high compared to other developed markets such as France (where it makes up 24%), Germany (23%), Italy and Japan (both 21%). For obvious reasons, this segment drives a nation's rate of household formation. Even when accounting for the fact that headship rates are declining, this demographic structure is forecast to drive a rate of family unit formation 30% above the long term average[4]. The potential increase in demand for family homes that this could entail may potentially provide a long-term structural tailwind for SFR.

There are also shorter term catalysts for demand. Mortgage availability in the US fell 91% between June 2006 and February 2009, as credit underwriting horror stories filled the column inches. Although access has become less constrained since then, it remains over 80% below the previous peak[5]. Although we do not see a return to the 'Wild West' days of 2006 – where some lenders were evidently irresponsible – we do think that the next move may be skewed to the upside, especially if Trump makes good on his promises to reduce regulatory oversight. We believe the average US household is also in an increasingly better position to borrow: unemployment has fallen from the 10% peak it hit in December 2010 to little over 4.5% today, which has helped reduce household-debt-to-disposable-income ratios back to the levels of the early 2000s[6]. In short, the pockets of the prospective US homebuyer are potentially deepening.

If this potential demand comes to fruition it may meet restricted supply. This is shown in Figure 1, which shows the number of single-family building permits since 1959, and forecast up to 2020 (indicated by the grey line). As can be seen, activity collapsed after the GFC and does not appear set to return to its long run average this decade, in our view. So, whilst supply is running below its long run average, demand may be structurally higher due to demographics, with the possibility of short term catalysts. For us, this represents an attractive fundamental configuration.

Figure 1: US SFR permits[7]

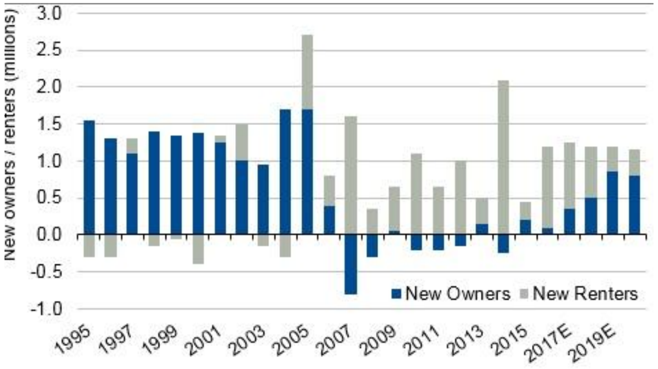


Institutional investors have previously opted for multi-family over single-family residences

Since the GFC, multi-family apartment (MF) accommodation has been far more popular with institutional investors than SFR, and the segment is currently 244% above the post-crisis low, and 53% above the previous cycle high. Doubtless, investors have felt that what they perceived as superior liquidity and homogeneity made the space more attractive than SFR. Looking forward from today, however, given recent price appreciation and significant new supply we do not see the same relative upside for MF.

Instead, we believe US SFR may experience a rental yield compression until it is more in line with other residential property markets globally. Why? Simply put, we believe that the US is not historically a renting nation, and a core strand of the American dream is the home-owning dream. We can see evidence of this in Figure 2, which shows that between 1995 and the GFC, owners were in the ascendency. As the crisis forced a more hand-to-mouth existence, this pattern was reversed, but we believe a return to a more historical norm may have begun. We estimate that 9% of MF units are occupied by families with children, whilst for SFR this figure rises to over 80%[8]. As the number of US households increase, and if their finances improve over the short term – as we have discussed – the outperformance of MF over SFR could potentially be reversed.

Figure 2: US new owners and renters[9]



Active managers can help provide efficient access to SFR

We believe one of the things that has kept institutional investors away from the SFR space is the perception of its operational difficulties: the challenges posed by idiosyncratic assets subject to significant geographic dispersion. Today, however, the industry norm is for gross/net yield ratios of 60%, with 94-96% occupancy rates, figures which are comparable to US MF[10]. As investors consider their allocations to alternatives, we believe that this may be an asset class worthy of attention – but the choice between ways to access these assets will be an important one for investors.

Footnotes

[1] Source: Morgan Stanley, RCA, Moody's.
[2] Source: The Economist, March 2017. http://www.economist.com/blogs/graphicde...
[3] Source: Census data, National Association of Realtors.
[4] Source: Morgan Stanley.
[5] Source: Mortgage Bankers Association.
[6] Source: Bloomberg, OECD.
[7] Source: John Burns Consulting, Census data.
[8] Source: Man GPM research.
[9] Source: Green Street Advisors, 06 June 2016.
[10] Source: Man GPM research.

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Should UK investment managers be despondent about Brexit?

By Peter Astleford, Partner and Co-Head of the Global Financial Services Group at Dechert

Peter Astleford

For someone who voted against, Brexit can be a scary thought. In our area, how will UK managers maintain and improve their fee flows from European investors post Brexit? Let's look at the facts. UK managers receive their fees from, broadly, managing UCITS and specialist funds and individual investor accounts. What are the Brexit risks to these revenue streams?

Fees from European retail funds ("UCITS") - UK managers generally target European investors through UCITS established in Dublin and Luxembourg (the "EEA Gateways"). These funds have an EEA marketing passport and are managed in the UK. This is set to continue after Brexit.

Fees from specialist or alternative investment funds ("AIFs") - Historically, many AIFs sold into the EEA were based in tax havens. For various commercial, tax and legal reasons, European based funds are now in the ascendancy. In general, these AIFs have an EEA marketing passport to sell to professional investors and are managed in the UK. This will also continue after Brexit.

I should add that while the Alternative Investment Fund Managers Directive ("AIFMD"), provides a mechanism for non-EEA funds to access the EEA, this is likely a red herring for the UK. No implementation of this mechanism is expected soon. Consequently, continuing to work through EEA Gateways is more realistic.

Fees from individual investor accounts – Lastly, UK managers access individual European investors directly via segregated accounts utilising a further European directive, the Markets in Financial Instruments Directive ("MiFID"). MiFID will be replaced by a second version (MiFID 2) prior to Brexit. Thereafter, non-EEA managers will, for the first time, be able to register with the new EU regulator (ESMA) to access European professional investors.

As a result, the three routes to access European investors should remain largely unchanged.

As ESMA could be slow to register UK managers, I recommend managers keep their European plans under review for future political developments. For example, a new manager or marketer could instead be established relatively easily elsewhere in the EEA assuring continued investor access. My only concern here is that a perception of excess competition amongst some EEA countries to attract UK businesses may lead to tighter EEA rules; A first pronouncement is already out there. Planning will also be required to cover UK registered sales staff that target Europe.

Other Incidental Issues – While fees should remain secure, some changes will be required. At present, UK managers can passport their operations into the EEA and vice versa. These reciprocal rights will disappear. As such, UK managers should seek European authorisation for any European branches and vice versa.

Equally, European based funds “operated” from the UK by a UK regulated manager will need to set up alternative arrangements. There are tried and tested routes to achieve this that will allow investment management fee income to continue to flow to the UK.

Conclusions - The next sixteen months (the likely negotiation period if any agreement is to be ratified in time) is probably insufficient to document a comprehensive agreement. More likely is a transitional arrangement allowing more time for definitive documentation while avoiding a “cliff edge”. A transition process will mean that business can continue (albeit while struggling to cope with the welter of existing regulatory changes not to mention the latest FCA "final" asset management report).

As outlined above, a hard Brexit should only require change “at the edges”. Remember, US managers already have significant access to the EEA market on a similar basis. Wholesale changes to those arrangements would be to the detriment of the EEA Gateways, European financial services businesses and investors. Meanwhile there are lots of opportunities for UK managers to find clients elsewhere.

In conclusion, the future looks good overall for a continuing UK and European industry that has seen the value of its open-ended regulated funds rise from euro 6.2 trillion in 2008 to over euro 14 trillion. Managers can get on with business. Those frozen in uncertainty will have only themselves to blame.

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Launching a hedge fund in Hong Kong

By Gaven Cheong, Partner at Simmons & Simmons LLP

Gaven Cheong

Introduction

So you want to launch your own hedge fund! That's great – you've taken the first important step in a challenging and complicated process that requires skilled consideration to deliver success. But where to from here? If there's one golden rule I would give to any start-up manager, it's this – speak to the right adviser! And by "adviser", I don't just mean a funds lawyer – a lot of new managers may choose to speak with fund administrators, prime brokers, Cayman Islands counsel or any of the "Big 4" accounting firms as a starting point before delving further into conversations with other service providers. The important thing is to identify an adviser who is well established and familiar with the jurisdiction in which you want to manage your fund, in terms of local norms, regulatory and tax requirements, and investor preferences.

Getting Started

What are some of the preliminary things you should be thinking about once you have decided that you want to launch a hedge fund?

Consider current employment situation

The existing employment documentations should be reviewed to consider whether there are any restrictions in setting up a new hedge fund business. In particular, the focus should be on complying with the existing employment obligations. For instance, when setting up the new fund, you must ensure that you continue to act in the best interests of the existing employer and be aware of any restriction in soliciting any colleague to leave the current company.

Choose and protect your brand identity

Before launching a new hedge funds business, it is extremely important to ensure that the names or trademarks you propose to use for your management business and funds do not overlap with existing names which are in use or registered trademarks. This is to avoid any unnecessary future rebranding (or at worst, litigation for trademark or copyright infringement) which can be costly and disruptive to your business. This exercise would involve performing checks on relevant registers in the country in which the fund entities will be domiciled, to ensure that the chosen fund names are available for use.

Decide on your management entity business structure

The most simple and common structure involves an offshore manager as it creates flexibility and potential tax benefits. However, some start-ups are established using more customised arrangements. Upon deciding on the structure, the management entitles will then need to be incorporated, followed by the preparation of relevant operating agreements, such as a shareholders' agreement for the offshore manager.

