AIMA
JOURNAL
Edition 121 | January - March 2020 | www.aima.org


06

28

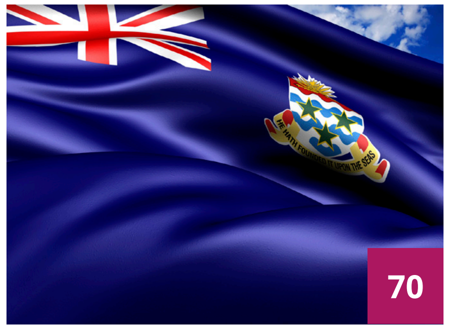
20

32

44


58

62

66

70

72

MESSAGE FROM AIMA'S CEO

I am delighted to share our 121st edition of the AIMA journal. Our first edition of the new decade presents the very best expert commentary our extensive membership base has to offer. We hope you will find these insights interesting and useful. Also, we would like to thank all those who contributed to this edition.

One of the big themes of recent years, which appears to become even more important in 2020, has been ESG and its implementation – responsible investment. The Journal opens with an article from **KPMG** that discusses in-depth how capital allocators can deliver attractive performance while remaining faithful to the ESG ethos. In a similar vein, **RSM** asks the important question which is on the minds of both investors and managers alike: "As ESG investing grows, how can investors measure success?" – going forward, quantifying how ESG factors contribute positively to return will help for broader adoption of responsible investment strategies and approaches.

On the following pages, we have an excellent overview from **Man AHL** on how the discussion on ESG has evolved from theory to practice, highlighting the growth of assets under management (AUM) dedicated to responsible investment strategies as well as the increase in the number of signatories to the UN-supported Principles for Responsible Investment, among other interesting developments.

Finishing off this edition's coverage on ESG, the question of diversity within the hedge fund industry (and across the broader financial industry) has become more prominent recently. **Aspect Capital** covers this important topic in the context of apprenticeships. This is a more UK-focused article, but it echoes principles which can be relevant in any market economy which values high business performance, creativity, innovation and better governance.

Passive investing is another trend which continues to grow in popularity. However, this poses passivity risks, especially around stewardship and governance, corporate actions and transparency. **Simmons & Simmons** leverages its international legal expertise and explores in detail how asset allocators can deal with these challenges in a pragmatic way – as we all know, there is a practical difference between what investors would like to do and what investors can do.

This is followed by an article from **Allen & Overy** looking at the rules that impact non-cleared OTC derivatives, focusing on the complex question of eligible collateral. These rules naturally vary with from one jurisdiction to another. However, Allen & Overy found that the broadest divergence in policy amongst regulators related to eligible collateral. Consequently, this article is a must read for anyone interested in non-declared OTC derivatives.

We couldn't present a new edition of the AIMA Journal without a detailed analysis on the volatility in overnight money market funds, considering the lack of liquidity in the repo markets which led the Federal Reserve to inject liquidity into the system from last September. As such, **CME Group** provides an interested take on the challenges facing the US central bank in dealing with volatility in the overnight secured financing market.

Meanwhile, **Clifford Chance** and **Gowling** provide great overviews on what changes to hedge fund advertising rules managers need to be aware of and the new marketing requirements under Cross-border Distribution Directive EU/2019/1160 and Cross-border Distribution Regulation EU/2019/1156 which introduce new rules relating to the marketing of alternative investment funds in the EU.

Additionally, the contribution from **ACA Compliance** speaks volumes about a compliance function designed for the roaring 2020s, encouraging firms to think strategically about this important role within their organisation as we enter the new decade.

Remaining in the area of regulation, **Five Continents** provides an enlightening update on certain rules that will affect "private funds", such as private equity, private credit and real estate funds in Cayman Island. The changes in question come from the so-called "Private Funds Bill", which is due to become law at the end of January 2020.

Cyber space is an area of growing importance for hedge funds. In this regard, **SS&C** evaluates the key cybersecurity considerations for investment funds and **Bardicredit's** article touches upon some core legal issues around security tokens – crypto assets are becoming more mainstream and investors need to be aware of the regulations governing their underlying technology: blockchain.

Moving on, **BNP Paribas** offers a piece on the introduction of new fund structures in Asia Pacific, which comes at a time of increased efforts to develop a single regional market for funds through various cross-border passporting themes. Consequently, this is a timely topic which is worth your attention.

As we approach the beginning of the UK's official departure from the European Union, asset managers continue to focus on the changes to the regulatory landscape that may impact their business. Against this backdrop, **Maples Group** explores the latest changes to the Irish asset management industry, focusing on the rise of MegaManCo authorisation – an enhanced version of SuperManCo, which allows fund sponsors to consolidate the management of their funds under one authorisation rather than having multiple self-managed UCITS and internally-managed AIFs.

Also, touching upon the important topic of capital allocation, whether investors choose to achieve their portfolio exposure through passive products or by selective active managers, diversification continues to be regarded as the holy grail of generating attractive returns. Asset management firm **Dynamic Funds** provides a detailed analysis of the power of diversification, making the case that investors should make room in their portfolios for alternatives.

To finish off this edition of the AIMA Journal, we have an article from **Third Eye Capital** on the liquid alternative market in Canada. The regime came into force in January 2019, allowing Canadian retail investors to access alternatives - there has been noticeable appetite for these products, but the market is still in the early stages. As such, it is exciting to see what the future holds for the story of liquid alternatives in Canada and, indeed, for the broader alternative industry globally.

Please do share your thoughts on this edition and let us know whether you wish to contribute in the future. We hope you find our new edition of the AIMA Journal engaging and informative and wish you a productive 2020.

Jack Inglis
Chief Executive Officer, AIMA

SUSTAINABILITY DOES NOT MEAN SACRIFICING PERFORMANCE

Anthony Cowell
Partner, Head of Asset Management
KPMG in the Cayman Islands
acowell@kpmg.ky

Amin Rajan
CEO
CREATE-Research in the UK
amin.rajan@create-research.co.uk

ESG is pivoting towards mainstream. No longer a box ticking exercise, it is a hard-nosed approach to investing as unfamiliar risks emerge.

Launched in 2006, the UN-backed Principles of Responsible Investing are now supported by nearly 1900 asset owners, asset managers and their service providers worldwide. At the 2015 COP21 Paris conference, 195 countries committed to reduce carbon emissions to achieve the 2C scenario. In the same year, the UN also issued a new implementation framework for its 17 Sustainable Development Goals – aimed at bolstering infrastructure spending, ending poverty and making the planet greener.

Pension plans are now adopting a holistic investment process where ESG factors sit beside financial factors, such that the assets are managed from a total risk–return perspective.

Such ESG integration is now occurring in three ways: using exclusionary screens to remove companies or industries not aligned to investors' ethical goals; evaluating all companies along ESG measures; and targeting specific social or environmental goals on top of financial returns. All this is done in the belief that ESG not only delivers better-informed decisions and credible outcomes. It also acts as an early-warning system for fat-tail or far-off risks that are hard to model statistically, owing to their long-term and infrequent nature.

Finally, taking an activist stance on governance – by exercising voting rights and strategic engagement – can deliver long-term value while exercising responsibility as an asset owner. Worldwide, some $30 trillion is now invested based on ESG criteria. The three are viewed as mutually reinforcing, not exclusive.

The starting point for ESG investing is governance. It forms the basis of strong environmental and social standards. It plays a key role in understanding how the company's vision and business practices are aligned to delivering the sustainability goals.

Critical to all three is investment stewardship that promotes active engagement with companies to protect and enhance the value of their shareholders' assets. Ethical exclusions without engagement have not delivered good returns at many pension plans.

As yet, there are no performance data going back far enough to confirm if ESG is a factor that drives risk and return in a systematic way over a long period – like traditional factors, such as value, momentum and low variance.

But ESG exposures are still deemed to be conveying information about future risks that are not captured by statistical models. The case in point is the current large reserves of fossil fuels. These could turn into 'stranded assets', as the global economy transitions towards a low-carbon future.

Opinion and evidence differ over whether ESG adds value. For most investors, it is a relatively new phenomenon. Only over time, its impact will become more evident. But its role as a risk mitigation tool is clear. Statistical models show that stocks in the worst ESG quintiles have total volatility that is higher by 10-15% and betas

that are higher by 3%.
In the near term, one key challenge is the paucity and reliability of ESG data. They emanate from a diversity of sources and do not follow uniform definition and data collection practices. Data vendors use different definitions that don't – as yet – fit into a standardized format. Evidently, there is over reliance on self-reported data, which encourages companies to report favourable data or opt out completely.

That does not detract from an important recent development. Large pension plans are already benchmarking their equity investments against a global equities index that selects best-in-class companies that are solving environmental issues. Japan's Government Pension Investment Fund with $1.3 trillion in assets has set an example that many are following.

So far, the most tangible impact relates to the governance risk inherent in emerging market equities and corporate debt, where the majority of companies are owned either by governments or by families. When these investments were delivering 10-15% returns annually in the 2000s, the risk was easy to price in. That is no longer possible, as their returns have almost halved.

Many EM corporates have been obliged to implement reforms that protect investor rights, diversify investor base, have independent boards, follow GAAP accounting practices, have independent audits, link executive incentives to long-term returns and have greater shareholder engagement. Progress has been gradual but no less visible.

ESG investing is a coming of age.

AS ESG INVESTING GROWS, HOW CAN INVESTORS MEASURE SUCCESS?

Anthony Decandido
Partner and Financial Services Senior Analyst
RSM US LLP
anthony.decandido@rsmus.com

As trends in investing go, there is perhaps no sector gaining more interest than ESG (Environmental Social Governance). The trend is a reflection of broader concerns in society, whether it is climate change, how companies are run or who is affected by a company's actions. And the money is following. According to Morningstar, inflows into ESG-related investments over the first three quarters of 2019 exceeded $4 billion in each quarter, far surpassing previous highs of $2 billion or less in previous quarters.

Yet, as more and more money flows into the sector, investment managers are facing increasing scrutiny over how they pursue returns while still adhering to the societal goals of ESG investments. For many managers, it has created a quandary- where do they draw the line between driving financial returns and seeking socially beneficial outcomes?

It's a question that has no clear answer and only highlights the need for an accreditation that would provide an important benchmark the industry so clearly needs.

Investment managers are no strangers to scrutiny. They have endured widespread regulatory changes during the Dodd-Frank era, which aimed to improve market stability and consumer protection. They have been the target of proposed sweeping policy reforms by presidential candidates and they now are being asked to demonstrate strong ESG missions and values.

But at what cost should investment managers proceed?

There is often an inherent tension between the actual benefits of applying ESG strategies and the financial cost needed to execute such strategies. Would a manager be willing to forfeit a few points of financial returns for the sake of doing good for society?

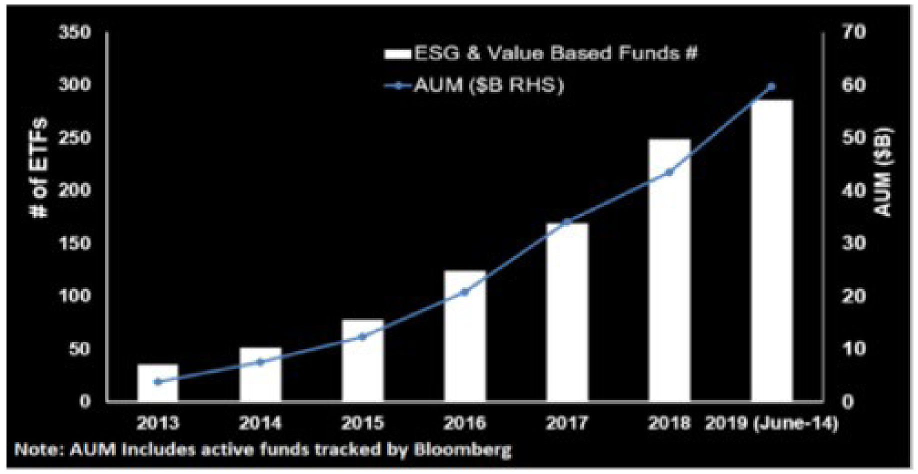
Many proponents of ESG investing argue that this trade-off is a false choice. They may argue that an investor can continue to earn a healthy return while still benefiting society, pointing to wind power investments as just one example.

However, the challenge remains on how to measure this benefit to society? There has yet to be a consensus on how this could or should be done.

This leads to other questions, including what exactly ESG represents? Is it the same as responsible investing, impact investing or sustainability? Even top industry professionals are split in their responses.

What is clear is that investors are pouring money into the sector. Many managers can point to successes and demonstrate the positive impact their investments are having – and that only attracts more investment. But industry professionals all have a different sense of ESG's stated objectives and outcomes. While some are interested in honest change, others may use it more as a marketing technique to raise their public profile.

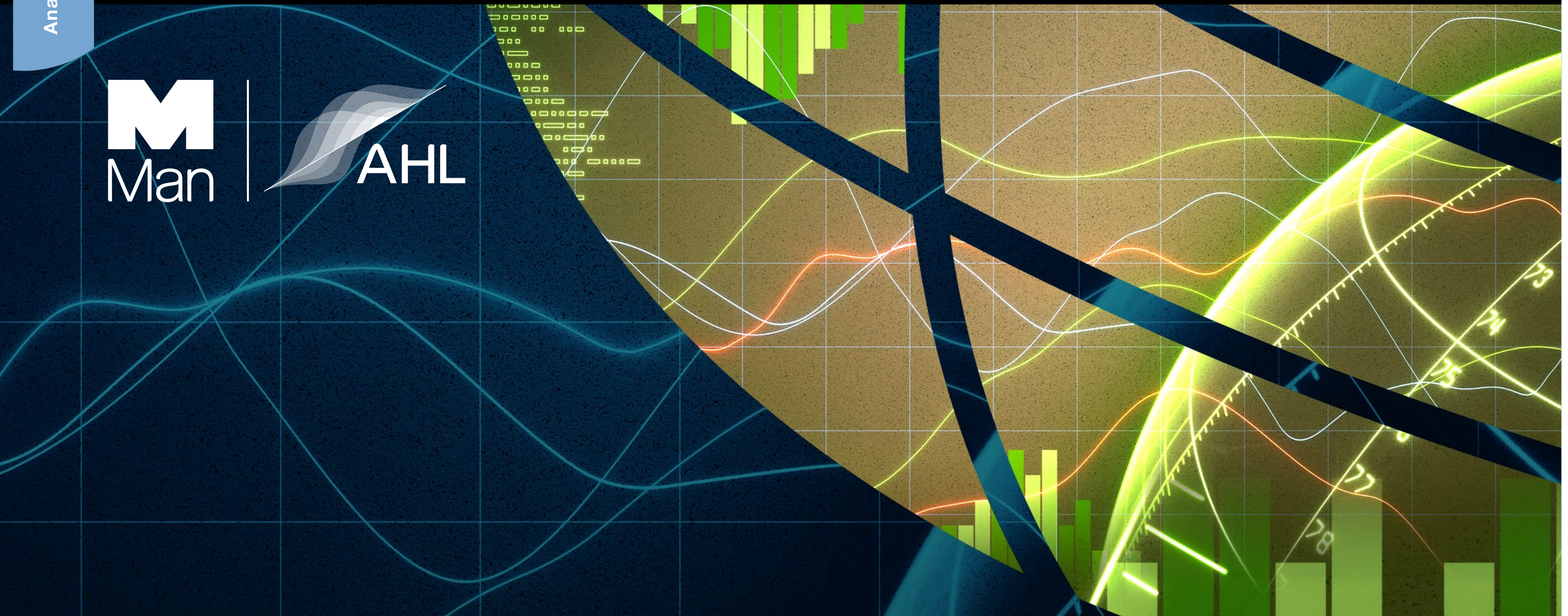
In the end, the lack of consensus leaves a need in the market for an ESG accreditation to determine, beyond hesitation, that a manager's intentions and behaviors fit a more sustainable outcome. [Morningstar] has made a significant effort toward this goal. Unfortunately, with good data still scarce and definitions still grey, it may be some time before managers earn a vote of confidence from investors, and more time before managers devote substantial resources to ESG.