Decide on your fund structure

The majority of hedge funds we have launched for our clients are domiciled in the Cayman Islands, which is relatively straightforward with generally less onerous ongoing obligations. Especially for managers looking to raise capital in this region (ie Pan-Asia), the Cayman Islands is a popular jurisdictional choice given investor familiarity with its laws and its structures, and the well developed legal and operational infrastructure that has been built up in this region to support such structures.

While the Cayman Islands is most commonly used, we are also able to advise start-ups using other fund domiciles, including the British Virgin Islands.

In determining the fund structure, you should consider your prospective investors, tax positions, investor expectation, cost and operational factors. Common fund structures include standalone and parallel funds, segregated portfolio companies (SPCs) and the master-feeder structure, each with distinct advantages and shortcomings depending on the need of the individual hedge fund. We have, in addition to the above, extensive experience with alternative approaches to fund structures, including, for example, the use of additional types of feeder funds, dual master funds, and the use of 'hybrid' structures (for example, structures that can accommodate closed and open-ended sub-funds, or that can deal with pockets for illiquid assets).

Prepare SFC application

Certain activities require regulation by the Hong Kong Securities and Futures Commission (SFC) if carried out in Hong Kong. These activities include, for example, dealing and advising in securities. These activities are widely defined in the SFO (the Securities and Futures Ordinance) and will most likely affect the operation of a hedge fund business. Carrying out these activities without obtaining an SFC licence is a criminal offence. The process of applying for an SFC licence, which generally takes about 20 weeks, requires the proper completion and submission of certain prescribed forms.

Agree seeding arrangements

It is important for a start-up hedge fund manager to be able to raise sufficient capital for the new fund to invest either at launch or shortly afterwards in order to optimise the investment strategy, meet the costs of increased compliance and provide comfort to potential investors. Seed capital is an up-front investment from a third party investor, which allows a hedge fund manager to deal with the concerns above and to launch a fund with an amount of capital that demonstrates to other potential investors and the market more generally that it is a business of substance.

It is, therefore, important for a start-up hedge fund manager to secure a seed deal. In recent years, due to the reduced availability of seed capital, it has been very competitive for start-up hedge fund managers to secure a seed deal on favourable terms. Ideally, a good seed deal that works for all parties involves careful balancing of the need to provide the seed investor with a sufficient economic interest and control over the business in order to provide them with comfort as to how it is being run, against ensuring that the hedge fund manager does not cede too much control or interests in profit streams or capital for what will hopefully become a successful hedge fund management business in the future.

Launch

Now that you've attended to the preliminaries, the next step is to consider the key work streams to actually launching your fund, understanding the documents and agreements that are required to be put in place and choosing service providers for the fund.

Plan your launch

Given the complexity of starting a new fund business, we advise start-up hedge fund managers to plan the launch of the new fund carefully so that things will not fall through the cracks. The launch plan should include different work streams, including manager set-up, fund set-up, marketing requirements, trading documentation and seeding. We offer our start-up clients access to a centralised document repository where documents may be stored and shared, which will be particularly useful in organising the documentation of the fund.

Negotiate a lease for your business premises

In parallel with setting up the hedge fund management entities and preparing the documentation for the fund launch, the negotiation of a lease agreement will likely take place when looking for business premises. As the landlord and the tenant have different priorities, the negotiation exercise seeks to balance the conflicting interests of the two. Start-up hedge fund managers should be aware of the key terms of the lease agreement, including, for example, payment of rent, rent review and break clause.

Staff

Your team of analysts and portfolio managers will need to be employed by the regulated entity in Hong Kong. This means needing to have employment agreements in place, and work visas (if they are not already Hong Kong residents).

Decide on directors and service providers

The choice of directors and service providers are important as they play significant roles in the fund. The decision will depend on the specific needs of the fund and we have extensive experience in advising in this regard. Independent offshore directors have now become an indispensable part of any fund launch, especially one that is focused on raising genuine third party capital from institutional investors. Having an independent board is important not only from a corporate governance perspective, but also for tax reasons (to avoid having your offshore fund brought onshore!).

We can assist with not only referrals to professional independent third parties that offer directorship services, but can also assist with reviewing and negotiating your director appointment agreements.

Prepare fund offering documents and agreements

The key legal documents required for a new corporate hedge fund include:

- Prospectus or Private Placement Memorandum (PPM)
- Articles of Association
- Subscription/Redemption Forms
- Investment Management Agreement
- Management Agreement
- Distribution Agreement
- Administration Agreement
- Prime Brokerage Agreement
- ISDA Documents

These documents are important and require careful drafting as they govern the relationships of different parties to a fund.

Negotiate prime brokerage agreements

The documentation under which a prime broker is appointed is complex and often very favourable to the prime broker – precisely how one sided is a matter for negotiation.

While bearing in mind that product-specific additional documentation may also be required, the key terms documenting the fund's relationship with its prime broker will be found in a prime brokerage agreement.

Negotiate administration agreements

Administration agreements document the provision of fund administration services to the fund by an administrator. The administrator is one of the fund's most important service providers. Start-up hedge fund managers should ensure that the appropriate services are being provided to the fund and that the fund agrees to terms that are market standard and do not expose the fund to greater liability than is essential. The typical services provided by an administrator include transfer agency services, anti-money laundering services, services in relation to the calculation and publication of fund net asset value, tax services and the preparation of unaudited financial statements.

Launch Day

The big day has arrived! Once your fund documents have gone through their various rounds of comments and input from your various service providers, and you have finalised versions on hand, here are some of the other things you need to think about before you finally press the launch button:

- Have you secured all the licences / regulatory approvals to operate your fund?
- Are your PB accounts / bank accounts opened and operational?
- Have you registered your fund with CIMA (including your directors)?
- Do your fund documents have all the necessary disclosures to ensure that they comply with local private placement requirements?

- Have you got your board minutes and launch resolutions (both Cayman Islands and Hong Kong) in order?

Conclusion

We have looked briefly at the various things a start-up manager should consider when launching a new hedge fund.

Launching a new fund is indeed a complex process as the planning and preparation of documents require a lot of negotiation, knowledge and care. Key decision points have to be identified and triggered in a way that is optimal from both a cost and timing perspective.

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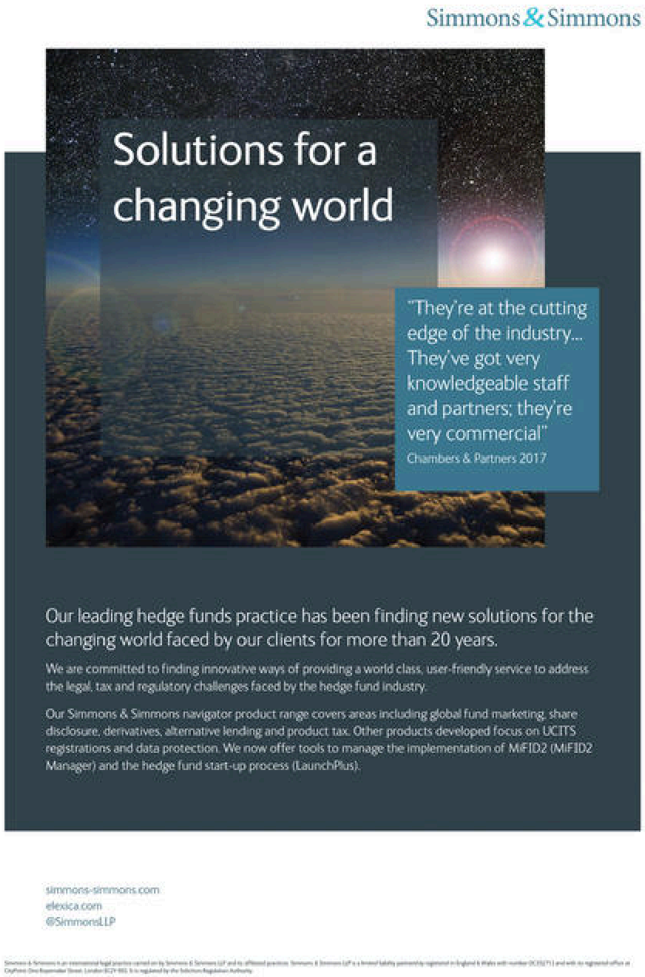

European Commission releases EMIR review proposals

By Chris Bates, Partner; Jeremy Walter, Partner and Will Winterton, Senior Associate at Clifford Chance

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On 4 May 2017 the European Commission published a legislative proposal to amend the European Market Infrastructure Regulation (EMIR), reflecting the outcome of its review of how EMIR has worked since its adoption in 2012. Rather than fundamental reform, the proposals set out a limited number of changes aiming to address specific issues identified in the review, although many of these will have significant impact on market participants. The Commission also issued a communication indicating that it would propose legislation in June 2017 to enhance the supervision of central counterparties (CCPs). Framed in the context of the UK's exit from the EU, this includes proposals for enhanced EU supervision and possible location requirements for third country CCPs that play a systemic role in EU markets

Timing

The Commission proposal will now make its way through the EU legislative process before being finalised and published in the Official Journal, likely during 2018. Most of the changes would take effect immediately the regulation enters into force (20 days after publication), without any transitional arrangements or conformance period.

However, some requirements would not take effect until six months later, such as the changes to the clearing threshold, the changes to insolvency protections and the new transparency obligations of CCPs. Other changes would take effect 18 months after the date of entry into force, including the new obligations on clearing firms, many of the changes to the regulation of trade repositories and the changes

to the technical standards on margin. The European Securities and Markets Authority (ESMA) would be required to draft technical standards to give effect to some of the changes by the date nine months after the date of entry into force.

Scope: expanding the definition of "financial counterparty"

The Commission proposal would amend the EMIR definition of "financial counterparty" (FC) to include:

- All alternative investment funds (AIFs) as defined in the Alternative Investment Fund Managers Directive: This would extend the scope of the definition to include AIFs registered under national law that are currently considered to be non-financial counterparties (NFCs). The change could also be interpreted to mean that all third country AIFs should be considered to be third country entities that would be FCs if established in the EU, regardless of whether they are managed by an AIF manager authorised or registered in the EU.
- Securitisation special purpose entities (SSPEs): Currently, many SSPEs are not subject to the clearing and margining obligations under EMIR because their own positions do not exceed the clearing threshold and they are not part of a group whose non-financial entities have positions exceeding the clearing threshold. The proposed change will potentially bring all SSPEs into the scope of clearing and margining obligations, with only some relief from clearing (but not margining) for SSPEs that are able to take advantage of the new clearing threshold for FCs discussed below. There is no proposal to extend the existing relief from margining for covered bond issuers to cover SSPEs, even though SSPEs would face many of the same practical issues in margining their hedging transactions, as they do not have access to liquid collateral without additional liquidity facilities.
- Central securities depositories. These changes would take effect as soon as the amending regulation enters into force and the Commission proposal does not include any conformance period or transitional provisions. Therefore, firms would need to carry out a reclassification exercise on their counterparties even before the legislation is officially published. It is also unclear how these changes affect existing contracts with entities that will become subject to margin and clearing obligations for the first time. In addition, entities that become subject to the clearing obligation for the first time may have to wait for six months before they can benefit from the new clearing threshold for FCs discussed below.

Changes affecting the clearing obligation

Per-class clearing threshold for NFCs

The Commission proposes to narrow the scope of the clearing obligation for NFCs, so that NFCs would only be subject to the clearing obligation for those classes of OTC derivatives for which they exceed the clearing threshold (revised Article 10(1)). However, it appears that an NFC that exceeds the clearing threshold for any class of OTC derivatives may still be treated as an 'NFC+' for all other purposes, including the margining of uncleared transactions. Therefore, this change may only provide limited relief for those corporates with large positions in commodities derivatives that wish to be able to continue to conduct normal treasury operations without margining costs. In addition, firms will need to build systems that can classify counterparties as NFC+ for some purposes and not for others.

New clearing threshold for smaller FCs

The Commission also proposes to introduce a clearing threshold for FCs with a low volume of OTC derivatives activity (revised Article 4(1)(a) and new Article 4a(1)). This threshold will be set at the same level as the clearing threshold for NFCs. However, where an FC's positions in OTC derivatives exceed the clearing threshold for one class of OTC derivative, the FC would become subject to the clearing obligation for all classes of OTC derivatives (as is currently the case for NFCs). In addition, unlike the treatment of NFCs, an FC's hedging transactions would count towards the clearing threshold and FCs would continue to be subject to margin and other risk mitigation obligations whether or not they exceed the threshold.

Clearing threshold calculation

Instead of carrying out clearing threshold calculations on a rolling basis, counterparties would instead need to calculate, annually, their aggregate month-end average positions for March, April and May (new Article 4a(1) for FCs and revised Article 10(1) for NFCs). This is broadly in line with the current process for calculating relevant thresholds for the margin obligations. However, the calculations are not identical and counterparties may need to build additional processes for this revised clearing threshold calculation (e.g., to calculate positions by asset class).

Removing barriers to clearing

The Commission proposes amendments to address concerns that counterparties with a limited volume of OTC derivatives activity may face difficulties in accessing central clearing. Clearing members which provide clearing services (and their clients which provide indirect clearing services) would be required to provide clearing services on "fair, reasonable and non-discriminatory commercial terms" (new Article 4(3a)). This goes further than the current requirement for clearing members to facilitate indirect clearing on reasonable commercial terms. The Commission would be empowered to adopt a delegated act to specify when commercial terms are to be considered fair, reasonable and non-discriminatory.

The proposal also provides that the assets and positions recorded in the separate accounts maintained by a CCP for its clearing members or a clearing member for its clients are not to be treated as part of the insolvency estate of the CCP or clearing member (new Article 39(11)). The Commission hopes that this will improve access to clearing by providing greater certainty that assets are protected in a default scenario, at least where assets are held with a CCP or clearing member. However, CCPs and market participants will need to analyse how this new rule interacts with national insolvency laws. In addition, the proposal does not specifically address the insolvency treatment of the 'leapfrog' payments made by CCPs to clients of insolvent clearing members or the positions held by clients of clearing members providing indirect clearing services.

In addition, the proposal aims to improve the transparency and predictability of CCPs' initial margin requirements. It would impose new duties on CCPs to provide their clearing members with a simulation tool allowing them to determine the amounts of initial margin that would be required by a new transaction and with details of its initial margin model (new Article 38(6) and (7)). The Commission would need to take these new requirements into account when evaluating the equivalence of third country regimes regulating CCPs recognised or seeking recognition under EMIR.

Extending the exemption for pension scheme arrangements

In the absence of a technical solution to allow pension scheme arrangements to participate in central clearing, the Commission proposes to extend the current exemption of pension scheme arrangements from the clearing obligation (revised Articles 85 and 89(1)). The extended exemption would apply until three years after entry into force of the amending regulation. The Commission would have the power to extend this exemption by a further two years. The Commission hopes that the extended exemption will allow CCPs and pension scheme arrangements to work together to bring pension scheme arrangements within the clearing obligation without negatively impacting pension returns.

However, the amending regulation might not take effect until after the current exemption expires on 18 August 2018. One potential solution to this timing issue might be to amend the RTS imposing the clearing obligation to create an extended phase-in period for pension scheme arrangements to bridge the gap until the amending regulation enters into force.

Removing the frontloading requirement

The proposal would repeal the existing 'frontloading' requirement under EMIR (current Article 4(1)(b)(ii)). Currently, contracts could become subject to the clearing obligation from the date when the CCP is authorised or recognised to clear a class of contracts even though ESMA has yet to consider whether to propose RTS mandating clearing of that class (although the RTS adopted to date have included provisions obviating this requirement).

Suspension of the clearing obligation

The proposal would also give the Commission powers to suspend the clearing obligation in specific circumstances, including where clearing may have an adverse effect on financial stability (new Article 6b). Suspension would be effective for a period of up to twelve months.

Changes affecting reporting of derivatives

Changes to reporting requirements

The Commission has proposed various changes to the EMIR reporting requirements. Some of these changes are likely to be helpful to market participants:

- CCPs would be responsible for reporting details of exchange-traded (non-OTC) derivatives transactions on behalf of both counterparties and for ensuring accuracy of the details reported (new Article 9(1a)), although this would not relieve counterparties from their obligation to report back-to-back transactions or transactions cleared on non-EU CCPs;
- firms would no longer need to report intragroup OTC derivatives transactions where one of the counterparties is an NFC (revised Article 9(1)), although the exemption would only apply where the transactions meet the conditions for an intragroup transaction under EMIR, including the condition requiring an equivalence determination for transactions with third country entities;
- firms would no longer have to report ('backload') transactions entered into before 12 February 2014 that were not still outstanding at that date (revised Article 9(1)), although backloading will continue for other contracts entered into before 12 February 2014.

However, FCs would become responsible for reporting details of OTC derivatives transactions with NFCs not subject to the clearing obligation (NFC-s) on behalf of both counterparties (new Article 9(1a)).

As with the similar requirements under the Securities Financing Transactions Regulation (SFTR), this would impose a direct regulatory obligation on the FC to report transactions on behalf of its counterparty, even if the FC has been unable to obtain all the required information from the counterparty.

Therefore, FCs will need to put in place new or revised agreements with all their NFC-counterparties, including any that currently report their own trades, to address this new regulatory obligation and accompanying risk. Managers of UCITS and AIFs would also become responsible for reporting trades on behalf of their funds.

These changes appear to apply when the amending regulation enters into force, with no transitional provisions. Therefore, counterparties might need to put in place the necessary agreements with clients and other systems changes before the legislation is officially published.

The proposal imposes new specific obligations on ESMA to draft implementing technical standards covering data standards, including entity, instrument and trade identifiers, and the methods and arrangements for reporting (revised Article 9(6)).

Registration and supervision of trade repositories

The proposal would impose new duties on

trade repositories to ensure the effective reconciliation of data between trade repositories, to ensure the completeness and accuracy of reported data, to facilitate switching by transferring data to other trade repositories when requested by their clients and to give counterparties access to data reported on their behalf by a CCP or FC (new Articles 78(9) and Article 81(3a)).

The Commission has proposed increasing the upper limit of the basic amount of fines ESMA can impose on trade repositories, with the aim of increasing the deterrent effect of the sanctions system (revised Article 65(2)).

The proposal also introduces a simplified application process for the extension of registration for trade repositories that are already registered under SFTR (revised Article 56).

Access to trade repository data

The proposal would give regulators in non-EU countries with their own trade repositories direct access to data held by EU trade repositories where certain conditions are fulfilled (new Article 76a).

One of these conditions is that under the legal framework of the third country, trade repositories are subject to a legally binding and enforceable obligation to provide EU regulators with direct and immediate access to data.

This addresses the Financial Stability Board request for authorities to remove barriers to regulatory access to information. Currently, authorities in these third countries only have rights to direct access to data held by EU trade repositories where there is an international agreement in place between the EU and the relevant third country, although this would remain a condition for recognising a third country trade repository for the purposes of meeting the EU reporting requirements.

Changes affecting the margin rules

The Commission proposal would expand the scope of the RTS on risk management procedures for uncleared OTC derivatives to include supervisory procedures relating to the level and type of collateral and segregation arrangements, to ensure initial and ongoing validation of counterparties' risk-management procedures (revised Article 11(15)(a)).

This would allow the RTS to include provisions requiring the prior regulatory approval of risk management procedures, including initial margin models.

Supervision of CCPs

The Commission's accompanying communication on responding to challenges for critical financial market infrastructures and further developing the Capital Markets Union (CMU) indicated that the Commission would present a further legislative proposal in June 2017 to address the supervision of CCPs that are of systemic relevance in the EU. This proposal was published on 13 June 2017.

The Commission's May 2017 communication stated that there is a need to enhance EU-level supervision by ESMA of systemically important EU CCPs and the role of the central bank of issue of the currencies used by EU CCPs.