Analysis

Man Institute

Man | AHL



Gatecrashing the Party: Can (Systematic) Macro Managers Invest Responsibly?

November 2019

A "socially responsible portfolio cannot primarily consist of derivatives," according to Belgian financial industry representative Febelfin. But does it have to be the case? Or could it be that the vantage point from which investors consider responsible investment ('RI') makes it harder to consider non company-related assets? In this article, we attempt to shed some light on why macro strategies, which can trade a broader set of assets than just listed equities or corporate bonds, might be harder to fit in current RI frameworks. We also explore how macro managers (with a bias towards systematic ones) can address RI, touching on the oft-mentioned topic of fiduciary duty.

Antoine Forterre
Co-CEO
Man AHL

1. Introduction

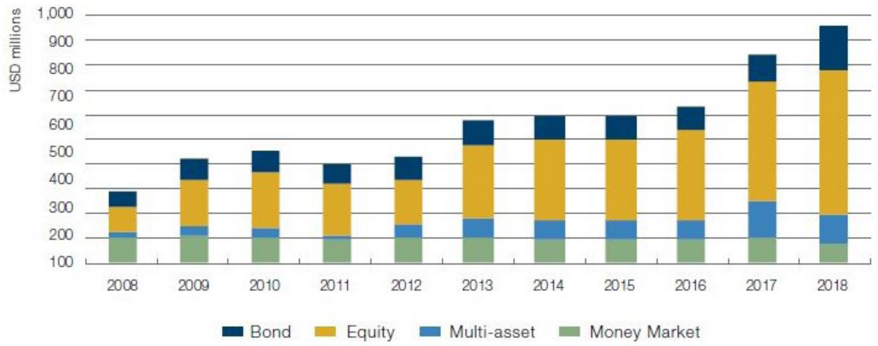
The discussion about responsible investment ('RI') has evolved from a low murmur to a rising crescendo in recent years. As of the end of 2018, more than 2,000 signatories, totalling USD80 trillion in assets under management ('AUM'), have committed to following the UN-supported Principles for Responsible Investment ('PRI', Figure 1). In conjunction, the base-line expectations of investors around environmental, social and governance ('ESG') issues have become more prevalent and stricter: either through exclusion lists by which stocks are removed from the investment universe for failure to meet certain ESG standards, or factor integration where ESG factors are included alongside financial factors to inform investment decisions.

However, investor expectations, and therefore the industry's response, remain predominantly focused on individual company-related assets, such as listed stocks, corporate bonds, infrastructure, and private equity and debt. This is best observed through a variety of publications, ESG-focused data providers or even the PRI's own websites and reports. Taking dedicated RI AUM as a proxy, 80% of strategies appear to be explicitly focused on equities and corporate bonds (Figure 2). Although some regulators and industry bodies have tried to address other assets such as derivatives[1], they remained focused on instruments backed by company-related assets and appear to ignore index futures, sovereign bonds or currency forwards. Indeed, the Belgian financial industry representative Febelfin goes as far as stating: "A socially responsible portfolio cannot primarily consist of derivatives."

Figure 1: The Growth in PRI Signatories

Source: Lipper IM, JP Morgan, Global Sustainable Investment Association; as of 31 December 2018.

Figure 2: Growth of Dedicated RI AUM by Asset Class



Source: PRI, JPMorgan, Lipper IM; as of 31 December 2018.

But does it have to be the case? Or could it be that the vantage point from which investors consider RI makes it harder to consider non company-related assets? In this article, we attempt to shed some light on why macro strategies, which can trade a broader set of assets than just listed equities or corporate bonds, might be harder to fit in current RI frameworks. We also explore how macro managers (with a bias towards systematic ones) can address RI, touching on the oft-mentioned topic of fiduciary duty.

1. See Febelfin report: "A Quality Standard for Sustainable and Socially Responsible Financial Products", February 2019; in particular paragraph 1.1.3.1 "Evaluating specific assets and portfolios – Derivatives".

2. Responsible Investment: From theory to practice

Responsible investing originates in the belief that certain non-purely financial factors can both influence the performance of portfolios and align investors with broader societal objectives. Using the PRI's framework as a common standard across the industry, responsible investing is thus defined as "an approach to investing that aims to incorporate ESG factors into investment decisions, to better manage risk and generate sustainable, long-term returns."[2] This definition, intentionally quite broad, is then qualified by encouraging investors to consider certain ESG topics or issues, and incorporate them into investment and risk processes according to six voluntary and aspirational principles (Figures 3, 4).

From an investment standpoint, the broad concept of responsible investment therefore appears to be translated in practice into: (i) an assessment on how certain actions (e.g. land use, fracking, employee relations, corruption), or the consequences of certain implied actions (e.g. climate change, water) might affect the risk / return characteristics of portfolios via the assets owned (cf. PRI Principle 1); and (ii) an imperative to influence the actions deriving from those assets (cf. PRI Principles 2 and 3) – as illustrated schematically in Figure 5.

Figure 3: Specific ESG Issues Listed by the PRI

Environmental Issues	Governance Issues	Social Issues
Climate change	Human rights and labour standards	Tax avoidance
Water	Employee relations	Executive pay
Land use	Conflict zones	Corruption
Fracking		Director nominations
Methane		Cyber security
Plastics		

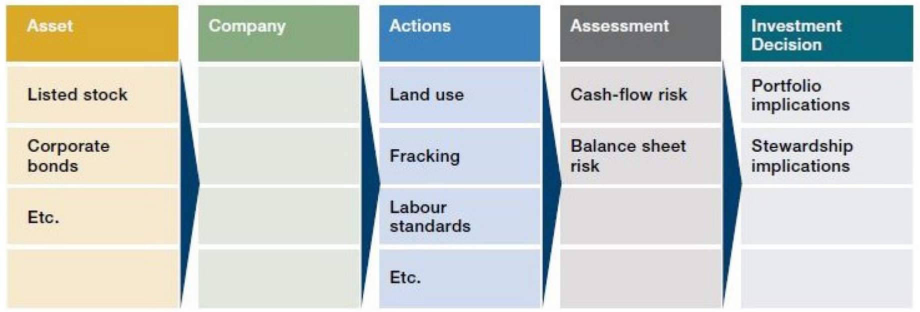
Source: PRI website.

Figure 4: PRI Principles

Principle 1	We will incorporate ESG issues into investment analysis and decision-making processes.
Principle 2	We will be active owners and incorporate ESG issues into our ownership policies and practices.
Principle 3	We will seek appropriate disclosure on ESG issues by the entities in which we invest.
Principle 4	We will promote acceptance and implementation of the Principles within the investment industry.
Principle 5	We will work together to enhance our effectiveness in implementing the Principles.
Principle 6	We will each report on our activities and progress towards implementing the Principles.

Source: PRI website.

Figure 5: Schematic RI Implemtation Process



Four points thus become apparent:

1. Because the application of RI relies on a predominantly qualitative assessment, attempts to quantify RI or ESG metrics remain discretionary and heterogeneous, as highlighted in analysis done by Man Numeric and illustrated by the multiplication of ESG data vendors. Only an industry-wide move towards unification, even auditing (as became the norm over time with financial metrics), of ESG data could lead to a common standard – although some believe that the standardisation of subjective factors would inevitably lead to loss of useful information;

2. Since the assessment focuses on certain actions, RI in its current approach has a bias towards company-related assets, where the nature of the operations is clear, and the actions (mostly) apparent as originating from an identified actor (e.g. management team). Other assets such as currency forwards, interest rate derivatives, broad equity indices or commodity futures do not obviously fit in the common framework;

3. As the objective of the assessment is to determine the risk/return implications and act upon them, the investment attributes of RI have taken precedence over the purely ethical ones: its stated purpose is primarily financial. This demarks RI and ESG approaches from faith-based or politically-driven ones which, although at the origins of RI[3], solely rely on personal ethical judgments. This gradual shift towards an economic nexus, reconciling RI with investors' fiduciary duties, has arguably made it easier for the investment industry to consider RI, and could help explain its growth in recent past. However, it is worth noting that the investment attributes of RI remain debated, and certain investors (most notably US pension trusts under current regulation[4]) can only apply RI to the extent it provides clear risk/return benefits – which become less clear the further away from company-related assets you get;

4. Finally, because responsible investing implies a level of active ownership, it can pose certain challenges for passive investors[5] or for managers who might trade thousands of securities, both long and short, with a short term holding period (e.g. 2-3 months).

As a result, from an intentionally broad definition, RI appears in practice to focus on strategies investing in company-related assets with a longer-term investment horizon, where the risk / return benefits of such approach can be objectively measured, leaving macro managers mostly to the side.

This begs the question: should that be the case? Or can macro managers address RI seriously, without accusations of greenwashing[6]?

> "Simplifying crudely, a systematic macro manager may aim for breadth and diversification, in contrast with the depth of a discretionary manager, who may delve deeply into an individual company's cash flow and balance sheet at the price of a reduced investment universe."

3. How Can Macro Managers Address RI?

A macro manager's instrument universe is typically wide, and focused on non company-related assets, such as commodity and financial futures, interest rate derivatives and currency forwards. Listed stocks can still be traded, but are often grouped in broad baskets (for instance, to express sector views).

This is even more prevalent with systematic managers, who rely on algorithms to process large amounts of data across numerous assets, potentially capturing small amounts of alpha from a wide universe through a repeatable process. A typical such manager might invest in tens of instruments, as well as hundreds (sometimes thousands) of stocks, over an investment horizon of a few weeks to a few months. Simplifying crudely, a systematic macro manager may aim for breadth and diversification, in contrast with the depth of a discretionary manager, who may delve deeply into an individual company's cash flow and balance sheet at the price of a reduced investment universe.

Based on Man AHL's experience, company-related assets might represent less than a third of the traded universe for systematic macro managers. In addition, the typical holding period of such managers is shorter than the one implied by common ESG approaches. Given that context, how can RI then be applied?

3.1. Follow Best Practices When Well Defined

First, macro managers looking to adopt RI should ensure they adopt industry best practices for the portion of their portfolios represented by listed stocks and other company-related assets. This includes integration and/or screening (which can be relatively straightforward for a systematic manager), as well as proxy voting. In that context, a systematic manager such as Man AHL can draw upon a broader RI framework, dedicated RI team and committee.

This includes:

- An exclusion list covering specific ESG issues, in particular: controversial arms and munitions, tobacco, coal and nuclear;
- Stewardship through proxy voting on all listed stocks;
- Where appropriate, engagement with investee companies through a dedicated engagement team;
- Enhanced ESG reporting.

Some of these practices, established for company-related assets, can also prove relevant for government-backed assets where specific actions can be assessed. However, approaches there remain ill-defined: issues surrounding human rights, corruption and weak governance can also apply to governments after all, and can have bearing on assets such as currencies or government bonds.

3.2. Accept Possible Conflicts and Collaborate With Asset Owners

Integration and/or screening, which are becoming increasingly common for equity or bond managers, can lead to some apparent contradictions: a manager might trade broad stock index futures which include stocks otherwise restricted; another might restrict certain oil-related stocks, whilst

2. Further PRI definitions can be found on their website.

3. The origins of RI are commonly attributed to the Quaker and Methodist movements. **4.** See Max M. Schanzenbach, Robert H. Sitkoff, "Reconciling Fiduciary Duty and Social Conscience: the Law and Economics of ESG Investing by a Trustee", ssrn. **5.** See PRI Discussion Paper: How can a passive investor be a responsible investor? **6.** Greenwashing refers to the practise of exaggerating the role of RI in an investment strategy, making it appear more "green" than it is in reality.

trading oil futures in the same portfolio. How can that be justified?

From an investment point of view, the idiosyncratic characteristics of certain macro instruments, and therefore their importance in a portfolio, might be such that their removal may adversely impact expected risk-adjusted returns. Following an RI assessment, an equity manager might decide to replace a given stock identified as an ESG 'offender' with another stock with similar properties, or exclude this stock altogether given the size of the possible investment universe, whilst maintaining - ideally increasing – the expected risk-adjusted return of its portfolio. However, a macro manager might be prevented from expressing any views on a given market if the instruments related to that market are excluded. For instance, a commodity manager not trading oil futures or other oil-related derivatives would struggle to take a view on energy markets.

A similar argument also applies to broad equity indices, accessed via futures or ETFs. The original indices, which pay no homage to any ESG consideration, have the clear advantages of being significantly larger, more liquid, and therefore cost efficient to trade, than their ESG counterparts – if they even exist. As an example, according to S&P Global, the main S&P 500 Index (launched in 1957) had more than 80 ETFs tracking it as of 30 September 2019, compared with six for the S&P 500 ESG Index (launched in January 2019). The market capitalisation of the SPY ETF stood at USD273 billion, compared with USD224 million for the S5ESG ETF, the largest ETF tracking the ESG-friendly version of the S&P Index.[7] Unless most market participants jointly agree to migrate (in particular asset owners who de facto set benchmarks), this situation is likely to remain.

In addition, participating in certain macro markets (e.g. commodities, currencies) does not necessarily lead to a position which conflicts with underlying ESG factors, especially if a manager has the ability to take both long and short positions. Indeed, take the example of coal futures: participating in this market might increase overall liquidity, which should benefit producers and consumers alike (a possible 'negative' from an RI point of view). However, being short the market might be perceived more positively as participating in downward trends against an ESG offender. Conversely, being long and participating in upward price trends could create incentives for heavy users of coal to search for cleaner substitutes – a 'positive' from an RI point of view. There is therefore no obvious consensus on the right thing to do.

This is different from saying that nothing should be done. Trading in commodity markets remains stigmatised in certain jurisdictions or cultures (ignoring the debated argument on liquidity provision) – sometimes rightly so, as illustrated by the example of onion futures from the 1950s (Figure 6).