It also stated that there is a need to subject non-EU CCPs to safeguards under the EU legal framework where they play a systemic role in EU financial markets and directly impact the responsibilities of EU and Member State authorities. The Commission acknowledged the need to avoid fragmentation of the global system but notes that, following the UK exit from the EU, a substantial volume of euro-denominated transactions would not be cleared in the EU and would no longer be subject to EU regulation and supervision.

In summary, the Commission's subsequent proposal published on 13 June 2017 grants increased supervisory powers and responsibilities to a new 'CCP Executive Session' within ESMA and provides for closer cooperation between the supervisory authorities and central banks responsible for EU currencies.

For non-EU CCPs, the proposal introduces a two tier system, whereby systemically important CCPs (so-called Tier 2 CCPs) will be subject to stricter recognition requirements, including direct supervision by EMSA.

It also gives the Commission power to decide that a Tier 2 CCP is so systemically important that it must be established in the EU and authorised under Article 14 EMIR in order to provide services in the EU. However, this location requirement is presented as a "last resort", if enhanced supervision is insufficient to mitigate potential financial stability risks.

Conclusion

The legislative proposal does not respond to all the requests made by market participants to simplify and enhance the EMIR framework, for example, the request for single-sided reporting or to allow market participants to meet their clearing obligation by indirect clearing on recognised third country CCPs. However, more changes may be introduced during the legislative process. In addition, the proposal would require the Commission to produce a new report reviewing the effect of EMIR three years after the amending regulation comes into force.

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Central Bank of Ireland publishes final feedback statement on Fund Management Company Effectiveness Requirements ("CP86")

By Ken Owens, Partner, PwC

Ken Owens

On December 19th 2016, the Central Bank of Ireland (the "CBI") published the feedback statement to CP 86 – third consultation. Marking the end of a consultation process which started in September 2014, the CBI also published the finalised guidance for fund management companies on managerial functions, operational issues and procedural matters and also published details of new rules for fund management companies on an effective supervision requirement and on the retrievability of records.

This feedback statement has been long awaited, with the main area of contention being the location rule for directors and designated persons, which the CBI had proposed in their June 2016 third consultation. In this regard the feedback statement brings some welcome relief which will make the location rule much more workable for all concerned.

Location Rule

The finalised rule on effective supervision states that a management company shall conduct a preponderance of its management in the EEA. The CBI then differentiates between management companies based on PRISM rating.

Management companies with a Low PRISM rating which will require at least:

(i) 2 directors resident in the Ireland,

(ii) half of its directors resident in the EEA, and

(iii) half of its managerial functions performed by at least 2 designated persons resident in the EEA.

Whereas management companies with a PRISM impact rating of Medium Low or above shall have at least:

(i) 3 directors resident in the Ireland or, at least, 2 directors resident in Ireland and one designated person resident in Ireland,

(ii) half of its directors resident in the EEA, and

(iii) half of its managerial functions performed by at least 2 designated persons resident in the EEA.

The feedback statement goes into some detail to explain how the CBI has reached this position and is reflective of the level of feedback and engagement which the CBI received from the industry in the consultation period. The feedback statement also explains the CBI's focus on the EEA from a location perspective which is something which was not evident from the third consultation when it was issued.

One important lesson for all of us from this lengthy process is that strong engagement in the consultation processes with the CBI can, and in this case, has made a difference to the outcome of the process. In the feedback statement the CBI states that the outcome was swayed, to a certain extent, by arguments concerning expertise and the need to facilitate organisational models which draw appropriately on the expertise of the promoter/investment manager.

Transition Period

The other notable point from the feedback statement is that the CBI has provided a transition period of 18 months for existing fund management companies giving them until 1 July 2018 to be in compliance. These new rules relate to the streamlining of managerial functions to 6 managerial functions, the Organisational Effectiveness role, the retrievability of records rule and the effective supervision requirement.

For organisations looking to establish new management companies the CBI has said that it will only approve applications for authorisation submitted on or after 1 July 2017 where the fund management company will be organised in a way which complies with the new rules introduced by CP 86.

The new rules will be included in the amended Central Bank UCITS Regulations and in the forthcoming Central Bank AIF Regulations.

Other Points to Note

Most of the proposals outlined in the third consultation have been retained as follows:

- The CBI has concluded that it is appropriate that where a director is appointed as a Designated Person, he/she should receive two separate letters of appointment – one for the role of director and one for the role of Designated Person.
- The CBI will look to receive a copy of each Designated Person's letter of appointment to be submitted as part of the fund management company authorisation process.
- The CBI has deleted the proposal which stated that Designated Persons should be employed by the same group of companies where such persons were not going to be working in the same location.
- The draft managerial functions guidance does not prohibit the appointment of an individual as both director and Designated Person.
- The CBI does not consider the appointment of an individual to the role of director and as Designated Person will automatically give rise to a conflict of interest.
- The CBI considers that appointees must be sufficiently senior in their roles to meet these expectations.
- Management companies will be required to have their own documented policies and procedures in each instance with this is required by regulation and will not be able to rely on delegate's policies and procedures to satisfy this regulatory obligation.
- The CBI is of the view that exception-only

reporting does not demonstrate a sufficient level of oversight and engagement by a Designated Person.

- Regular meetings between Designated Persons and delegates should be held to allow Designated Persons properly perform their role.
- Notwithstanding the establishment of any committees, the CBI obliges a Designated Person to be responsible for the performance of his/her managerial function.
- Regarding alternate Designated Persons, Designated Person is classified as a Pre-Approved Control Function in accordance with the CBI's Fitness and Probity regime.
- There is no 'alternate Designated Person' role under that regime. Stakeholders should refer to the Fitness & Probity statutory requirements, standards and regulatory guidance in relation to the appointment of a 'temporary officer'.
- A management company shall keep all of its records in a way that makes them immediately retrievable in or from Ireland.
- The CBI has clarified its expectations as regards its minimum requirements for record retention, archiving and retrievability of the relevant documents of a fund management company.
- The CBI has reiterated that it places significant importance on proper and adequate recordkeeping and that procedures and processes should be in place which seek to avoid manipulation in so far as is possible.
- The CBI considers that a fund management company, notwithstanding the delegation of activities or the manner in which documentation is stored, must be able to produce records on request from the CBI.
- The CBI expects that fund management companies will subject their record retention policies to an annual audit. This reflects the level of importance which the CBI places on a fund management company's recordkeeping.
- The CBI has clarified that such an audit may be undertaken by an external party or internally, for example by the internal audit function of the fund management company.
- Annexes I and II of the managerial functions guidance allocate internal audit tasks to the Organisational Effectiveness role. However the CBI goes on to note that the precise allocation of regulatory obligations amongst managerial functions is a matter for each
- fund management company and it may be that, for any particular company, the particular regulatory obligations should be attributed differently.
- The CBI is proceeding with the requirement that fund management companies should maintain a dedicated and monitored email address.

A post Brexit roadmap for management company substance

Coming just 3 weeks after the CBI issued its third consultation on fund management company effectiveness, the UK's decision to leave the EU featured in many of the responses received by the CBI. A number of respondents raised the issue of how the proposed exit of the UK from the EU would affect the CBI’s approach.

As regards the CBI's perspective on the UK's position post Brexit, the CBI gave a nuanced response saying that in formulating their feedback statement and the final rules "we have been cognisant of this aspect". The feedback statement goes on to say that, as subsequent arrangements for the UK post Brexit remain the subject of major negotiations, it is was not possible for the CBI to predict the outcome of those negotiations. Interestingly the CBI then states that they have set out in some detail the factors which are relevant to their assessment of the extent to which an authorised entity can be considered to be subject to effective supervision (feedback statement page 12 paragraph c) and that these factors should allow interested parties to assess the likely impact, if any, of different forms of Brexit on the application of the CBI's rules.

Now that the rules and guidance for management companies have been finalised, managers and promoters have the ability to confidently plan for the implications of Brexit with a clear roadmap from the CBI of their substance requirements for Irish UCITS management companies and AIFMs.

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"A riddle, wrapped in a mystery, inside an enigma"

By Michael Beart, Director and Marie Barber, Managing Director at Duff & Phelps

Michael Beart

Marie Barber

For those acquainted with the topic, Winston Churchill's now famous words taken from his 1939 BBC broadcast provides a more than fitting description of the Disguised Investment Management Fee (DIMF) legislation. More than two years after coming into force, many taxpayers (and also a great number of advisors) remain confused as to the full implications and intentions of the DIMF legislation despite exposing investment managers to potentially crippling personal tax liabilities.

The complexity of the DIMF legislation, combined with its staggered introduction and key amendments, has left many managers unsure about how and when it applies. Furthermore, the potential to cut through typical non-domicile protections, corporate structures and transfer pricing positions is perhaps one of the most fundamental and misunderstood areas to the legislation. Put it simple terms, it can operate such that individuals are taxed as if they personally receive their share of management and performance fees directly in the UK regardless of the commercial position and intervening corporate realities. With new guidance anticipated in 2017 we would expect HMRC to start to use the new legislation to its full potential and raise additional tax revenues from the asset management industry.

Legislative background

The DIMF legislation is a piece of targeted tax avoidance legislation focused on the asset management sector and first came into force in relation to fees arising from 6 April 2015. The legislation is part of a wider overhaul of the taxation of investment managers in the UK and extends equally to the hedge fund industry.

The legislation imposes an income tax charge on fees that are deemed to arise to an individual performing investment management services in a tax year from an investment scheme and/or managed account. The deeming provisions operate such that a fee arises to an individual if they receive it directly or if certain 'enjoyment conditions' are met. The introduction of the enjoyment conditions is one of the key amendments that widened the scope of the legislation. Should the enjoyment conditions be met, the legislation provides for some exemptions, however the exemptions are themselves barred in certain situations, for example where the fees are used to reinvest back into the fund. As such it is paramount to step through the legislation from start to finish. However, on undertaking the analysis many taxpayers may find themselves uncertain as to how to interpret the legislation and are left guessing as to the intention behind certain provisions. The net result in some cases will have a considerable impact on commercially driven business models.