Figure 6: Onion Futures

In the 1950s, two futures traders cornered the onion market, resulting in prices being pushed so low that many onion farmers went bankrupt whilst they profited. The resulting regulatory backlash led to the passing of the Onion Futures Act in 1958, which banned futures trading in onions.

Although such behavior would nowadays likely fall under market abuse regulations, it illustrates why trading in commodity markets, in particular agricultural ones, still carries a stigma in some jurisdictions, and why the UN has in the past cautioned against "excessive speculation" in them.[8]

Since the ban however, various commentators have noted that the onion market has not been as efficient or liquid as other commodity markets, with farmers being unable to hedge themselves. In 2008, Fortune Magazine was writing: "And yet even with no traders to blame, the volatility in onion prices makes the swings in oil and corn look tame, reinforcing academics' belief that futures trading diminishes extreme price swings. Since 2006, oil prices have risen 100%, and corn is up 300%. But onion prices soared 400% between October 2006 and April 2007, when weather reduced crops, according to the U.S. Department of Agriculture, only to crash 96% by March 2008 on overproduction and then rebound 300% by this past April."

Although the market has evolved since and regulators have attempted to address some of these issues (e.g. futures position limits, market abuse regulations), this topic remains complex and cannot be looked at under a simple financial filter only. Recognising it openly, managers should allow asset owners to apply their own preferences to portfolios, whilst stating clearly in their RI policies what activity is encompassed and to what extent RI frameworks are applied. This should avoid potential accusations of greenwashing.

7. On 3rd October 2019, the CME Group announced it would launch on 18th November 2019 the E-mini S&P 500 ESG Index futures, the first futures linked to the S&P 500 ESG Index. **8.** See https://www.un.org/press/en/2012/ga11223.doc.htm, although this applies predominantly to physical markets.

3.3. Actively Contribute

In keeping with PRI Principles 4 and 5, macro managers trying to apply RI should also actively participate in the broader RI debate, working together to increase understanding of specific issues. Some of these will overlap with other segments of the industry, such as the treatment of broad equity indices, which affects both passive and macro managers alike.

Finally, managers can address RI through their own company initiatives, demonstrating a sound culture and good E, S and G properties themselves. This, along with an active participation in the broader RI debate together with asset owners, regulators and industry groups, can go some way to reassuring investors that the manager truly values these characteristics and practises what they preach.

Following the steps above, a manager investing predominantly in macro assets can still address responsible investment whilst remaining intellectually honest about the challenges of applying it to certain assets or strategies.

4. Responsible Investment, Fiduciary Duties and Macro Investing

Having reviewed why macro strategies can be challenging to fit within current RI approaches, a question remains: how could RI approaches be more accommodating? Answering that question requires us to do a detour via the realm of fiduciary duties – the set of laws and regulations governing the relationship between the underlying asset owners, and the people acting on their behalf.

As we have seen previously, one of the implications of current RI approaches is the focus on investment attributes: the aim is to incorporate ESG factors into the investment process alongside other financial factors, in order to improve (or at least maintain) the expected risk-adjusted returns of a portfolio. For company-related assets, this integration relies on a relationship between asset and investment decision which is apparent (Figure 5), and can be rationalised or even, in some cases, tested.

However, the absence of underpinning actions for macro assets makes any RI assessment difficult, as illustrated by previous examples. Instead of evaluating how the actions of a management team might impact the financial performance of its company, attempts to evaluate macro instruments seem to rely on an assessment of how investors' actions (i.e. trading in that market) might impact the broader market, and from there market participants – a tenuous link at best.

As a result, such an assessment is likely to fail the risk / return test which underpins current RI approaches, particularly if the macro investor has the ability to go both long and short assets. For instance, if a manager expects to generate positive returns over time by being long or short coal futures, the removal of that asset from the trading universe is likely to reduce diversification, decreasing expected risk-adjusted returns at the portfolio level. In contrast, a fundamental equity manager might decide to underweight or remove coal manufacturers in her portfolio because of negative long-term views on carbon emitting industries – therefore improving expected risk-adjusted returns.

Investors, and in particular asset owners, can still decide not to trade certain assets, taking the view that any return is not worth the risk of doing harm. However, this becomes an ethical judgement: in itself, the financial impact could be detrimental. In making that judgment, investors are implicitly or explicitly determining the expected financial value they are prepared to forego in exchange for broader societal benefit – provided their prevailing regulations allow it. Indeed, while the European Commission has prevented trading in commodities in UCITS[9] fund structures, current laws governing pensions in the US mandate that pension trustees act solely and exclusively for the financial benefit of their members[10] – de facto preventing any form of RI motivated by ethical judgements. Trustees of UK pension plans have more flexibility in applying non- financial factors, provided trustees "have good reason to think that scheme members share a particular view, and their decision does not risk significant financial detriment to the fund".[11]

Other jurisdictions will have their own rules, but responsible investment in macro strategies seems ultimately to meet the reality of fiduciary duties. Although putting ethical attributes above investment ones would enable RI to be more accommodating, allowing too much deviation towards non-financial factors is likely to leave too much room for interpretation, going against public policies aimed at safeguarding the financial future of millions of individuals.

5. Conclusion

The growth of responsible investing has, in practice, been contained to certain segments of the asset-management industry (fundamental stocks and bonds portfolios). Other segments, such as macro strategies, have been mostly ignored from the debate – partly, we argue, because the foundations on which responsible investing is built do not easily support certain asset classes or strategies. Given the ongoing paradigm shift in the asset management industry, with investors moving from asset class allocations to capability risk-budgeting and the subsequent rise of risk premia and passive strategies, investors are at risk of considering RI on an ever-decreasing proportion of their portfolios – an unintended consequence which both asset owners and managers should seek to avoid.

Through a combination of best practices (when they are well-defined), active participation in debates to enhance the effectiveness of RI principles (when best practices are not defined), and honest self-adoption of RI principles, we believe managers can overcome the inherent challenges in addressing responsible investment in macro portfolios.

Ultimately, however, the applicability of RI as a concept might remain somewhat unclear for macro portfolios, outside of stocks and other company-related assets.
The PRI itself acknowledges that, clarifying that ESG issues can affect portfolios "to varying degrees across companies, sectors, regions, asset classes and through time". Clarifying best practices for those other asset classes would however ensure that RI approaches reach all corners of investment portfolios, no matter how small or large.

9. Undertakings Collective Investment in Transferable Securities. **10.** See Max M. Schanzenbach, Robert H. Sitkoff, "Reconciling Fiduciary Duty and Social Conscience: the Law and Economics of ESG Investing by a Trustee", ssrn. **11.** See The Pension Regulator, A Guide to Investment Governance, June 2019.

SUPPORTING SOCIAL MOBILITY THROUGH APPRENTICESHIPS

Amanda Cherry
Director of Organisational Development
Aspect Capital
amanda.cherry@aspectcapital.com

The hedge fund industry, like the financial services industry as a whole, has come under increased scrutiny from stakeholders in recent years for its lack of diversity.

Aspect is proud to support AIMA's promotion of D&I in 'The Alternatives' and we agree with the premise that a genuinely diverse set of perspectives, and a workforce that is a true reflection of our client base and society as a whole, will lead to improved business performance, creativity and innovation, as well as better governance.

To that end, it has been pleasing to see the progress that has been made across the industry to begin to address gender inequality, with gender pay gap reporting and other initiatives such as the Women in Finance Charter, pushing forward this agenda. However, while gender disparity has been an area of focus, we see diversity going much further, looking beyond gender to address cultural and social diversity. We believe that encouraging social mobility represents at least as big a challenge to the industry, but it has often taken something of a back seat.

Many of the challenges inherent in fostering social mobility within the industry are deeply-embedded, reducing the pool of talent from which roles can be filled through a combination of old-fashioned attitudes towards recruitment, entrenched perceptions of the industry itself and geographic and socio-economic factors. The following is not an exhaustive list but are among some of the most challenging obstacles to recruiting from a socially - and culturally-diverse - talent pool which we have observed:

• The widely accepted view that a prestigious university education is a pre-requisite to entry into the industry, whereas young people from disadvantaged families are a third more likely to drop out of education at 16 to pursue lower-skilled, lower-paid and insecure jobs. [1]

• The perception of the industry as an elitist institution and its tarnished reputation following the financial crisis and subsequent scandals.

• The fact that the UK hedge fund industry is almost entirely based in central London: a young person's geographical and socioeconomic background has a profound impact on their prospects for social mobility, with regional disparities in the UK now wider than in any other western European country.[2]

• A simple lack of visibility and awareness of the roles available among disadvantaged social groups.

In that context, we believe that apprenticeships represent an exciting way to access a vast pool of talented individuals from diverse backgrounds who would otherwise neither consider nor be considered by the financial industry, whilst also creating opportunities for social mobility from which we and the industry can benefit.

It is for these reasons that Aspect has actively embraced the government's Apprenticeship Levy since the scheme was launched in April 2017, hiring eight apprentices in that time: six across back office functions such as operations, treasury, fund accounting and IT, one into the front office data team and one trading desk assistant.

We partner with whichever apprenticeship provider runs the best-fit course for the role we have on offer, usually sourcing them via the Institute for Apprenticeships. That provider then helps us to recruit the right candidate through various atypical channels, to attract local and national candidates with the right attitude towards learning.

To date, our most engaging apprentice hiring experience has been with WhiteHat, who recognise that hiring young people based on a CV is somewhat spurious. Instead the candidates film a brief clip of themselves explaining why they wish to study the apprenticeship on offer. We look at the candidates' energy, motivation, ability to learn and take action, and we make the decision to hire following a brief face to face interview. Another apprenticeship provider, LDN, asks that we take a small group of potential candidates forward for a one-day work trial (thus allowing candidates to gain a day's work experience even if they aren't successful) and choose our apprentice from that group.

We have found Level 3 courses to be basic but well structured, with pastoral support from a coach who helps the apprentices to transition from (usually) school-leaver to full-time employee. The courses at Level 4 are akin to the first year of an undergraduate degree, and often lead to a globally-recognised qualification such as CISI, and the more UK-based IMC or ACCA, whilst the combined Level 4, 5 and 6 courses lead to a bachelor's degree.

The experience has been challenging at times (teenagers can be hard work!) but we have learned a great deal and are hugely supportive of the scheme. The benefits we have reaped by embracing the levy have materially outweighed the challenges. What we now have is a diverse group of enthusiastic and engaged employees who have different perspectives, a propensity to learn, and are also great ambassadors for the industry.

The challenge of social mobility is a complex one that requires an integrated strategy, active intent and continual effort, alongside a shift in policy involving government, education and employers. Yet, there are many opportunities for investment managers to immediately introduce changes and begin operating in ways that positively influence social mobility.

Given the focus on diversity and inclusion across the hedge fund industry and the wider financial services industry, we believe that the apprenticeship levy provides one such opportunity for firms to tackle their diversity efforts. The levy has been successful in creating jobs for people from all backgrounds, as well as driving greater understanding and interest amongst groups who would not usually consider finance as a career option.

This endeavor to improve diversity has ultimately been for the mutual benefit of not only the individuals themselves, but also the firm, our stakeholders and society as a whole.

1. and **2.** https://www.5percentclub.org.uk/apprenticeships-key-to-creating-social-mobility-economic-growth/

THE RISKS OF PASSIVITY IN OVERSEEING YOUR ASSETS

Robert Turner
Partner
Simmons + Simmons

Paul Baker
Partner
Simmons + Simmons

Chloe Lim
Supervising Associate
Simmons + Simmons

Mark Uttley
Supervising Associate
Simmons + Simmons

Introduction

This article explores the practical challenges, faced by asset managers of all types, arising out of recent regulatory reform and scrutiny; the changes in social and political expectations; and opportunities and threats as litigation is increasingly being viewed as an asset class.

This article illustrates these practical challenges across three current themes in the asset management industry:

1. Stewardship and governance;
2. Corporate actions; and
3. Transparency.

Stewardship and governance

In the last decade, there has been a huge shift from assets being managed using active strategies to managers employing passive strategies. Morningstar, the data provider, reports that out of mutual funds and ETFs that buy US stocks, 48% of those US stocks were held by passive funds in 2018.[1] Not only have investors looked to passive strategies as a cheaper way of investing but, in the market circumstances, studies have also found that these passive funds have outperformed active funds over time.[2] Morningstar looked at almost 10,000 European active and passive funds over a ten year period, splitting these into 49 different categories, of which there were only two where the majority of active funds performed better than their passive peers. The shift in favour of passive management has led to reduced emphasis on price discovery – except perhaps in the developing activist market.

In parallel, there has been increasing interest in and criticism of the role that asset managers play (or don't play) in stewardship and governance of the companies in which they have invested. Notably, the last few years has witnessed the integration of environmental, social and governance criteria ("ESG") in investment decisions becoming mainstream, with ESG being increasingly seen as not simply a method of screening out companies whose business conflicts with the asset owner's beliefs (e.g. guns, alcohol, adult entertainment), but instead a source of risk management (e.g. poor governance or poor environmental practices may at some stage manifest in events that destroy shareholder value) or a source of alpha. The FT reported in August this year that, according to Morningstar, the AUM in ESG mutual funds has almost doubled to $1.8 trillion.[3] In the EU, the recently implemented Shareholder Rights Directive II (2017/828) has created an obligation for asset managers to develop and disclose an engagement policy which includes how they monitor investee companies on a number of issues, including ESG. In addition, the EU is in the process of developing further rules relating to the disclosure of ESG risks and opportunities.[4] There have also been calls from the pension trustee community for the FCA to intervene by developing ESG policies that fund managers have to implement.[5]

The upshot of this is that even passive managers are expected by investors, regulators and the general public to exercise increasingly active scrutiny over the companies in which they invest and be a force for change where required.

However, the market in which passive managers operate in is highly competitive on cost. The costs of stewardship and governance are borne out both in terms of the time and money needed to scrutinise investee companies and engaging with management and other shareholders on governance issues. How managers deal with the trade-off between stewardship and their own costs and profitability will be a key consideration over the next few years, and one which could come to define the market. The danger is that stewardship and the cost of stewardship is left to some, with others preferring the competitive cost advantage of not engaging over doing the right thing.

At the same time, of course, active managers have come under considerable scrutiny in recent years on costs with concern being raised in some quarters that, after fees are taken into account, investors would be better off investing in passive tracker funds. While the cost adjusted performance of passive funds has been assisted by generally buoyant equities markets in the decade since the financial crisis, this has not stopped regulatory intervention. At times, some regulators could be said to have come close to giving financial advice itself to the effect that passive management offers better value.