Despite DIMF issues stemming from the corporate structure adopted, the responsibility to disclose and pay any tax liability rests with the individuals providing investment management services, not the business. The risk is that addressing the legislation could fall between the gaps in the relationships between corporate and personal tax advisors. Quite understandably many personal advisors who should be including DIMF disclosures in the individual's tax returns will not have the full understanding of the corporate structure required in order to undertake the analysis.

Additionally, the existence of a potential personal liability, requires individuals to exercise their judgement as to whether the legislation applies when completing their own personal tax returns. This creates an extra complication that different individuals working alongside one another in the business could file differently, i.e. one could make a disclosure and the other may not. There is no mechanism to ensure consistency across all such individuals with respect to what is disclosed to HMRC.

HMRC Guidance

HMRC first published guidance on the DIMF legislation in 2015, however despite numerous amendments to the legislation it has yet to be officially updated, even though HMRC acknowledge it does not cover material points amended (e.g. the enjoyment conditions). Draft guidance covering the amendments was informally published for comment on 21 October 2016 but cannot be relied upon and a final revised version of the guidance is expected to be released towards the end of Summer 2017.

What it is possible to infer from the guidance is that HMRC consider that a wide range of factors are relevant to determining when a fee arises to an individual, such as equity ownership, voting rights, the use offshore structures and trusts. The original guidance suggested some 'safe harbours' for genuine corporate management vehicles with sufficient substance but disappointingly these have not been retained as the legislation has been amended. Instead they provide more indication as to their views on topics such as when it is reasonable to assume an amount would have arisen to an individual. Rather ominously it states that HMRC will pay particular attention to structures which rely on claiming that investment management activities are partially performed by a vehicle outside the UK in a low (or no) tax jurisdiction and closely examine the substance of the purported offshore activity, in other words, the transfer pricing of the transactions in place.

Interaction with other legislation

It is important to note that the DIMF legislation operates independently to a number of other key pieces of tax legislation applicable to the industry. Managers with international structures may be required to consider both transfer pricing and diverted profits tax (DPT). However, both transfer pricing and DPT have small and medium sized enterprise ('SME') exemptions, but DIMF does not have an equivalent protection. Nor for that matter does the investment management exemption ('IME).

Equally the non-domicile regime that many in the industry benefit from provides no protection from the DIMF legislation as it treats all amounts arising to individuals as part of their UK trade. Furthermore, it is not clear how this interacts with the new tax rules for non UK domiciled individuals. DIMF also has the potential to apply to non-resident individuals if they are providing services in the UK.

Similarly, it is unlikely that protection from a DIMF charge will be available under the various double tax treaties that the UK is party too. Where part of the structure is based in other EU countries, an argument may be considered under the EU treaty freedoms and in particular, the free movement of capital, as the DIMF legislation may impede non-resident investment management companies attracting capital from the UK and vice versa. However, making such an argument could be a long and costly affair and is more likely to fail than succeed.

Action to be taken

Given the wide and complex implications of the DIMF legislation investment managers need to review their arrangements and assess whether the legislation applies. Seeking the support of a specialist tax QC in reaching a conclusion on the legislation is an increasingly popular theme and provides additional support for the conclusions made. However, taxpayers shouldn't necessarily think the conclusions reached will be positive.

As best practice, it is important for managers to review the position annually, at the end of each accounting period, and understand how to practically manage the tax risk for their business and individuals involved in performing investment management functions. A plan of action should be developed at both the corporate and individual level, as consultation may be vital for achieving a consensus. Where the legislation has a material impact and is inadequately covered in the guidance, taxpayers may consider approaching HMRC to confirm the position. In a world of increased scrutiny and transparency, it is important for managers to take prompt action, review their affairs and consider the implications of the updated guidance once it is released later this summer.

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SM&CR – reading the regulatory mind-set

By Gavin Stewart,
Head of Strategy Execution of Financial Services Group, Grant Thornton

Gavin Stewart

Driving cultural change will require more collaboration between firms and the regulators due to the extension of the Senior Managers & Certification Regime (SM&CR)

We are approaching a decade since the markets froze in August 2007 and Northern Rock collapsed, signalling the start of the financial crisis. SM&CR, due to come into force in 2018, originates in these events.

Understanding this context, in particular its effect on the mind-set of regulators and of Parliament, will be critical to making a success of the new regime. The Parliamentary Commission on Banking Standards (PCBS) report was not subtitled “changing banking for good” by accident. Its core purpose was to change firms’ culture, and we should therefore view SM&CR as a means to that end.

In the first wave covering banks and insurers, both regulators and firms tended to focus on implementing the detail of the regime as an end in itself. This ensured accountability maps were clear and the rollout was as smooth as possible. However, this approach focussed too much on the implementation process, partially obscuring the outcome. The second wave, covering all remaining regulated firms – more than 50,000 - including hedge fund managers, alternative credit managers and funds of funds, is now looming, and regulators’ attention is starting to shift. Two forces are driving this – a year’s practical experience of the regime, and the much larger and more diverse nature of the second wave of firms.

Practical experience will drive behaviour

Unsurprisingly, operating the new regime on the ground is posing challenges to both firms and regulators. For firms, accountability maps, by their nature, are often too neat to represent accurately what happens in practice, particularly when there is a problem. For regulators, there will be some tension between recognising that each firm is different and the desire to compare different approaches.

The sheer spread of firms also makes the second wave of SM&CR a challenge. The new regime will encompass everything from large asset managers to dentists and therefore will demand a different approach, with far more proportionality built in.

The first time the regulator sets a precedent by taking action against a senior manager, a new tone will be set for what happens thereafter. Firms are already wary of this and regulators will likely feel under pressure to show the regime works as intended by holding individuals to account successfully. In addition, this will play out against the background of some senior managers retiring or moving role, and new ones being appointed and approved.

This too will influence the future behaviour of both firms and regulators.

The framework for regulatory relationships

One school of thought is that SM&CR will have little effect on regulatory relationships and that, if it does, this will be confined to banking, its original focus. However, this ignores the fact that the regime will produce accountability maps that purport to cover the entire organisation, a significant departure from the Approved Persons regime it replaces. It also underestimates SM&CR's symbolic importance, with the Prudential Regulation Authority, for example, already declaring its success as a key component of the revolution in regulation that has taken place since the crisis.

Given all this, the new regime will probably provide the de facto framework for the regulators' relationships with firms. In particular, their perception of SM&CR is likely to shape how they make two of their key assessments of the inherent risk a firm poses, namely the firm's openness with the regulator and the quality of its systems and controls.

If both these assessments are consistently high, regulators are likely to view firms much more positively, through thick and thin. Historically, many firms have struggled to understand what openness means in practice, and so have relied predominantly on their systems and controls. However, these can never be fool proof, which leaves firms exposed when a problem occurs. SM&CR creates a set of expectations around openness, perhaps for the first time, and so could lead to a better mutual understanding about what it means in practice.

Implementing for the long term

Changes in culture and in firms' openness with its regulators will not happen overnight, but firms should still carefully consider them through their implementation of SM&CR. This is because, even if only sub-consciously, regulators will begin to look at firms through the lens of the new regime even as it is being put in place.

Business change, communications and the future measurement elements of these programmes are all therefore likely be more important than ever. Testing the new arrangements against potential adverse scenarios should also be a core part of the approach and their design should contain enough flexibility to allow firms to reflect how the regime works under the pressure of future events.

Risks and opportunities for firms

Firms can find the regulators, particularly the Financial Conduct Authority due to its wide remit and complex structure, quite siloed, and as a result can receive mixed messages. This is sometimes compounded by the fact that firms usually deal with regulators on a transactional basis, often reflecting their own silos. SM&CR will challenge this status quo on both sides by applying a single lens across firms' management and governance.

This will put a premium on firms' ability to build a consistent overall relationship that encompasses all their regulatory touchpoints. If firms continue with a transactional approach, they might therefore be running increased regulatory risk, particularly if they encounter a problem and SM&CR does not operate as intended.

However, building such a relationship will be a major challenge for most firms. Even where they have a single focus point for regulatory affairs, these departments can easily become overly defensive to regulators' scrutiny. This can mean they try to present a shield to protect senior management from regulatory overload, while they often also find it hard to maintain their knowledge of the firm's business and the risks it is running. These challenges are likely to be especially acute for small/medium sized firms providing alternative finance, who do not have a named FCA supervisor and so will have little continuity of experience with the regulator.

Firms should therefore consider carefully what sort of overall regulatory relationships they want to have in the longer term. For many firms, this is likely to involve a greater degree of internal coordination and forward thinking.

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Progression in Cayman

By Deanna Derrick, Business Unit Director, Hedge Funds, at Intertrust Cayman

Deanna Derrick

"In the Cayman Islands, we have seen an increasing number of separate classes being created in funds to specifically accommodate the increasing demand for SRI strategies."

Sustainable Responsible and Impact Investing (SRI) has been gaining increased focus globally as investors give greater consideration to environmental, social and governance (ESG) factors despite ESG factors being widely considered non-financial in nature. Independent directors offer investors and managers increased confidence regarding adherence to the ESG programmes by virtue of the directors' impartial oversight. Independent directors need to grasp the strategies and activities of a SRI focused fund to help provide the appropriate checks and balances needed to ensure the fund's ESG monitoring programmes are effective.

When and how did it all begin?

From the 1960s, mostly through political unrest, SRI gained in popularity. Arguably, significant advances and the growth of SRI started upon the formation of the United Nations-backed Principles for Responsible Investment (PRI) in early 2006. In the first year, PRI had 100 signatories with $6.5trn of AuM. PRI has a voluntary and aspirational set of six investment principles. One principle is the incorporation of ESG factors into investment practices, and other principles address good governance, integrity, accountability and transparency. PRI signatories account for approximately half of global institutional assets ($62trn) with over 1,700 signatories including both investors and asset managers.

The Sustainable Accounting Standards Board (SASB) noted that over half of the almost 300 policy instruments established in the 50 largest economies to encourage investors to consider long-term value drivers, including ESG, were established between 2013 and 2016 despite limited sustainable investing concepts (primarily negative/exclusionary) being around since the late 1800s. SASB was established in 2010 to address the need for ESG related data that is relevant, reliable and comparable. The increased number of policy instruments aligns with the growth of PRI signatories and investor asset allocation to SRI.

What market share is currently attributed to SRI investments?

As detailed in the Global Sustainable Investment Review 2016 (GSIR), released by the Global Sustainable Investment Alliance (GSIA) at the end of March 2017, global sustainable investments accounted for approximately $22.9trn of AuM at the start of 2016. Globally sustainable investments grew 25.2% over 2014. SRI in the United States alone represented $8.72trn of the AuM, representing an increase of 33% over 2014. Unsurprisingly, 53% of the AuM is attributable to Europe but encouragingly the relative US contribution has increased to 38% of the global sustainable investments. As expected, the report indicated that asset allocation remained weighted towards the institutional investors; however, the relative growth of retail investors in Canada, Europe and the United States had increased to 26% with over 33% of the SRI AuM invested by retail investors in the US.

What are the definitions and how are they measured?

GSIA used an inclusive definition for sustainable investing which encompassed screening (negative /exclusionary, positive/best-in class or norms-based), ESG factor integration, sustainability themed investing, impact/ community based investing and corporate engagement/shareholder action.

Negative/exclusionary screening represented the largest sustainable investing strategy globally ($15trn in assets) as well as the largest sustainable-themed strategy in Europe. ESG factor integration ($10.4 trn) and corporate engagement/shareholder action ($8.4trn) were the second and third largest SRI activities, with the US being the biggest contributor towards ESG factor integration.

GSIA acknowledges that increased disclosure by PRI signatories is enhancing ESG transparency. Given this, the GSIA report notes that several factors including market penetration of SRI products, development of new products that incorporate ESG criteria and the incorporation of ESG criteria by large asset managers across wider portions of holdings are driving the increased growth in ESG.

What are you seeing from a Cayman funds perspective?

In the Cayman Islands, we have seen an increasing number of separate classes being created in funds to specifically accommodate the increasing demand for SRI strategies. Unique classes are created in ongoing funds that include SRI strategies and activities. In addition, a number of separate fund entities that specifically integrate SRI themes and strategies, including screening and the integration of ESG factors, have been launched as either funds of one (similar to a managed account) or as collective investment funds.

To a lesser extent, we still see side letter provisions that integrate SRI themes; however, notably the side letters more frequently address negative/exclusionary activities rather than a comprehensive SRI programme. ESG factors have become increasing topical with credit and emerging markets managers.

What role do independent directors play in supporting SRI strategies?

The oversight by the board of Cayman funds encompassing SRI needs to include an understanding of the strategies and activities being employed in order to develop an effective monitoring programme. Given the variety of activities and factors that SRI can incorporate, the board will want to consider points relevant to the strategies and activities to effectively monitor the specific aspects of the SRI programme.

For example, if a fund intends to deploy positive best in class screening to accomplish the SRI strategy, it is important that the fund does not drift to a negative/exclusionary methodology; therefore, the board meetings of the fund directors should include monitoring points that confirm that best in class screening has been used as the fund's SRI programme is executed. The fund's board of directors needs to understand the programme so that they can appropriately monitor adherence and application. Knowledgeable independent directors can provide the objective oversight as an unbiased check and balance for investors.

We also see independent directors being appointed to advisory committees. Advisory committees are formed by the boards of the funds and can assist with independent oversight of the SRI programme to help mitigate conflicts that arise when the fund board members are part of the investment management team.

What lies ahead for SRI?

Despite the recent delay in the US Department of Labor (DOL) fiduciary rule anticipated in April 2017 and Trump's executive orders and proposed budget cuts affecting environment and social programmes, the future of SRI appears to be increased AuM commitment by both institutional and retail investors. At the end of 2016, DOL updated their guidance for ERISA plans regarding statements of investment policy (including proxy voting policies). This new guidance confirms that material ESG considerations are permissible when a trustee develops its statement of investment policies[i]; a clarification which may result in even greater ERISA plan asset allocation to SRI.

Independence on the board of funds holding Plan assets provides oversight that is removed from the day-to-day deployment of the ESG program. Given independent directors provide conflict-free governance in the best interest of the investors, plan trustees will gain valuable comfort in discharging their fiduciary duties because they have independent monitoring of not only the fund's performance but also the adherence to investment policies integrating ESG factors.

To date, SRI and ESG factors continue to be topical with increasing inflows. Globally, a number of managers are launching SRI funds integrating ESG factors. We believe SRI growth in emerging markets will continue as emerging markets embrace ESG factors and improve reporting. We also anticipate a growth in analysis regarding the impact of incorporating ESG factors to investment performance.

Recently, PRI has launched a due diligence questionnaire for the practices for responsible investing as a tool for investors and managers. PRI's six principles will continue to encourage growth in SRI related funds. As SRI continues to grow, investors and managers both benefit from the conflict free oversight provided by the independent directors on funds boards deploying SRI strategies.

How The UK's SMCR Will Affect US Firms

By Adele Rentsch, Associate, Markets Regulation at AIMA

Adele Rentsch

Post financial crisis, U.K. banks were hit with tough new senior manager accountability rules, allowing the regulator to vet their senior staff and defining new levels of personal responsibility for management. Asset managers are next in line, with the rules being rolled out to the rest of the U.K. financial services industry from 2018. As we know from the experience of the banks, non-U.K. staff is also in the firing line.

What are the new rules in the U.K.?

The U.K. Senior Managers and Certification Regime currently applies to U.K.-regulated banks and insurers. The regime focuses the U.K. regulator's attention on the very top layer of management of U.K. firms. Those managers can only be appointed if approved by the regulator. The rules also make it easier for the regulator to hold individuals personally responsible for failings within their remit. This has caused a lot of angst among senior banking staff.

The new rules also push the onus back onto firms to verify the fitness and propriety of a significant proportion of their staff, including salespeople and traders. When the rules get extended to the asset management community, this is likely to cause huge headaches for H.R. and compliance teams in terms of revising recruitment processes and annual performance assessments.

There are also new conduct rules that apply to all staff members, except for the few identified as ancillary staff (e.g. cleaners and security guards), with firms having to provide training on what those rules mean in the context of individual roles. Firms have to report breaches of the conduct rules to the U.K.'s Financial Conduct Authority (FCA) each year.

Why is this of interest to staff in the U.S.?

While the rules apply directly to U.K. firms, U.S. staff involved in the U.K. business may very well be captured by the new rules, for example, global business heads (e.g. the head of I.T.) or managers of the U.K. business located offshore. A U.K. firm will also have to think carefully about how it outsources trading and other functions to U.S. affiliates to make sure this doesn't blur accountability lines. Overall, this may lead to a lot of very difficult conversations and decisions about reporting lines and potentially costly restructures for global asset managers.

Likewise, traders and other staff located in the U.S. aren't safe either. If they're involved with the clients or business of the U.K. entity, they may well be caught by the regime. This means the firm will have to sign off on their fitness and propriety when they're hired and annually thereafter for them to continue in their role.

What is the deadline for the new rules coming into force?

The rules are being extended to all U.K.-regulated firms from 2018. However, the exact timing and arrangements to transition to the new rules are yet to be announced. But overall, this doesn't really give firms much time to assess how the rules impact them and get ready.

Is there still time to influence the final rules?

The FCA has committed to designing the new rules to apply proportionately across firms of differing size, type and complexity, but we don't yet know what this will look like in practice.

AIMA has engaged directly with the FCA over the last year to raise particular challenges with extending the rules to asset managers. We continue to encourage our members to raise specific issues or questions with us, so we can channel these through to policy makers or supervisors at the FCA.

While there may still be some scope to raise particular concerns with the FCA, a word of caution: for the banks, the final rules were not materially different from the draft rules. There may also not be much time between releasing the final rules and their go-live.

The clear message for firms is not wait for the final rules to start on implementation.

How can you start getting ready?

The U.K. Government has already told us that the rules for asset managers will look very similar to what is already in place for banks. On this basis, AIMA has already started rolling out an education programme for our members.

In advance of the draft rules coming out, we would encourage firms to look at reporting lines and delegations, and start mapping out who has overall responsibility for the different parts of the U.K. business.

U.S. senior managers who are potentially captured should fully understand their personal responsibilities under the regime, and may want to carefully review their insurance arrangements and indemnities.

At the staff level, the new regime may mean that firms have to change employment contracts, including for in-scope individuals in the U.S. Firms will also need to ensure that any changes to, for example, staff training and annual performance assessments are extended to non-U.K. staff, as necessary.