In the UK, the FCA fired the starting gun in 2015 with its Asset Management Market Study, and further to market consultations, eventually arrived at the concept of funds needing to perform an "assessment of value" for investors. Fund manager directors are now required to assess whether a fund provides value to investors on an annual basis. Managers will have to consider the costs of stewardship activities against this

1. https://www.bloomberg.com/news/articles/2018-12-31/shift-from-active-to-passive-approaches-tipping-point-in-2019 **2.** https://moneyweek.com/496019/passive-funds-beat-active-funds-yet-again/

3. https://www.ft.com/content/247f4034-4280-318a-9900-87608a575ede **4.** https://europa.eu/rapid/press-release_IP-19-1571_en.htm **5.** https://www.ft.com/content/ccae1431-d9a6-31da-9702-3f35076990ed new regulatory framework and there is a clear tension between the pressure on fees and expectations on stewardship; squeezing profit margins even further. Managers will need to develop suitable policies for stewardship activities and ensure that the value of these activities is recorded. However, given that stewardship activities can take a number of years to come to fruition, there are clearly issues with how this fits into the FCA's annual value for money reporting cycle.

Corporate actions

One aspect of stewardship is whether and how managers participate in corporate actions. Corporate actions can relate to a number of different topics. We touch upon shareholder actions and scrip dividends (where issuers provide shareholders with an option to receive additional shares instead of a cash dividend) here.

A recent US study[6] found that asset managers are failing to optimise corporate action decisions (such as scrip dividends, rights offerings and tender offers), apparently resulting in widespread losses. The authors say that in relation to scrip dividends alone, aggregate losses to beneficial owners exceed US$1bn a year. Against the backdrop of increasing pressure on asset managers to make optimal corporate action decisions, one can see the potential for increased regulatory and litigation risks as a result of investors and regulators scrutinising such decisions made by managers.

In jurisdictions where the class action regime requires participants to opt in, there is a risk of managers failing (without justification) to opt in to relevant actions and leaving money on the table. Having a blanket policy of not opting in or failing to opt in to a class action that would have ultimately resulted in a gain for investors could have serious implications, including investor claims and regulatory interest, particularly for managers trying to demonstrate that their fees represent value for money.

The growth of the litigation funding industry has also opened up opportunities for managers to bring their own claims without tying up as much capital or having to shoulder legal fees for complex claims which run over a period of years. This presents opportunities for managers to obtain value through investing in litigation as an asset class.

There is however a conflict here: the targets of the litigation funding industry are often asset managers - for instance, as set out below, one litigation funder has set aside £6.6bn for claims against asset managers relating to closet tracking. Looking to the future, it is very possible that we will see a number of funded claims against asset managers relating to a failure of stewardship or not providing value for money and the relationship between asset managers and litigation funders may become strained.

Transparency

Transparency continues to be scrutinised by regulators. Linked to its value for money agenda, the FCA has devoted significant time to issues around the disclosure of fees and charges. Earlier this year, the [FCA issued supervisory publications] concerning the review of disclosure of costs by asset managers and retail intermediaries to retail customers, warning that firms should review their disclosure about costs and charges as a matter of priority. This followed the FCA's Asset Management Market Study findings that weak price competition in the asset management sector was partly a result of ineffective disclosure of such information.

Disclosure of costs and charges goes hand in hand with "closet tracking", where it is said that an actively managed fund charges a fee that is commensurate with active management but is, in practice, tracking a benchmark too closely to warrant an active fee. The logic being that an investor would

therefore have been better off investing in a passive fund as, after costs, their return would be higher.

Several European regulators, including ESMA, the FCA, the Central Bank of Ireland and others have examined this issue, often using various metrics to identify potential closet trackers. The standard regulatory response has then been to contact managers of those funds and request further information, particularly relating to what was disclosed to investors about the strategy and the benchmark used. The CBI published its findings in July this year, noting there were cases where target outperformance against a benchmark was less than the fee charged, meaning that, even where the fund generated a top end return, investors in affected share classes would not realise a positive return compared to the benchmark.

Interestingly, the Norwegian Court of Appeal has recently given judgment on a closet tracking case between the unitholders in the DNB Norge securities fund and DNB Asset Management, allowing 180,000 investors to recover allegedly excessive fees (£30.4m) charged for an actively managed fund, because the product delivered was tracking its benchmark more closely than investors were entitled to expect. At its heart, the case is not about a tracker fund masquerading as an active fund and charging a higher fee (as over time, the fund had outperformed its benchmark). Rather, the case was about whether, on average and over time, the manager had, in the implementation of its investment judgement, demonstrated a sufficiently active approach to justify its fee relative to the investor information provided. For further analysis on the Norwegian case, see our article [here]. While there have been no equivalent cases in the UK, as noted above, one litigation funder has set aside £6.6bn in anticipation of claims arising from overcharging across the industry.

Comment

The challenge for asset managers is how to respond to the competing pressures to do more and charge less.

There are some relatively straightforward things that managers can do to try to mitigate some of the risks. For instance, having clearly documented policies for dealing with corporate actions, participating in class actions and the parameters of any stewardship activity, disclosing these to investors in the interests of transparency and in order to manage the expectations of investors of what they are getting in return for their fees (and so meeting the "value" expectations of the FCA).

6. Frenchman, Carr (2018) Corporate Actions: The case of the missing billions. (November 13, 2018)¬

There are also more involved and expensive responses, including hiring dedicated teams to look and engage with stewardship issues. However, this might be a luxury that is open only to the largest managers with the requisite resources.

As the first round of value for money reporting takes place in the UK, we expect that managers will need to consider carefully how they engage with and oversee their investment portfolio and demonstrate that what they do is in the interests of investors.

Simmons & Simmons LLP has a dedicated Contentious Asset Management team, consisting of dispute resolution specialists in the asset management sector. The Contentious Asset Management team is led by specialists Robert Turner and Paul Baker.

MAKING ELIGIBLE COLLATERAL INTELLIGIBLE

Paul Cluley
Partner
Allen & Overy
paul.cluley@allenovery.com

Of all the ways in which Variation Margin and Initial Margin rules impact non-cleared OTC derivatives, the question of eligible collateral is the most complex. In this note we identify some of the problems, and a solution.

Eligible collateral rules vary by regulator

The many local law mandatory margin rules applicable to non-cleared OTC derivatives have a common ancestor – a G20 decision in 2011 to add margin requirements to the wider reform programme that had been launched in 2009 in the height of the financial crisis.

The Basel Committee on Banking Supervision and the International Organization of Securities Commissions were mandated to develop global standards for margin, and a framework document was published in September 2013. The baton was then passed to global regulators to implement those standards in the markets for which they have responsibility, and those rules have for a long while been in force (or at least proposed / published) in all G20 jurisdictions and beyond.

There are a number of areas in which the rules vary from one jurisdiction to another: the types of OTC derivatives within scope, the settlement cycles for delivery of margin, and the governance requirements for the use of an Initial Margin (IM) model.

However, the area which presents the greatest challenge is eligible collateral – the rules about which types of assets are eligible to be posted or collected as Variation Margin or Initial Margin and the conditions to that eligibility (for instance, minimum ratings and haircut percentages). This is where we find the broadest divergence in policy from one regulator to another, and the biggest challenge in interpretation.

Put simply, it's not just that the eligible collateral rules differ between regulators, you often cannot even read one set of eligible collateral rules against another.

Why does this matter? Why do you care if one regime's rules are different from another's?

It matters because, directly or indirectly, you are often required to comply with an overlap of rules. For instance, you may be directly subject to regulation under both the EMIR rules in the EU and the Prudential Regulator rules in the US. Or you may be subject to direct regulation only in the EU but become indirectly caught by US rules, if your counterparty is US-regulated, then regulators would be required to collect collateral from you in compliance with those rules.

Examples of 'problem assets'

Let's take some real-life examples of where complexity arises:

• Under EMIR rules (and in Japan, Hong Kong, Singapore and pretty much everywhere else frankly), eligibility of debt securities is a function of the credit rating of either the bond itself or the issuer. But not in the US. US rules do not permit any reference to external credit ratings, and creditworthiness is not a factor in eligibility and haircuts.

• Under US and HK rules, a security can be eligible based on the existence of a guarantee. You can assess eligibility and haircuts by looking to the identity of the guarantor. This is not the case under EMIR.

• Fannie Mae and Freddie Mac are huge issuers of debt securities that are commonly used as collateral. And yet their classification varies greatly. Under US rules they are effectively treated as quasi-sovereign – which is in line with how they are regarded in the market generally. But under other regimes they do not enjoy any special status and, given that their issuance is essentially asset-backed, are generally ineligible as collateral.

• Finally, if you are considering equities as collateral, the eligibility is generally limited to the constituents of specified indices (although not always – Canada looks to the market on which they are admitted to trading, for instance). The list of eligible equity indices varies enormously, and in some cases (Hong Kong for instance) there is not even a list of indices but rather a description of the characteristics of an eligible index.

Navigating eligible collateral rules

All of these illustrate the difficulty of assessing eligibility across multiple regimes. We call this "finding the highest common factor" – for any given asset type and combination of regimes, what limitations can you apply to capture as many eligible securities as possible, and with the lowest haircuts, whilst still being fully compliant? Doing this requires a deep understanding of many different regimes, and few people have the time to become experts in the minutiae of regimes – especially those that would not otherwise impact their business.

It is for this reason that AOSphere, an affiliate of Allen & Overy LLP, has launched a new online product **"G20 – Eligible Collateral Checker".** This allows you, with just a few clicks, to identify asset types and rules and generate an easy-to-read report which sets out the highest common factor, with minimum ratings and haircuts, across all relevant regimes.

You can request a free trial of **G20 Eligible Collateral Checker** at: https://www.aosphere.com/aos/g20-ecc

Cash and cash equivalents

Another hot topic, and an example of how different regimes can conflict, is the ability to use cash and/or Money Market Funds (MMFs) as collateral for Initial Margin. Both the EU and US rules contemplate funds as IM collateral, with eligibility, maturities, haircuts (and, in the case of EU, ratings) to be assessed by looking through to the underlying fund assets. The simplest and most liquid of these instruments, money market funds, have surprisingly fallen through the cracks – for a relationship required to comply with both EU and US rules, said funds do not constitute eligible collateral.

This is an astonishing outcome given that the margin rules generally are intended to incentivise the use of high quality, liquid assets – why would they conspire to exclude cash and a cash-equivalent asset like MMFs?

The answer, as is often the case, is the law of unintended consequences which comes into play when individual regulators operate a little too parochially.

The US rules allow cash, but only on the condition that it is immediately reinvested into another form of IM eligible collateral (and MMFs would be the most obvious candidate). The EU rules allow both cash (without the obligation for reinvestment) and funds which are EU UCITS. The problem is that to be eligible as an EU UCITS, the fund needs to have internal liquidity measures that include repo arrangements. To be eligible as a US fund, there is a strict prohibition on the use of repo arrangements. The two positions conflict and cannot be reconciled.

Industry bodies are lobbying the EU and US regulators to remove the obstacles on both sides – to extend the EU rules to allow non-EU collective investment undertakings (and therefore sidestep the requirement for repo-based liquidity) and amend

the US rules so that funds can use repo and securities financing techniques and still be treated as eligible.

Until that happens, the ability to use cash and cash-equivalents as Initial Margin for cross-border relationships is subject to serious limitations – despite being the asset at the top of the BCBS/IOSCO guidelines for eligible collateral and having the lowest valuation haircut (of 0%, if denominated in the relevant termination currency).

Eligible Collateral check list for IM Phase 5 & 6 firms

So, if you are coming into scope for IM rules, what questions do you need to start asking about eligible collateral?

• What regime combinations will my relationships be subject to?

• Are substituted compliance rulings available to simplify the analysis?

• What assets will I readily be able to access to post as IM collateral?

• What eligibility rules (including ratings, maturities and haircuts) will those assets be subject to?

• Looking at the last two questions, what does my optimum posting portfolio look like?

• Will I be delegating asset selection to my custodian (the "triparty" service) or will I choose my assets and check and value my counterparty's posting myself (the "third party" approach)?

• If triparty, how can I express my collateral choices in the operational documents required by my custodian?

• Will I insist on symmetry between my posting and

collecting collateral rules?

• Are there some assets that I just cannot accept, perhaps for commercial / risk monitoring reasons or because I do not trade them and would not be able to liquidate them quickly enough?

• Am I happy with the regulatory eligibility rules, or would I want to make them tighter? For example, add maximum maturities, increase the haircuts, impose a higher minimum rating.

• Are there some characteristics (e.g. subordinated, structured, inflation-linked, coupon-stripped) that I just will not accept or that I want to apply different terms to?

It is no surprise that eligible collateral tends to be amongst the first topics on dealers' agendas when they start IM repapering discussions with Phase 5 institutions. It pays to start thinking early about what you are willing to post and collect, and using a tool like **G20 Eligible Collateral Checker** to understand how the rules might impact your choices.

CHALLENGES FROM VOLATILITY IN OVERNIGHT MONEY MARKETS

The research views expressed herein are those of the author and do not necessarily represent the views of CME Group or its affiliates. All examples in this presentation are hypothetical interpretations of situations and are used for explanation purposes only. This report and the information herein should not be considered investment advice or the results of actual market experience.

How much volatility in the overnight secured financing market is appropriate for the Federal Reserve (Fed) to allow? This is a key question with which the Fed has been grappling after the unexpected spike in the overnight rate on 17 September 2019. And, the anticipated volatility of overnight financing has significant implications for how asset managers, and particularly leveraged hedge funds, finance their risk positions – overnight or with term financing.

On the 17th of September 2019, the median secured overnight financing rate (SOFR) traded at 5.25% compared to the usual 2.13%, with the highest 1% of trades occurring at or above 9.00%. To contain the spike in rates, and to make sure there was no re-occurrence at year-end 2019, the Fed pumped a massive amount of liquidity ($400 billion) into the financial system through purchases of Treasury bills and overnight and term repurchase operations. The liquidity injection did the trick, in terms of not allowing any repeat of the mid-September spike. Year-end 2019 came and went with hardly a ripple in the overnight secured financing market.