Hedge funds, Brexit and the EU

By Jack Inglis, CEO, AIMA

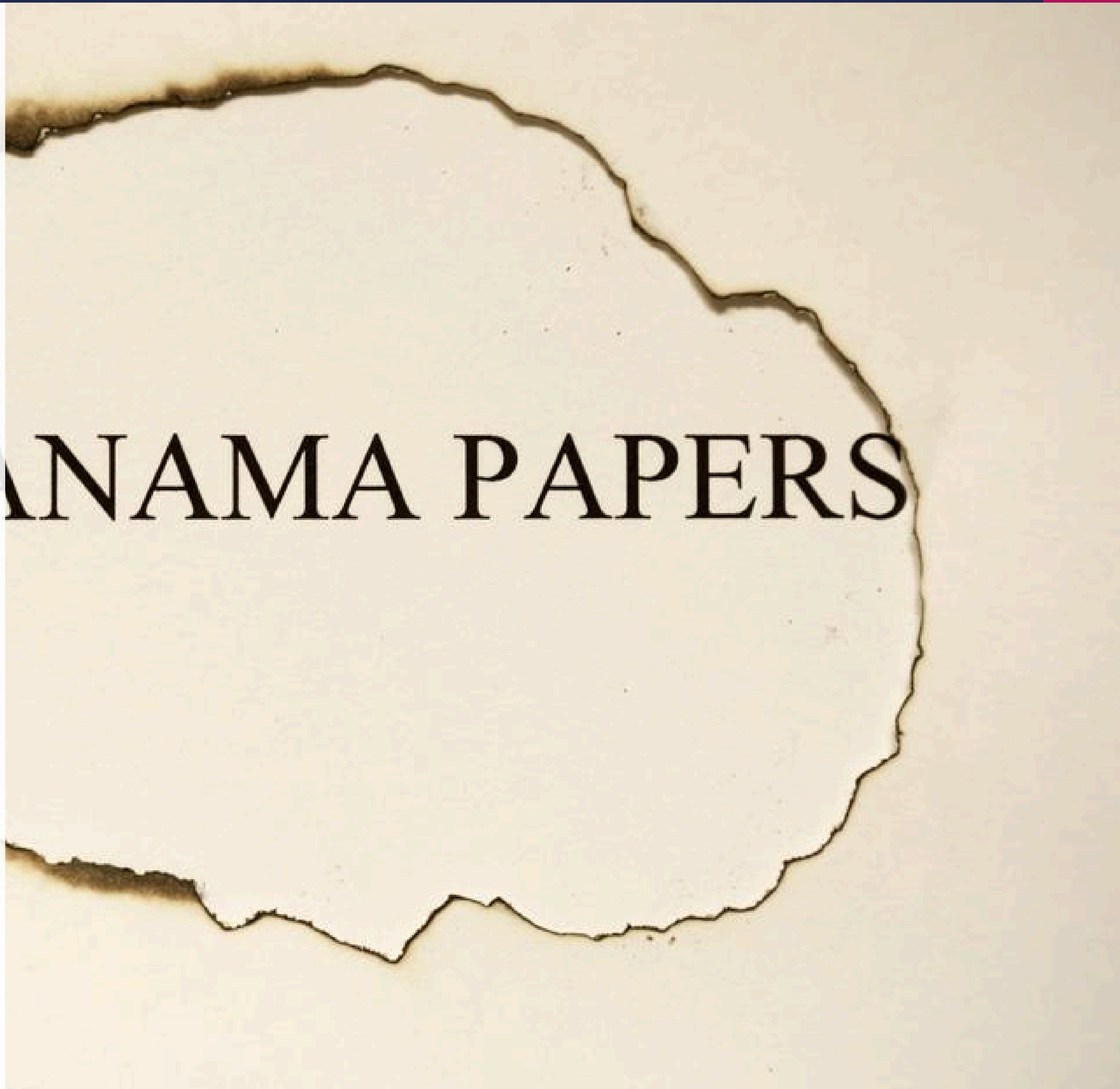
Now that the UK has begun to negotiate the terms of its exit from the European Union, the hedge fund industry has once again been cited in the process. At a speech in London in June, the former Liberal Democrat Leader and 'Remain' campaigner Nick Clegg said that Britain's Brexit strategy was being shaped by an "elite" of hedge fund managers, right-wing politicians and newspaper proprietors. Mr Clegg went on to suggest that hedge fund executives in Britain regarded "EU-wide regulations [as] an overburdensome hindrance to their financial aspirations".

The remarks, made at an event at Chatham House, echoed speeches that we heard in the run-up to the referendum itself and were a reminder that the myth of an industry opposed to official oversight and regulation persists, at least in some quarters.

We have said this many times before, but let's be clear: the hedge fund industry as a whole was (or is) neither definitively pro- nor anti-Brexit. No hedge fund management firm took a corporate position. Some individual hedge fund business owners did publicly express a view but these were on both sides of the debate.

The over-riding concern from Brexit , then and now, is ongoing access – to investors and to talent. In terms of regulation, from the EU and elsewhere, the industry (as reflected in AIMA's Policy Principles) has always supported regimes that treat investors fairly, promote transparency, protect shareholder and credit rights, detect systemic risk and combat market abuse.

Yes, the EU Directive on Alternative Investment Fund Managers over-reached and has been problematic. But with it in place we at AIMA have continued to want to make it workable. There may be differences of opinion within our industry on the rights and wrongs of Brexit, but we can all agree that good and workable regulation reassures investors, promotes financial stability and helps the industry to grow.



The Panama Papers: A missed opportunity?

By Paul Hale, Global Head of Tax Affairs, AIMA

Paul Hale

Joe Ware in his recent piece for Reaction marks the anniversary of the leaking of the Panama papers. He sees this as a catalyst for the measures to be enacted in the Criminal Finances Bill and an opportunity to force greater transparency onto offshore jurisdictions such as the British Virgin Islands.

I see the Panama Papers rather as a missed opportunity, in the UK at least, which could have put the public debate on much better informed ground. As Joe notes, the Panama Papers revealed the dubious dealings of "a host of senior politicians across the world from Bashar al-Assad to Vladimir Putin, and led to the resignation of the Prime Minister of Iceland". Instead the UK public remembers that our Prime Minister had owned shares in a collective investment scheme registered with HM Revenue & Customs as thousands of other such funds are and that Emma Watson used an offshore company to hold a property.

It is easy for the press and campaigning NGOs to conflate "criminality, corruption and terrorism" – and tax evasion - with tax avoidance, but they are very different. The former indeed rely on secrecy and the solution lies in the enactment and enforcement of proper measures against money laundering and other financial crimes. This includes the disclosure of beneficial ownership information between government authorities. The focus internationally at the EU, the OECD and the UN is on non-cooperative jurisdictions which do not collect and provide the information.

It is worth noting that there were few (if any) Cayman Islands companies identified in the Panama Papers. Cayman has for some years recognised that its future lies as a financial centre that can offer high-value services, particularly in markets such as investment funds and securitisation vehicles. Offshore financial centres provide a tax neutral venue with appropriate regulation where funds can be raised from institutional investors and used for investment across the world. To do that, offshore financial centres must meet international standards and be seen as reputable. Cayman, for example, is a leading member of the OECD's Global Transparency Forum and meets FATF and other requirements. It, like the other Crown dependencies and overseas territories, is entering into arrangements for the establishment of a central registry and the immediate exchange of beneficial ownership information on demand with each other and the UK.

Joe and other campaigners want to go further and require that the offshore financial centres adopt public registers of beneficial ownership, something that few developed nations apart from the UK have instituted (and so Miss Watson's walk-on role in the Panama Papers). Public availability of this information, contrary to Joe's argument, has little relevance to the efficient functioning of the markets. This is a clash between the public interest and the right of the individual to privacy. In the absence of compelling reasons otherwise, the latter should win.

The tax rate that a country chooses to adopt is a distraction in this debate. By holding assets offshore a person cannot escape the obligation to pay taxes in accordance with domestic laws. In any event, most developed countries including the UK impose little or no tax on foreign investors and even exempt domestic holding companies from tax on dividends and capital gains from overseas subsidiaries. Onshore investment funds and securitisation regimes are not subject to tax - tax neutrality is as relevant to these as to the offshore financial centres. Once again, it is a matter of disclosure of information and the offshore financial centres are compliant with FATCA and the Common Reporting Standard.

It is no less true for being a truism that any tax avoidance by a multinational enterprise in the countries where it is operating must have occurred before the profits arrive offshore. In fact, it is a bit more complicated than that.

The structures used by the multinationals to operate in the countries in which they operate have been enshrined in domestic and international tax law. They arose in the high tax era thirty years or more ago when the US aggressively used transfer pricing rules and controlled foreign companies legislation to force its businesses to declare profits in the US tax net. Since then, corporate tax rates have fallen outside the US but successive administrations, rather than following that path, instead relaxed the requirement to bring profits into US tax. That reduced the effective tax charge but the position was reached where other jurisdictions were taxing the profits properly allocated to them under international tax laws and feeling short changed, while the US was not fully taxing the balance. So, in large part it was not overseas taxes but US tax that the multinationals were not paying.

The BEPS project and unilaterally introduced diverted profits taxes are addressing the issue of profit allocation. However, the effect may be to shift tax payments from the US to other jurisdictions, since the tax paid there potentially becomes a tax credit in the US. This is an important part of the rationale behind the competing tax reforms being promoted by President Trump and the Republican party. They both wish to cut US tax rates so that the US tax system no longer acts as an inducement to US multinationals to invest abroad.

This brings us to the (Republican) elephant in the room. Delaware's closed corporate register is far larger than that in Cayman. The US has not adopted CRS and the IRS is not able to meet its obligations to make reciprocal exchanges of information under FATCA – which a Republican element wishes to repeal. How will the EU face the prospect of labelling the largest economy in the world a non-cooperative jurisdiction?

Five things we learned at AIMA's flagship regulatory forum

Jiri Krol, Deputy CEO, Global Head of Regulatory Affairs, AIMA

Jiri Krol

By Jiri Krol, Deputy CEO, Global Head of Government Affairs, AIMA

Representatives of more than 20 regulatory agencies as well as dozens of asset managers gathered in Paris in April 2017 for one of our flagship global events, the AIMA Global Policy and Regulatory Forum 2017, and affiliated workshops. The event came just days after the UK Government invoked Article 50, triggering the country's long, two-year farewell to the European Union. It came only a few weeks before the French presidential elections, which could be as seismic as either the Brexit referendum in the UK last June or the US presidential elections last November. And the event also came during the extraordinary first 100 days of Donald Trump's administration. All three events cast a long shadow over the proceedings.

The events over the two days were conducted under the Chatham House rule, meaning particular comments or opinions can't be attributed to specific speakers. But I would like to reflect on some of the core themes.

Brexit cannot lead to a 'race to the bottom' in the EU 27

For the delegates from the UK, accustomed to a very UK-centric perspective on Brexit in the British media and at dinner parties, the conference provided a European and global view. A recurring message from the EU policymakers and regulators we heard from, and to whom we spoke, was that the "EU 27" – the post-Brexit European Union Member States – will need to work even harder in future to ensure a level playing field within the bloc. One speaker said that Brexit posed the 27 a profound challenge and one that the Member States needed to quickly face up to and prepare for. There was also general agreement that the EU's capital markets union project will need to continue and possibly acquire a greater urgency given the relatively higher reliance on banking by the 27.