To appreciate the overnight money market volatility conundrum the Fed faces, we need to examine the issue from several perspectives. First, we will look at the history of overnight money market volatility, including a look at how the Fed's targeting of the federal

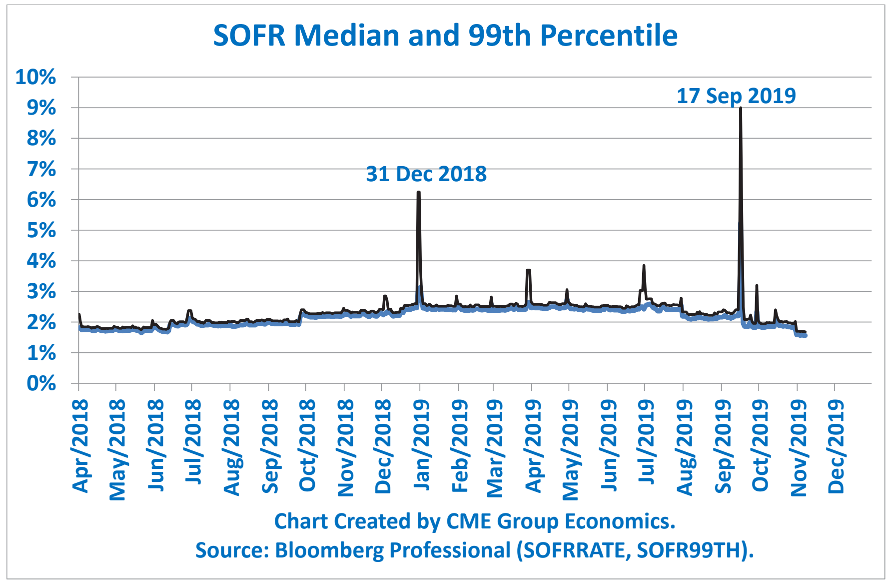


Chart Created by CME Group Economics.
Source: Bloomberg Professional (SOFRRATE, SOFR99TH).

Blu Putnam
Chief Economist
CME Group
bluford.putnam@cmegroup.com

funds rate has changed since the Great Recession of 2008-2009 – especially compared to the Greenspan era in 1990s and early 2000s. We will then discuss the challenge that an expanded balance sheet poses for the Fed in enforcing its short-term interest rate policy. Finally, we will look at how money market volatility aligns with the Fed's choice of rates, as well as contemplating how the expected volatility might impact how overnight market participants chose to manage these risks – including using CME SOFR futures & options, and term repurchase agreements.

History lesson: The Fed was once very comfortable with volatility in overnight rates

A little history of the volatility of the overnight money markets is instructive. We only have detailed daily data, from the Federal Reserve Bank of New York, on the overnight secured financing market (SOFR) from April 2018 – but we can look at the volatility of the overnight federal funds market much further back in time. Indeed, we can observe several different phases of volatility in overnight money markets.

Essentially, recent history (from the 1990s) suggests there have been four phases of overnight rate volatility. In the 1990s and into the early 2000s, the Fed was relatively aggressive in its short-term interest rate management. Under the guidance of Chair Alan Greenspan the Fed was regularly changing policies, often with the objective of fine-tuning the economy and inflation prospects. During this period, overnight federal funds experienced an annualized standard deviation of around 3%, and occasionally much higher. After the equity market tech wreck in 1999-2001, as well as the 9-11 attack in 2001, the Fed eased its target federal funds rate to 1% and held it there for several years. During this "1% rate period," overnight money

Secured Overnight Financing Rate and Federal Funds Rate

August 2019 versus 17 September 2019

Secured Overnight Financing Rate	August 2019 Average	17 September 2019	Federal Funds Rate	August 2019 Average	17 September 2019
SOFR 1st Percentile	2.08%	2.25%	Fed Funds 1st Percentile	2.06%	2.05%
SOFR 25th Percentile	2.12%	5.00%	Fed Funds 25th Percentile	2.10%	2.15%
SOFR Median Rate	**2.13%**	**5.25%**	**Fed Funds Median**	**2.13%**	**2.30%**
SOFR 75th Percentile	2.20%	5.85%	Fed Funds 75th Percentile	2.13%	2.50%
SOFR 99th Percentile	**2.27%**	**9.00%**	**Fed Funds 99th Percentile**	**2.18%**	**4.00%**

Source: Data from the Federal Reserve Bank of New York through the Bloomberg Professional (SOFR1ST, SOFR25TH, SOFRRATE, SOFR75TH, SOFR99TH, FEDLPE1, FEDLPE25, FEDL01, FEDLPE75, FEDLP99)

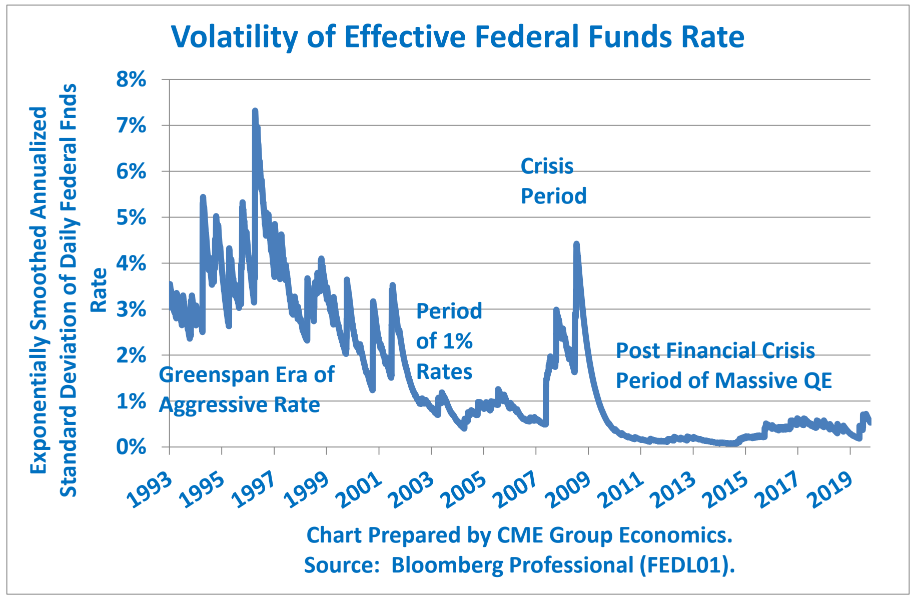


Chart Prepared by CME Group Economics.
Source: Bloomberg Professional (FEDL01).

market rate volatility dropped under 1%. This period of calm was shattered by the financial panic in 2008, which introduced a period of significant counterparty risk, and volatility spiked. The financial panic was followed by the post-Great Recession era of very low rates and Fed asset purchases, known as quantitative easing (QE). During the post-Great Recession era, overnight federal fund rate volatility fell to near zero, and then rose marginally as the modest unwinding of QE commenced.

Role of Fed's balance sheet in complicating challenge of managing overnight rates

QE changed the way the Fed enforced its federal funds target (now a range) to relying on the interest rate paid on deposits at the Fed, including excess and required reserves of the financial system. Prior to the QE era, the Fed had used repurchase (repo) activity to enforce its desired federal funds target rate. And, the Fed was typically willing to accept some meaningful volatility in the money market rates. Although this willingness declined materially in the 2002-2006 period compared to the 1993-2001 period of more active interest rate management under Chair Greenspan.

The introduction of QE as a policy tool meant that the amount of excess reserves, held as deposits by financial institutions at the Fed, ballooned from nearly nothing to over $2 trillion at its peak in 2014. It is also critical to note that prior to the financial panic in 2008, the Fed paid 0% interest on required and excess reserves, which is why banks did not like to hold excess reserves prior to 2008. The decision in late 2008 to start paying interest on deposits

Once the Fed stopped expanding its balance sheet in 2015, and then shrinking it materially in 2017, the impact on excess reserves was especially significant. The composition of the Fed's liabilities matters. With outstanding currency (paper money in circulation) growing faster than nominal GDP, and with the Fed accepting deposits from a variety of non-bank institutions (including the US Treasury), the Fed's actual total of banking sector deposits declined much more rapidly than its overall balance sheet. And, it is the banking system's deposits at the Fed that determine excess reserves and provide the liquidity for overnight financing markets.

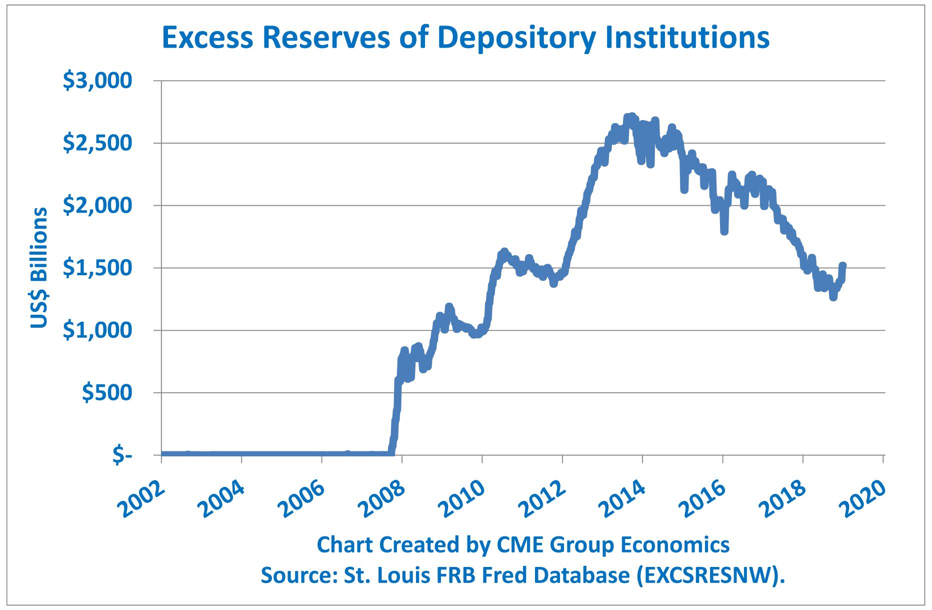
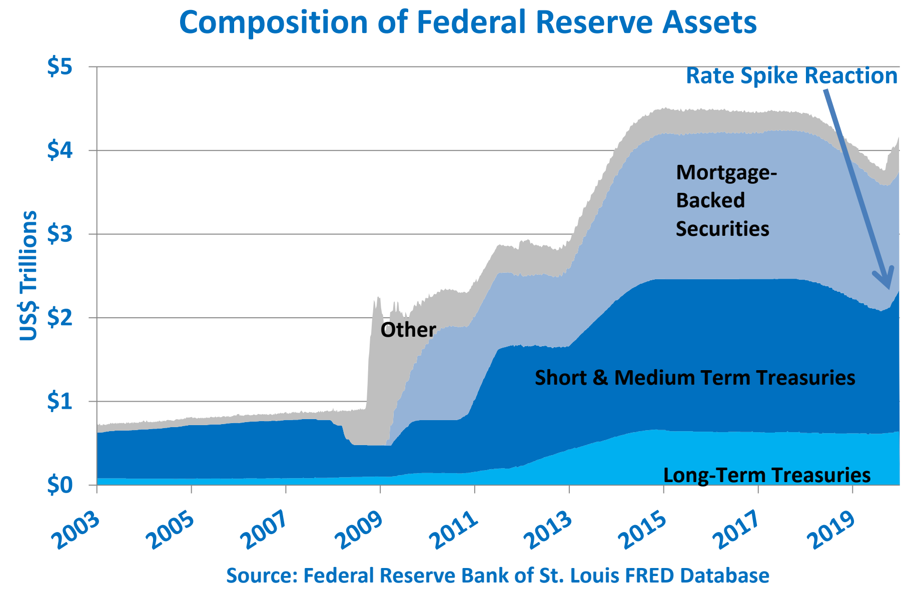


Chart Created by CME Group Economics.
Source: St. Louis FRB Fred Database (EXCSRESNW).



Source: Federal Reserve Bank of St. Louis FRED Database

Overnight financing markets, including federal funds, have often had small spikes at quarter and year-end days, partly due to bank window dressing ahead of publishing data on their assets and liabilities. Yet on 17 September 2019, there was a perfect storm of money flowing into the US Treasury's account at the Fed – coming from banks (and their customers) to purchase US Treasuries (there had been a big auction to settle) and also to make Q3 corporate tax payments. This activity reduced excess reserves dramatically and contributed to the spike in overnight secured financing rates.

One might ask why banks did not see an opportunity in the repurchase (repo) market to earn unusually high returns, even if only for a day. Of course, banks did see the opportunity, but their ability to move quickly to allocate capital to back expanded repo lending was hindered by various post-Great Recession capital regulations designed to limit bank proprietary trading. And, banks also had the choice of owning short-term Treasury bills instead of participating in the repo market. Again, the choice was based as much on capital requirements, which favor T-bills, versus proprietary activity in the repo market (larger capital haircut).

The Fed, caught by surprise, acted aggressively to calm the overnight markets by buying Treasury bills and providing overnight and term lending facilities to the repo market. From end-August 2019, before the SOFR rate spike, the Fed balance sheet was $3.76 trillion, and after the SOFR rate spike the balance sheet ballooned by $400 billion to $4.17 trillion by end-2019 to make sure the overnight money markets were calm at year-end.

The Fed's decision on how to manage volatility in overnight money markets will impact the demand for term lending in the repurchase (repo) market. As greater volatility in the overnight rates increases the importance for asset managers and others to use term-lending facilities to diminish the risks of an overnight spike. Put another way, the lack of volatility in overnight money rates, both federal funds and secured overnight financing, has probably contributed to the decline in the use of term-lending facilities as well as the use of short-term deposit markets, such as LIBOR (London Interbank Eurodollar deposit rates).

Bottom Line: The Fed has some conflicting objectives to balance

The Fed currently targets the federal funds rate as the key policy instrument for short-term rates. Many members of the Fed's Federal Open Market Committee (FOMC) are known to be interested in exploring whether the Fed should target a more representative market rate. After all, activity in overnight federal funds is less than $100 billion a day, while the overnight secured financing market trades almost $1 trillion on any given day. This has led some analysts to wonder whether the Fed will switch, at some point in the next year or two, to targeting SOFR instead of federal funds.

When the Fed targets a rate, the credibility of the policy decision depends on the Fed's ability to hit the target. That is, if there is considerable volatility in the target rate, then the Fed might lose some credibility in terms of its ability to enforce the target.

There is also the matter of indirect consequences to consider. If the Fed wants to facilitate a smooth transition to the use of SOFR as a reference rate for floating-rate financing activity, then encouraging the use of term repurchase agreements would fit well into this objective. This means the Fed has some incentive not to eliminate all the volatility in overnight rates, as that would mean less incentive for market participants to use term-lending facilities.

Another issue is the management of the overall size of the Fed's balance sheet. When the Fed embarked on QE, it was all about asset purchases. What many analysts pointed out, including ourselves, is that liabilities matter. Large parts of the liability side of the Fed's balance sheet are determined by market demand – such as currency outstanding or deposits of non-bank institutions – and these are growing much faster than bank deposits with the Fed. If the amount of bank excess reserves is a contributing factor to the liquidity in overnight money markets, then the Fed balance sheet policy must keep a sharp eye on growth of non-bank liabilities and how this impacts excess reserves of banks.

Finally, the Fed has to consider the changing environment of bank regulations impacting capital requirements. As capital requirements for banks have generally increased and become more specific since the financial panic of 2008. Even if banks see opportunities for profitable lending, as occurred on 17 September 2019 with the SOFR spike, then banks may not respond if capital requirements constrain them or favor other activities (such as owning US Treasury bills outright). This issue feeds into how much risk should be allowed. As the elimination of risks, such as overnight rate volatility, has the potential to feed the search for yield and contribute to a more risky financial system, not a less risky one.

The bottom line is that the Fed faces a complex set of challenges as it decides how to manage the volatility of money market rates. The $400 billion spent expanding liquidity after the mid-September rate spike worked to create year-end stability, but it also does not seem like a sustainable policy and it reversed the modest shrinking of the balance sheet. As the Fed grapples with how to manage short-term money market rates, the decision of what rate to target; the desire to encourage term lending; the desire not to encourage risk taking by eliminating certain risks; and the credibility of rate targets, all come into play. What the Fed decides to do for the longer-term will say a lot about its monetary policy priorities, as well as inform asset managers of the expected risks in the overnight financing markets. Fortunately, market participants have SOFR futures and options as well as term repo facilities to use as tools for hedging overnight rate volatility.

CHANGES TO HEDGE FUND ADVERTISING RULES

Jeff Berman
Partner
Clifford Chance US LLP

Jeffery LeMaster
Partner
Clifford Chance US LLP

Andrew Nelson
Associate
Clifford Chance US LLP

Krishna Skandakumar
Associate
Clifford Chance US LLP

On Nov. 4, 2019, the SEC proposed amendments (the **"Proposed Amendments"**) that would comprehensively modernize the Advertising Rule and make it relevant to a 21st-century hedge fund industry.

The SEC is proposing a one-year transition period beginning on the effective date of the Proposed Amendments once it is adopted.

Advisers would be permitted to rely on the amended Advertising Rule as soon as they are able to comply with its conditions but would not be required to do so until the end of the transition period.

Summary

• **The Proposed Amendments are intended to provide a "principles-based" approach.** In its proposing release, the SEC stated that "[t]he proposed rule would replace the current rule's broadly drawn limitations with principles-based provisions" and would impose "general prohibitions of certain advertising practices, as well as more tailored restrictions and requirements that are reasonably designed to prevent fraud with respect to certain specific types of advertisements." By "articulating a disclosure concept" in lieu of specific requirements and prohibitions, the Proposed Amendments aim "to accommodate the continual evolution and interplay of technology and advice."

• **As amended, the Advertising Rule would expressly cover communications with hedge fund investors.** The Proposed Amendments would revise the definition of "advertisement" (discussed below) to include any communication "that offers or promotes the investment adviser's investment advisory services or that seeks to obtain or retain one or more investment advisory clients or investors in any pooled investment vehicle advised by the investment adviser." A "pooled investment vehicle" would be defined to include either (i) an "investment company" under the Investment Company Act of 1940, as amended (the "**1940 Act**"), or (ii) a company (such as a hedge fund) that would be an "investment company" but for Section 3(c)(1) or Section 3(c)(7) of the 1940 Act. The definition of "advertisement," however, would exclude advertisements and sales literature relating to hedge funds and other registered investment companies.

• **The Advertising Rule would continue to apply to registered investment advisers only, and not exempt reporting advisers.** Despite the SEC's recent tendency to make new rules adopted pursuant to Section 206(4) of the Advisers Act (such as Rule 206(4)-5, the "pay-to-play" rule) applicable to both registered investment

advisers and advisers relying on an exemption from registration, the amended Advertising Rule would continue to apply only to registered investment advisers. Exempt reporting advisers, including US and non-US fund managers relying on the "private fund adviser exemption," while not bound to comply with the specific requirements of the Advertising Rule, would remain subject to the Advisers Act's general anti-fraud provisions (including Rule 206(4)-8 with respect to pooled investment vehicles). Moreover, we would note that exempt reporting advisers should also consider any changes in general market practice and investor expectations that result from adoption of the Proposed Amendments.

• **As amended, the Advertising Rule would distinguish between "retail" and "non-retail" clients and investors.** The amended Advertising Rule would, for the first time, draw a distinction between clients and investors that are "qualified purchasers" for purposes of Section 3(c)(7) of the 1940 Act or "knowledgeable employees" as defined in Rule 3c-5 under the 1940 Act ("**Non-Retail Persons**") and all other clients and investors ("**Retail Persons**"). In the limited circumstances in which the Proposed Amendments apply the Non-Retail/Retail distinction – all involving the communication of performance results (discussed below) – the requirements for advertisements distributed only to Non-Retail Persons are substantially less prescriptive.

OTHER SIGNIFICANT CHANGES

• The Proposed Amendments would thoroughly rework the definition of "advertisement" to mean "any communication, disseminated by any means, by or on behalf of an investment adviser, that offers or promotes the investment adviser's investment advisory services or that seeks to obtain or retain one or more investment advisory clients or investors in any pooled investment vehicle advised by the investment adviser." Advertisements would exclude "live oral communications" that are not broadcast on radio or television, over the internet or by way of social media. Nor would an advertisement include a "communication by an investment adviser that does no more than respond to an unsolicited request for information specified in such request," unless (i) the communication is made to a Retail Person and includes performance results or (ii) the communication includes hypothetical performance (discussed below). Finally, as noted above, the definition of "advertisement" would exclude advertisements and sales literature relating to hedge funds and other registered investment companies.

• As amended, the Advertising Rule would still provide that an advertisement may not include any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading. The Proposed Amendments list a number of additional general prohibitions – the "principles" on which the amended Advertising Rule would be based – under which an advertisement may not:

• include a material claim or statement that is unsubstantiated;

• include an untrue or misleading implication about, or reasonably be likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to the investment adviser;

• discuss or imply any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without clearly and prominently discussing any associated material risks or other limitations associated with the potential benefits;

• include a reference to specific investment advice provided by the investment adviser (referred to as a "past specific recommendation" in the current Advertising Rule) where such investment advice is not presented in a manner that is fair and balanced;

• include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced; or

• otherwise be materially misleading

Performance Information/Track Records

In its proposing release, the SEC discusses – and, where noted below, the Proposed Amendments include – "more tailored restrictions and requirements" intended to give effect to the above principles requiring references to specific investment advice and the presentation of performance results to be "fair and balanced."

• Gross and net performance results. As amended, the Advertising Rule would prohibit "[a]ny presentation of gross performance, unless the advertisement provides or offers to provide promptly a schedule of the specific fees and expenses (presented in percentage terms) deducted to calculate net performance." An advertisement distributed to Retail Investors, however, must actually present net performance (instead of merely providing a schedule of deductions to calculate net performance), calculated using the same time period and methodology as, and with equal prominence to, the presentation of gross performance.

• Cherry-picking and extracted performance. With limited exceptions, the amended Advertising Rule would prohibit an advertisement from including related performance – i.e., the performance results of portfolios "with substantially similar investment policies, objectives, and strategies as those of the services being offered or promoted" ("**Related Portfolios**") – unless the advertisement includes performance of all Related Portfolios. Similarly, the Advertising Rule would prohibit an advertisement from including the performance results of a subset of investments extracted from a portfolio (so-called "extracted performance") unless the advertisement provides or offers to provide the performance results of all investments in the portfolio.

• Hypothetical performance. As amended, the Advertising Rule would permit an advertisement to include performance results that were not actually achieved by any of the investment adviser's client portfolios – i.e., "hypothetical performance" – only in specific circumstances. Hypothetical performance includes (i) performance derived from representative model portfolios that are managed contemporaneously alongside portfolios managed for actual clients, (ii) performance that is backtested by the application of a strategy to market data from prior periods when the strategy was not actually used during those periods, and (iii) targeted or projected performance returns with respect to any portfolio or to the investment services offered or promoted in the advertisement. The amended Advertising Rule would permit an advertisement to include hypothetical performance, but only if the investment adviser provides sufficient information "to enable a recipient of the advertisement to understand the criteria used and assumptions made in calculating such hypothetical performance" and "the risks and limitations of using such hypothetical performance in making investment decisions."

• Track records portability. Regarding the circumstances under which an investment adviser may advertise the performance results of Related Portfolios that were advised by the adviser when it was part of, or by the adviser's investment personnel when they were employed by, another firm (the "Predecessor"), the Proposed Amendments appear to rely more fully on a principles-based approach. The SEC's proposing release confirms that a Predecessor's performance results must comply with the "more tailored restrictions and requirements" applicable to Related Portfolios generally (such as with respect to cherry-picking and the use of extracted performance). However, with respect to the specific issues concerning the "portability" of a Predecessor's track record – e.g., whether investment personnel "primarily responsible" for the Predecessor's performance will be primarily responsible for the advisory services offered or promoted in the advertisement, or whether a "substantial identity of personnel" exists between the investment committee at the Predecessor and the investment committee at the advertising adviser – the proposing release is notably less definitive.

On the one hand, the SEC appears to suggest that the relevant SEC staff ("**Staff**") guidance, including the Great Lakes (1992) and Horizon (1996) no-action letters, continues to be valid and, in fact, none of the Staff guidance relating to track record portability is included in the proposing release's list of no-action letters being reviewed for possible withdrawal. The SEC also seems to suggest, on the other hand, that disclosure of all material facts may be enough to cure an otherwise misleading presentation of a Predecessor's performance results, contrary to the Staff's apparent position in Great Lakes and Horizon that Predecessor performance, without the appropriate continuity of investment personnel, is misleading per se. Indeed, the proposing release specifically requests comment on whether the Proposed Amendments should be modified to condition the use of Predecessor performance on compliance with the "primarily responsible" and "substantial identity of personnel" standards – an indication that track record portability is, at least for the time being, a matter of principles.

Testimonials, Endorsements and Third-Party Ratings

The Proposed Amendments would lift the general ban on testimonials, endorsements and third-party ratings in the current Advertising Rule. Instead, the amended Advertising Rule would take a more nuanced approach. Client and investor testimonials and third-party endorsements would be permitted so long as the advertisement clearly and prominently discloses (i) whether a testimonial or endorsement was given by a client or investor or by a third party and (ii) if compensation was provided to the person giving the testimonial or endorsement. Third-party ratings or rankings would be permitted in an advertisement so long as "the investment adviser reasonably believes that any questionnaire or survey used in the preparation of the third-party rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses" and the advertisement clearly and prominently discloses (i) the date of, and period of time covered by, the third-party rating, (ii) the identity of the third party who created and tabulated the rating, and (iii) if compensation was provided in connection with obtaining or using the third-party rating.

CYBERSECURITY ISSUES FOR INVESTMENT FUNDS

MEASURES TO MITIGATE A GROWING THREAT

Robert Humann
Director
SS&C GlobeOp

In early 2019, an email began circulating among fund firms that appeared to be from a legitimate researcher.

It referred to rumors that the European Securities and Market Authority (ESMA) was considering suspending short selling under Brexit, and offered a briefing document on the topic. When recipients clicked on the link to obtain the briefing they were greeted with a blank page, raising suspicions that the email was planting malware in the firms' systems. Those fears were further exacerbated when the purported attacker boasted about having compromised several firms in an online forum, and threatened more.

Whether this "phishing" attempt was an actual cyber attack or an elaborate hoax, as some suspect, it nonetheless underscored the vulnerability of funds to cyber threats. The financial services industry is the primary target of cyber thieves, and as a growing industry sector, funds can no longer assume they are too small or too far under the radar to be victims.

What is at risk?

What makes funds attractive targets for malicious actors? The most valuable commodity on the dark web is sensitive, confidential client data, what security experts call personally identifiable information or PII. In the PwC 2018 Global State of Information Security survey for Mainland China and Hong Kong, customer records were the most commonly acknowledged target of security infractions. Fund firms also hold valuable trade secrets, such as proprietary research or trading algorithms, which could cause serious financial and reputational damage if compromised. And of course, there are the fund assets themselves – sophisticated thieves are not simply after data, but are employing nefarious means to steal money from funds, financial gain being among the top motivators for a cyber attack.

Apart from these direct risks, funds also face regulatory pressure to make sure they have security controls and incident response plans in place. Under the EU's GDPR, fund firms have a fiduciary duty to protect their clients' data and assets. In the US, the SEC has made cybersecurity a priority in exams. The UK's FCA outlines several cyber-resilience principles that firms are expected to follow, and firms are required to notify the authority of any actual or suspected breach or incident. Other global regulators such as ASIC (Australia); CIMA (Cayman); CSSF (Luxembourg); CBI (Ireland); and the SEC (USA), amongst others, have all published guidelines. Weak controls put firms at risk for regulatory sanctions.

Types of attacks

Given these risks and responsibilities, it is vital to be aware of the types of attacks to which your firm is most likely to be subjected.

Business email compromise (BEC) or "phishing" attacks, like the one cited earlier, are the most common type of attack, reportedly the starting point for 90% of data breaches. These attacks prey on human negligence and naivete, duping employees into divulging sensitive information, or clicking on links or attachments that unleash malware giving attackers entrée to a firm's network and the data and applications residing within.

Employee device compromise similarly exploits human mistakes. As employees increasingly use their personal laptops or mobile devices for work, a stolen device can give attackers easy access to their firm's systems and data.

Funds are also likely targets of ransomware attacks, in which the attacker shuts down critical operations in demand for payment. Ransomware attackers are clever. They purposely keep their ransom demands comparatively low so that victims will be inclined to pay, knowing the cost of lost business or client lawsuits would be much higher. Similarly, a bad actor may launch a distributed denial of service (DDoS) attack that can disrupt critical business activity, such as trading, or target a client portal, making it impossible for investors to get information or communicate with the firm.

The reasons for targeting funds also vary widely. Theft of data and financial gain, as noted earlier, are the most common. Competitive espionage, sometimes abetted by state actors, is another motivation. Firms may also be targeted by disgruntled current or former employees, or by "hacktivists" who

want nothing more than to make a statement by sowing disruption.

Assessing the costs

Data on the costs of cyber attacks is widely inconsistent and can be misleading, in part because breaches have become so pervasive that it's hard to keep up, but also because there are many different cost components. First, there is the actual direct financial losses to the fund and its investors, if thieves succeed in gaining access to fund accounts. Even if there are no direct losses, there are costs associated with repairing the damage, including attack investigation and remediation, hardware and software replacement, crisis management and client notifications.

A compromised firm will likely be subject to regulatory fines and sanctions, as well as investor lawsuits and legal fees.

Add all these components up and you can see how the cost can quickly escalate beyond the initial damage or financial loss. Less easily quantified is the lasting reputational damage and loss of investor confidence, which will likely result in client defections and raise hurdles to future fundraising efforts.

Basic internal security measures

Unfortunately, there is no cybersecurity silver bullet. There are, however, a combination of measures firms can and should take to minimize the risk of a breach, and to mitigate the impact when (not if) a breach occurs.

Understanding that a firm's most glaring vulnerability is often the human element, employees need to be trained, educated and equipped to recognize phishing emails and beware of clicking on or responding to an email from an unknown source. Firms should also have polices restricting or governing the use of personal and portable devices for business purposes. Devices should be secured with access controls and password protection.