Speakers agreed that regulations will need to be implemented with greater consistency. Discussions touched on the AIFMD review and issues around delegation. More than one speaker referred explicitly to the threat of a "race to the bottom" as EU states compete over the City of London's market share. There was also much talk of London's importance to the EU economy, particularly in terms of asset management, and of the need to strengthen the already powerful partnership between the UK's asset management sector and EU markets.

As AIMA sees this crucial issue, we believe there are currently four key unanswered questions:

- The willingness of UK legislators and regulators to place asset management at the front of their thinking as a UK growth industry post-Brexit;
- The willingness of the EU to grant equivalence and thus access to the UK as a third-country under various pieces of EU financial services legislation;
- The future of policy direction of existing and future EU financial services legislation, in particular the maintenance of private placement regimes under AIFMD and the Capital Markets Union project; and
- The degree of access in the UK to skilled employees from the EU and beyond.

The Trump administration may not deregulate the financial system

A number of speakers at the conference spoke about the inconsistency between political rhetoric in the US currently and the likelihood for substantial financial regulatory reform. There was a consensus among our panellists that much of the Dodd-Frank Act, including those aspects relating to reporting and swaps, will not be repealed. As one speaker put it, repealing the Act wholesale would severely damage US asset managers seeking access to the EU and other markets on the basis of regulatory equivalency.

Areas that our speakers felt might be looked at, however, include the Volcker rule – the post-crisis crackdown on prop trading and on banks owning stakes in alternative asset managers – and the role of the US in international regulatory and supervisory bodies.

Asset managers are helping to make markets more stable

A number of speakers reflected on the fact that the asset management industry has been relatively stable in the near-decade since the crisis. There clearly is now much more recognition than ever before in Europe of the usefulness of market finance and of the fundamental differences between banking and asset management. AuM is not a balance sheet and redemption requests to a fund are very different to a run on a bank, as one speaker noted.

A recurring theme was whether the huge volumes of data now being routinely disclosed to regulators by market participants around the world are helping regulators better understand risk concentrations. Some speakers clearly believe that regulators are swamped and still lack the tools to analyse the information accurately.

There was also a recognition that the large financial markets continue to be heavily influenced by the actions of central banks. Questions were posed as to whether these interventions were making markets more or less stable. One speaker acknowledged that Europe's financial system may still be too fragile to withstand a major shock.

Costs of compliance will be thoroughly assessed

There were welcome utterances from several regulators on both sides of the Atlantic about the need for thorough impact assessments to be carried out into the costs of compliance and the unintended consequences brought by post-crisis regulatory reforms such as the AIFMD. Regulators said they will be seeking not only industry-wide views but feedback from individual firms.

In terms of reporting requirements, there were renewed promises by regulators in different jurisdictions to work together more closely in order to avoid unnecessary duplication and to seek to make the disclosure of data less burdensome. But regulators also spoke about the need to improve the quality of data they received from fund managers. As one put it, “the data is very messy, it’s incomplete and we’re still trying to fill in the gaps”.

Alignment of interests keeps growing

A new feature of the GPRF this year was a panel devoted to hearing from institutional investors in hedge funds. As we know, most investors in hedge funds and private credit funds today are institutions. More than half of all pensions, two-thirds of all foundations and four-in-five endowments allocate to hedge funds. Given the dominance now of this constituency, it is vital that their voice be heard more frequently in policy and regulatory discussions.

Speakers opined on the active/passive investing debate, on the differences between institutional and retail products, and, above all, on fees. There was general agreement that the days of “2&20” as a standard fee structure were numbered and that therefore the media narrative is increasingly divorced from reality. The panel also touched on the increasingly sophisticated and tailored structures designed to create ever-closer alignment between fund managers and investors.

Earlier, policymakers spoke about the need for costs to come down and for transparency, particularly around fees and expenses, to increase. AIFMD and MiFID in Europe and Dodd-Frank in the US have already substantially increased disclosure, but clearly additional policy prescriptions are being considered, in order both to increase investor protection and to increase the competitiveness of the EU asset management sector.

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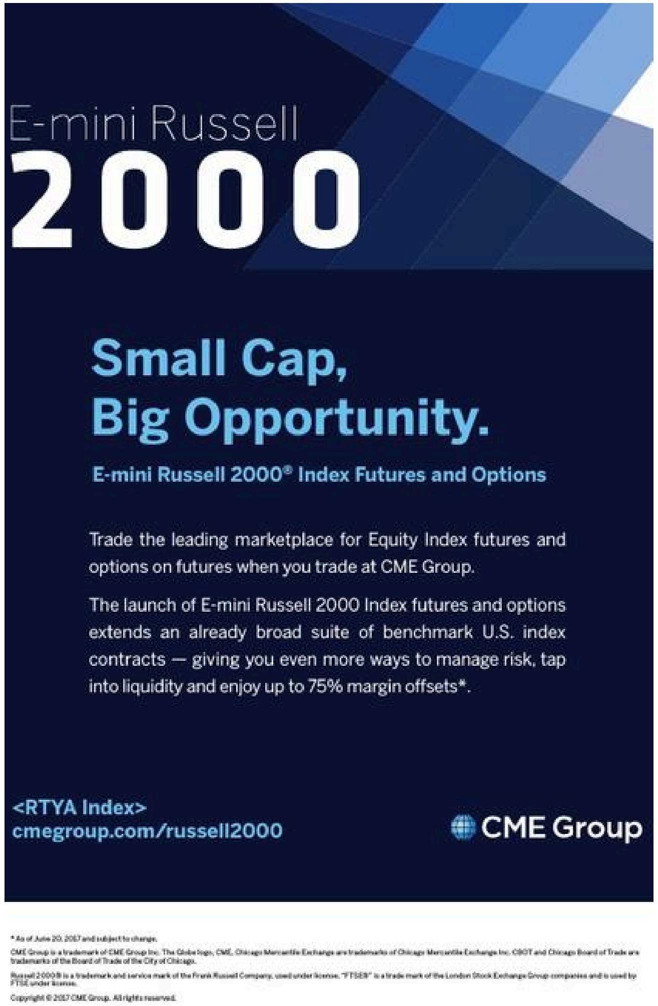

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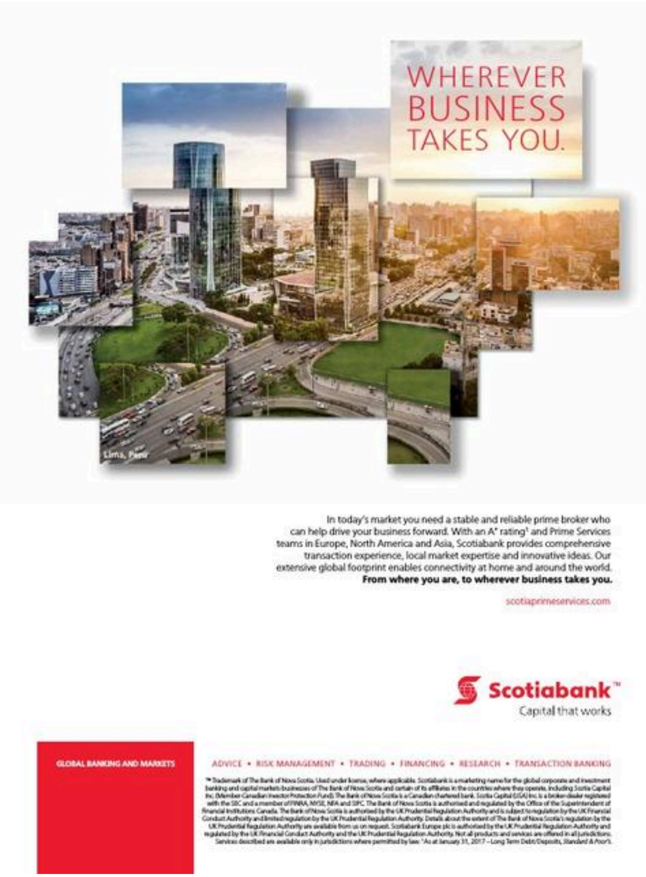

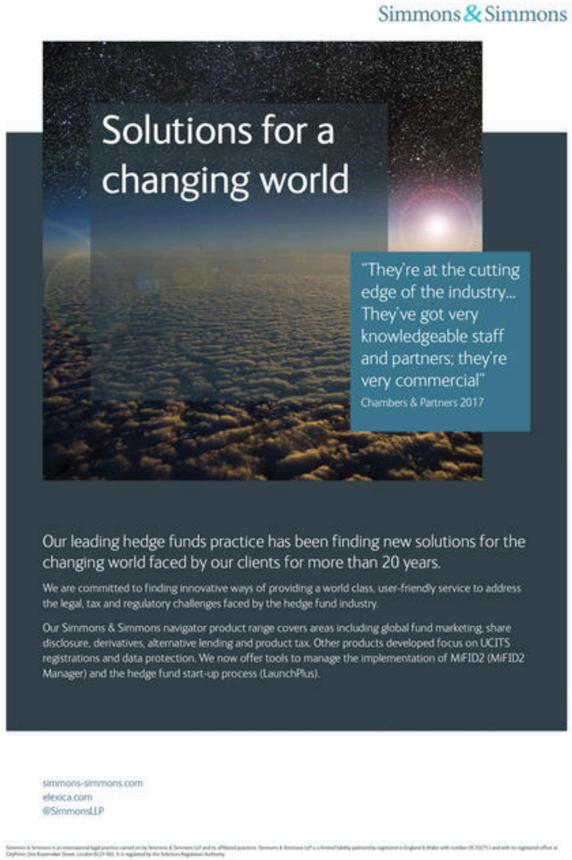

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