Conduct an independent threat assessment with a cybersecurity consultant to identify gaps and vulnerabilities. Invest in a robust security infrastructure. This investment includes firewalls and intrusion prevention systems, but also includes automated breach detection and response capabilities to mitigate the impact of threats that succeed in penetrating perimeter defenses. Firms should also have an offsite business continuity and disaster recovery backup. Regulators will expect firms to have written incident response plans delineating roles and responsibilities and actions to be taken. Moreover, they will expect you to be performing due diligence on technology and service providers, vendors and other third parties whose systems interact with your firm's – not just at the outset of a relationship, but continuously.

SS&C: What we're doing

"We've invested heavily in security measures," says Chief Technology Officer Anthony Caiafa, "including the deployment of a global Security Information and Event Management (SIEM) system to gather threat intelligence from a variety of sources and correlate it with our systems internally to ensure we have a secured environment, we have also partnered with an industry-leading provider of email protection solutions to flag and block suspicious emails and spam."

UNDERSTANDING THAT A FIRM'S MOST GLARING VULNERABILITY IS OFTEN THE HUMAN ELEMENT, EMPLOYEES NEED TO BE TRAINED, EDUCATED AND EQUIPPED TO RECOGNIZE PHISHING EMAILS AND BEWARE OF CLICKING ON OR RESPONDING TO AN EMAIL FROM AN UNKNOWN SOURCE.

Security is a shared responsibility

Alternative fund firms and their service providers have a shared responsibility to implement security safeguards. Each party's responsibilities should be clearly delineated at the outset of the relationship and continually monitored. Fund managers should be mindful of regulatory requirements and expectations around security, equip employees to be the first line of defense against cyber thievery, and invest in technologies to guard against both external and internal threats. Service providers should be prepared to demonstrate the measures that they have taken to protect client data and assets in their care. Working proactively and keeping each other informed, fund managers and service providers can reduce the risk that they will fall victim to increasingly sophisticated threats targeting the fund industry.

"We've invested heavily in security measures including deployment of a global SIEM [Security Information and Event Management] system to gather threat intelligence from a variety of sources and correlate it with our systems internally to ensure we have a secured environment. We have also partnered with an industry leading provider of email protection solutions to flag and block suspicious emails and spam."
CHIEF TECHNOLOGY OFFICER
ANTHONY CAIAFA

THE (IL)LEGALITY OF SECURITY TOKENS

George Salapa
Co-Founder
Bardicredit
george@bardicredit.com

Crypto has gotten a bad rap with people. Strangely, the biggest issue seems to be that people don't trust crypto in general, which is outright strange given that trust was supposed to be the 'main thing' about blockchain.

Sometimes too good is not good at all. Billions have flown into crypto during the ICO heyday, but to what use? Flawed business models have been built on a pre-mature technology. Arguably, this all but hurt blockchain.

Question: has crypto been an overtly complex plan by techies to loot the poor?

Anytime people come up with a new use case for blockchain, it is burdened by the negative reputation. Security tokens, for one, have had a hard time to not look like a last ditch effort to raise money by those who failed during the ICO bubble.

Not fair? Security tokens are a digital representation of investments like stocks and bonds. Unlike traditional financial instruments, security tokens can be pre-programmed to 'automate away' many functions that are currently undertaken by institutionalized middlemen. I have covered this subject in much more detail in , but in essence: whenever someone buys a stock, in order for the transaction to take place, a convoluted network of custodians, brokers, clearing houses and central depositaries goes to work to record and execute the transaction. And all along, they all maintain their own record of truth in their own ledger which they try to reconcile between each other. It is a system that has evolved naturally and historically from paper stocks and bonds. In some more complex situations, this system is beginning to show signs of age.

But that is besides the point. The bigger question: how long can the financial infrastructure stay analog? Nothing that has ever gone from analog to digital reverted back. That's why security tokens are important - they have shown the world that it is possible to automate functions that have always required verification by some form of institutionalized authority.

A security token is a digital record of ownership. It is a line of code that keeps track of who owns how much of some total balance, and that gets continually updated whenever a transfer of that balance takes place between parties. The transfers themselves can also be restricted depending on certain conditions which can be written in code, so that for example a particular security token cannot be sold to investors before they undergo checks to prove their source of wealth, the results of which are recorded on blockchain only to be picked up by the code to decide if the transfer can take place.

Similarly, dividends can be automated using a line of code. A smart contract can be deployed alongside the security tokens to execute certain action when specific conditions are met. For example, the smart contract can be fed information from the internet through an oracle about the date, so that on 31 December 2019, it can automatically send out dividends to all owners of that particular security token. It can also automatically withhold a portion of these payments to account for the withholding tax (for each tokenholder the amount withheld would be different, depending on the tax domicile of the tokenholder, which will be picked up by the code from the record of the checks mentioned above).

Consider for a moment the efficiency that can be achieved with securities that are pre-programmed in this way to remove the need for human work. It is just as impactful that none of these actions - trading, voting, dividends - require approval of centralized authorities because they are performed by a computer code. And since everything will be recorded on one immutable ledger, any errors that could be caused by human factor are completely eliminated.

Derivatives are financial products whose value is derived from some underlying asset or relationship. The level of complexity (and hence the need for institutional involvement and oversight) is much higher with derivatives than traditional financial primitives like equity or debt. This is where the discussion gets really exciting. High-value derivatives are in the form of legal agreements between two parties that may last many decades. The oversight and management of these legal relationships can be very expensive and paperwork-heavy. Smart contracts on blockchain can automate the execution and performance of the derivatives by converting operational aspects of the legal contracts to computer code. This can include rights, prohibitions and obligations, any related calculations, as well as the execution of actions depending on certain conditions (e.g. time or change in interest rate). A computer code can easily observe time, and automatically exchange payments between two parties on an interest rate swap.

History shows that financial innovation tends to be extremely impactful. The rise of stock market catapulted Brits and Dutch to become dominant global superpowers in the 17th century. Security tokens may seem like the obvious next stage in the evolution of finance, but their adoption is (and will continue to be) slow and problematic. This is partly due to the fact that the technology is still far from perfect. Discussion of the technological challenges would deserve an article of its own, but in essence there is the a) lack of interoperability between different protocols, b) limited scalability given the size and complexity of smart contracts.

Technology can be improved, and most of these challenges can be overcome. Several projects are already underway with a mission to develop blockchains dedicated to security tokens, albeit if in different forms.

A much bigger issue is that security tokens attack the institutional establishment of today's financial markets. New technologies tend to face slow adoption. People don't like to get out of their comfort zone, learn and test new things. But, in the case of security tokens, the change is not only uncomfortable, but downright hard.

By its very design, a security token eliminates the need for middlemen, but this is a contradiction to legal systems of most countries of the world, which requires exactly that: oversight by institutionalized middlemen like custodians. Few countries outside of Europe have embraced security token, and some, like the U.S., prefer to somewhat ignore their existence. Most security token offerings in the U.S. have indeed been restricted to private investment rounds offered to accredited investors only. Few have attempted to register a full public offering with SEC, and those that have, ended up paying dearly for the process and costs. Blockstack, which has filed under RegA+ exemption notes that the fees for the process amounted to $3M, including the development of a new blockchain just for that.

And not even that gives the company full clarity. The offering simply doesn't add up with the current regulatory framework. Blockstack explains some of those uncertainties in their Offering Circular. Because their securities (tokens .. sorry) do not need, for example, a central depositary (because transactions are cleared automatically on blockchain as a consensus of computers), they could be classified to perform the function of a transfer agent.

It is evident that wider application of security tokens requires rewriting rules, and that is not easy. Some European countries have done better than others. Several European countries will soon adopt their versions of a 'blockchain act', which gives firm legal grounding to many elements of the blockchain technology. Legal systems of some countries, like Liechtenstein, for example, are technology agnostic, which means that security tokens are recognized by law as just another alternative form of financial instrument, so that the local regulators accept and can also approve full public offerings of security tokens in accordance with European Prospectus Directive.

Even where the law is more welcoming and progressive, security tokens remain for now a more efficient instrument for crowdfunding and capital formation at a lower cost to the issuer thanks to the inbuilt automation and digitalization of the process.

But, this is nothing to scoff at. Public markets are a fraction of the global wealth. There are trillions (and more) of private assets in the world that could be securitized with tokens. Common (retail) investors have very limited choices of what they can invest in, which is especially frustrating in the current negative yielding market environment.

ASIA PACIFIC'S NEW CORPORATE FUND STRUCTURES

Caleb Wong
Head of Alternatives, Asia-Pacific
BNP Paribas Securities Services

Caleb Wong outlines the virtues of OFC, CCIV & VCC. "The introduction of new fund structures in Asia Pacific comes at a time of increased efforts to develop a single regional market for funds through various cross-border passporting schemes."

Hong Kong, Australia and Singapore recently introduced new corporate fund structures (the OFC, CCIV and VCC respectively), which are designed to be internationally competitive and entice asset managers to domicile investment funds in the Asia Pacific (APAC) region. Although each of these new structures shares similar goals, there are important differences between the three vehicles.

Getting to grips with OFC, CCIV & VCC

Asset managers need to consider a number of factors, including regulatory, competitive and investor demands, when considering where to domicile their investment fund offerings.

In APAC, where assets are forecast to double from their 2016 levels to nearly $30trn by 2025, Australia, Singapore and Hong Kong are looking to further build and reinforce their positions as regional asset management hubs. Regional governments and regulators are committed to attracting investment, increasing cross-border trade and regulatory cooperation to create a dynamic and globally competitive funds management industry.

The introduction of new fund structures in Asia Pacific comes at a time of increased efforts to develop a single regional market for funds through various cross-border passporting schemes -- notably, the ASEAN Collective Investment Scheme (ASEAN CIS), the Asia Region Funds Passport (ARFP) and various bilateral schemes such as the HK-China Mutual Recognition of Funds (MRF) scheme.

Hong Kong's Open-Ended Fund Company (OFC)

Hong Kong's mutual funds have not been able to accommodate diverse needs from fund providers, though its laws have long allowed asset managers to set up investment funds in a unit trust structure. The OFC allows them to set up under a corporate structure.

Unlike a unit trust structure, the OFC does not require a trustee, but acts for and on behalf of itself. Additionally, its enabling law – the Securities and Futures Ordinance – permits it a variable capital structure, which is not the case with companies formed under the Companies Ordinance. An OFC is also simpler and cheaper because it only requires compliance with Hong Kong legislation.

An OFC can have an umbrella and sub-funds structure, and the law supports cross-investment of sub-funds. It can be public or non-public, and must have a board of directors with at least two individual directors. It must appoint a fund manager, an external auditor, and a custodian who has responsibility for all safekeeping of assets.

Singapore's Variable Capital Company (VCC)

This specialised corporate structure introduces a fourth fund type to Singapore and is designed to provide fund managers with greater operational flexibility and help them reap economies of scale and monetary savings.

The enabling law (the Variable Capital Companies Act 2018) supports umbrella and sub-funds structures, with sub-funds able to appoint a local board of directors and use the same service provider as the umbrella fund.

A VCC covers both traditional and alternative assets, can be open-ended and closed-ended, and can be used for retail and non-retail strategies. A retail fund requires three directors, a non-retail fund requires one.

Singapore's strategic positioning in the region and its role as one of the world's most competitive nations should further attract interest from asset managers.

Australia's Corporate Collective Investment Vehicle (CCIV)

With the largest fund management industry in the Asia Pacific region, the introduction of the CCIV could prove to be a boon for the country.

CCIVs have a range of benefits: they have an internationally recognised corporate structure limited by shares; they are designed to integrate with the ARFP cross-border initiative; and they complement the existing regulatory framework, potentially creating cost efficiencies and reducing compliance costs.

In a first for Australia's fund management market, a CCIV must have one sub-fund (and can have more). Additionally, sub-funds can offer a range of investment strategies delivering increased investor choice, scale and cost-savings.

To protect investors, sub-funds' assets and liabilities must be kept separately, with each CCIV required to have an authorised corporate director, which must be a public company. It is expected that the law will permit both retail and wholesale CCIVs and introduce a depositary requirement for retail CCIVs.

Benefits, drawbacks and challenges to consider

When it comes to fund managers weighing up options around where to domicile, and whether to take advantage of the new Asia Pacific corporate fund structures, there are no 'right' answers. In making their decision, fund managers need to factor in a number of variables, not least the demands of the target investor pool and the regulatory obligations for the fund in question.

Additionally, fund managers need to consider the objectives and specifics of each vehicle, including: the establishment and running costs involved; compliance requirements; taxation elements; and how closely their investment strategies will align with each option.

For example, a US-based fund manager who is focused on North American investments would have little reason to domicile their fund in Australia, Hong Kong or Singapore; unless they were specifically targeting investors from these or other Asia Pacific locations.

In addition, a fund manager based in Asia Pacific and looking to export an Asian-based investment strategy might consider the advantages of domiciliation in the Asia Pacific region not only to target APAC investors but also to offer a recognised fund structure to other potential markets.

Furthermore, a domicile like Luxembourg has a long history of hosting funds and a strong track record, and is rightly regarded as well-tested and secure. The Ucits framework, which evolved over 30-plus years in Europe, is considered the dominant cross-border brand globally, and in Asia more than 100 fund managers have used Ucits-compliant funds (commonly Luxembourg-domiciled Sicavs) to gather in excess of $250bn across more than 1,000 separate funds.

Leveraging the Ucits experience, regional governments and regulators are committed to developing Asia Pacific as an investment management hub, and the evolution of the various passporting schemes and fund structures is, in effect, Asia Pacific's response to the dominance of the Ucits brand in the region by offering local alternatives.

As such, the costs and benefits of these new corporate fund structures warrant careful consideration by fund managers and investors, to understand how those might better suit their objectives.

Push and pull factors

In considering whether to use these structures, a number of push and pull factors are relevant. Investors keen for robust regulatory guidelines might find the corporate structures, being propounded by Australia, Hong Kong and Singapore, of interest. This links to the "pull" factors in Australia, Hong Kong and Singapore's favour. They are well-regarded in terms of their legal and regulatory jurisdictions which reduces risk.

Additionally, each jurisdiction has introduced regulations that have been developed in consultation with the asset management industry and we believe that largely, a fund-friendly approach has been adopted. However, some aspects of the current CCIV drafting create some commercial challenges and further engagement with industry and subsequent refinement would be welcomed. Another factor is that all are located in a dynamic region that will grow fast in the coming decades. Also, each is based in the same time zone as the investors they are targeting – unlike funds in, say, Europe – and that makes investor interaction easier.

Further points to consider

As noted in the first part of this analysis, there are a number of differences between Australia's CCIV, Hong Kong's OFC and Singapore's VCC. Some of these differences may drive the appeal of particular jurisdictional structures for regional fund managers. For example, in Australia, the CCIV regime places additional requirements for retail funds versus wholesale funds; notably, there is no depositary requirement for wholesale CCIVs which is mandatory for retail CCIVs.

In addition, the current drafting of the CCIV law for wholesale operators is more onerous than the existing framework for wholesale unit trusts. This could potentially act as a disincentive for fund managers looking to establish a wholesale CCIV.

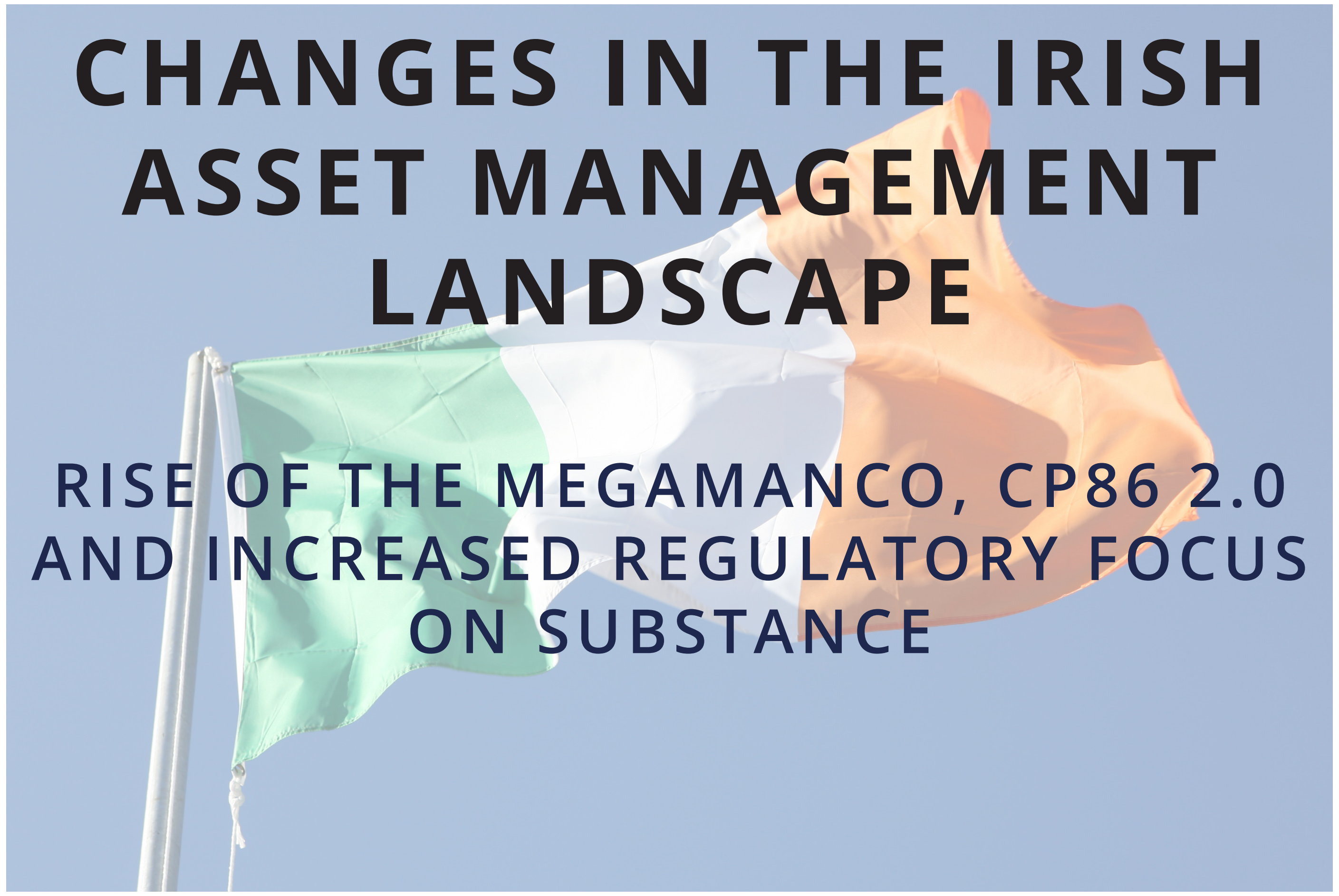
Taxation is another important topic. When it comes to OFCs and VCCs, we are awaiting clarity on a number of points. In Hong Kong, stamp duty implications associated with OFC are subject to limitations; the transfer of shares in OFC is subject to stamp duty; however, stamp duty is not applicable for OFC shares allotment and cancellation.

Private OFCs in Hong Kong are eligible for tax exemption under certain conditions, as defined by the Inland Revenue Department.

And, in Singapore, a VCC will be treated as a company and a single legal entity for tax purposes; with the sub-funds in umbrella VCCs having their name included on the Certificate of Residence.

In relation to the Australian CCIVs, the current proposal treats sub-funds as separate entities for tax purposes; so that a single CCIV can serve as the umbrella for many different investors and investments. Distributions will have both taxable and non-taxable components, with non-resident taxation only applicable to the taxable components. Withholding tax rates continue to be a focus of industry consultation, which is continuing.

Singapore also says VCCs will benefit from its tax incentive schemes for funds under sections 13R and 13X of the Income Tax Act. while approved fund managers, managing an incentivised VCC, may be eligible from the 10% concessionary tax rate under the Financial Sector Incentive-Fund Manager (FSI-FM) scheme.



CHANGES IN THE IRISH ASSET MANAGEMENT LANDSCAPE

RISE OF THE MEGAMANCO, CP86 2.0 AND INCREASED REGULATORY FOCUS ON SUBSTANCE

Aaron Mulcahy
Partner
Maples Group
aaron.mulcahy@maples.com

Fearghal De Feu
Associate
Maples Group
fearghal.defeu@maples.com

There has been a substantial change in the Irish asset management landscape since the UK government invoked Article 50, triggering the countdown to Brexit.

One of the more significant changes is a marked increase in interest in the already popular 'SuperManCo' (a dual authorised AIFM and UCITS management company) and the 'MegaManCo' (an enhanced version of the SuperManCo, allowing for additional 'MiFID top up' permissions). In tandem with this increase, there has been a shift in the substance expectations of the Central Bank of Ireland (the "CBI") for new entities. This has led to firms, authorised post July 2018 being subject to new substance requirements. Now that Brexit contingency arrangements are largely in place, the CBI has signalled its intention to bring entities authorised before 2018 in line with its current expectations on substance which may require those firms to review and build out their resourcing model.

Rise of the MegaManCo

There has long been a trend in Ireland for fund sponsors with multiple fund ranges to consolidate the management of their funds under a SuperManCo authorisation, rather than having multiple self-managed UCITS and internally-managed AIFs.

The SuperManCo has proved popular because it can be used to manage multiple ranges of AIFs and UCITS and can passport its services across the EU by way of a freedom of services passport or on a branch basis. From a regulatory perspective, the authorisation process under UCITS and AIFMD can be streamlined and run in parallel and once authorised it can benefit from centralised thematic inspections, one CBI supervisory contact and a single set of regulatory documents. The SuperManCo also allows for operational efficiencies with one board and one set of senior management responsible for key management functions, known as designated persons ("DPs").

Prior to Brexit, it was relatively uncommon for SuperManCos to be authorised to undertake MiFID top up permissions such as individual portfolio management ("IPM") and investment advice. Activities were typically limited to collective portfolio management of UCITS and / or AIFs.

The prospect of UK managers losing their ability to offer services such as IPM and investment advice across the EU in the case of a 'hard Brexit' resulted in UK managers seeking out flexible solutions to allow them to continue to manage segregated mandates and to market funds on a pan-European basis. Such options included establishing a MiFID firm or a MegaManCo in the EU27. While it is difficult to estimate the number of new applications for authorisation, the CBI has indicated that it has received over 100 Brexit-related authorisation applications. In addition, since 2016, there have been an increasing number of firms choosing to be authorised or upgraded to a MegaManCo (circa 18) or seeking stand-alone MiFID authorisations (circa 29).

The MegaManCo has proven to be a flexible alternative to establishing a MiFID firm in Ireland for firms who do not require the full list of MiFID services (most notably execution of orders) – as it combines the ability to manage multiple AIFs and UCITS with the flexibility to perform the key MiFID authorised activities of IPM, investment advice and receipt and transmission of orders. In particular, IPM facilitates a fund sponsor to continue to act as discretionary investment manager for EU segregated mandate clients (with appropriate levels of delegation/outsourcing back to the UK affiliate firm) and investment advice facilitates marketing and distribution activities of investment capabilities across the EU.

A Shift in Substance Expectations

In July 2018, as UK firms sought to put Brexit contingency arrangements in place, the European Securities and Markets Authority published a series of opinions, which sought to support supervisory convergence in asset management (the "Brexit Opinions"). The focus of the Brexit Opinions was to avoid regulatory arbitrage. In particular, the Brexit Opinions required that national competent authorities apply additional scrutiny to firms seeking authorisation with less than three locally-based full time equivalents ("FTEs").

The CBI's application of the Brexit Opinions resulted in firms seeking SuperManCo and MegaManCo authorisation in Ireland post-the Brexit Opinions being met with the CBI's substance expectations (which vastly exceeded those required of incumbent firms). Now that Brexit contingency arrangements are largely in place, the CBI has indicated that it intends to increase focus on firms authorised pre-2018 – to ensure alignment by them with the obligations imposed on firms who were authorised post-2018.

Bridging the Gap – CP86 2.0

This increased focus has come at the same time as the CBI's thematic review of its Fund Management Company Guidance ("CP86 Guidance"), which commenced in mid-2019 and is ongoing ("CP86 2.0"). This is expected to operate in three phases. Phase 1 was a detailed questionnaire, issued to more than 300 firms (across the spectrum of Irish management companies, self-managed UCITS and internally managed AIFs). Phase 2 was a desk-based review that involved a request for a detailed list of documents from selected firms in the areas of:

(i) board documentation (including organisational effectiveness);

(ii) the investment management function; and

(iii) the fund risk management function.

Phase 3, which is due to commence shortly, will involve a series of onsite inspections of selected firms. Recently the CBI indicated that the review should complete during the first half of 2020 with communications being issued to industry during the second half of 2020.

One likely change to arise from the CP86 review relates to the substance elements as set out below:

• Increased time commitments for DPs: There is a possibility that current time commitments for key management functions (as indicated to the CBI in the initial Individual Questionnaire process) will be required to increase.

• DPs to be based in Ireland: The outcome may be a requirement for some or all DPs to be located in Ireland (or in any EU27 branches of the firm).

• AUM-based resource requirements: The requirements may be set depending on the nature, scale and complexity of the firm / fund's business. While there have been trends based on AUM to date, the CBI may consider implementing AUM as a key metric in making this assessment.

• Implications for relocating staff for Irish operations: For existing funds / firms, in order to support Irish -based DPs, this may require the build out of a full Irish presence (premises etc.), a broader executive function (executive directors, a CEO etc.) and possibly Ireland-based support staff.

If implemented, the above changes may require the 176 existing Irish UCITS management companies and AIFMs authorised before 2018 to review and build out their resourcing model, particularly where they rely on DPs provided by the fund sponsor or third party firms. To the extent that the time commitments are increased materially, it may make the provision of DPs a less common model as the persons providing such services will be required to concentrate their time across a small number of Irish management companies. This may result in firms who rely on DPs provided by third parties to engage their own staff in Ireland or to replace DPs with staff from the firm's group based in Ireland or any EU27 branches of the firm. These challenges will be more acute for the 244 existing self-managed UCITS and internally-managed AIFs who typically have no staff, and instead rely on DPs provided by the fund sponsor or third party firms. Depending on the substance requirement that will apply to such entities, it may be necessary for the fund sponsor to consider obtaining CBI authorisation of a SuperManCo to avail of the benefits noted above, engage the services of a hosted SuperManCo arrangement or look to move the fund to a third party platform with its own SuperManCo.

Conclusion

The last two years have seen a significant change to the Irish asset management landscape with the emergence of the MegaManco and the impact of supervisory convergence being felt by firms seeking authorisation through the CBI's enhanced substance requirements. The gap between firms' authorised pre- and post-the Brexit Opinions has not gone unnoticed and the CBI's messaging to industry and focus of CP86 2.0 all point to the prospect of this gap closing. This enhanced focus on substance will provide challenges for some as they seek to align their substance with the CBI's expectations and opportunities for others, who benefit from the possible consolidation of Irish management companies and are willing to provide hosted SuperManCo solutions to third-party funds.

EU AIFMD - NEW MARKETING REQUIREMENTS FOR ALTERNATIVE INVESTMENT FUNDS

Kam Dhillon
Principal Associate
Gowling WLG (UK) LLP
kam.dhillon@gowlingwlg.com

The Cross-border Distribution Directive EU/2019/1160 **(CBDD)** and Cross-border Distribution Regulation EU/2019/1156 **(CBDR)** amend the Alternative Investment Fund Managers Directive EU/2011/61 **(AIFMD)** and introduce new rules relating to the marketing of alternative investment funds **(AIFs)** in the European Union **(EU).**

The new rules will impact existing practices in relation to marketing activities - the key changes being the introduction of a new 'local facilities' requirement and potentially new notification and verification requirements when marketing AIFs to retail investors in the EU, as well as a new 'de-notification' procedure to follow when an EU alternative investment fund manager **(AIFM)** ceases marketing AIFs on a cross-border basis.

Objectives of the new rules

The new rules aim to harmonise regulatory and supervisory approaches to marketing activities for AIFs managed by EU AIFMs within the framework of AIFMD, and in particular, to reduce barriers to the cross-border distribution of funds within the EU and to ensure a more uniform, and higher, standard of protection for investors.

Which AIFMs are in scope?

These new rules apply to authorised EU AIFMs. Whilst the UK is a full member of the EU, this would capture full scope UK AIFMs and small authorised UK AIFMs.

The CBDR extends the new rules to managers of qualifying European venture capital funds **(EuVECAs),** European social entrepreneurship funds **(EuSEFs)** and European long-term investment funds **(ELTIFs)**.

Other small registered AIFMs in the UK (such as internally managed, closed-ended investment companies and external managers of certain property funds) are not in scope of the new rules under the CBDD or the CBDR.

What about non-EU AIFMs?

Unless stated otherwise in this article, these new rules do not apply to non-EU AIFMs (such as Canadian or US fund managers) marketing their AIFs in the EU under the national private placement regime **(NPPR).**

It will be up to the national competent authority in each EU member state to determine whether to extend the new rules to non-EU AIFMs under the NPPR.

New requirements for marketing communications

Marketing communications must:

• be identifiable as such;

• describe the risks and rewards of purchasing an AIF in an equally 'prominent' manner;

• be fair, clear and not misleading; and

• not contain any information contradicting, or diminishing the significance of, investor disclosures which the AIFM is required to make.

In addition, where an AIF is required to publish a prospectus under the Prospectus Regulation (EU/2017/1129) or a key information document **(KID)** under the Packaged Retail and Insurance-based Investment Products Regulation (EU/2014/1286), marketing communications must:

• not contain information about the AIF that contradicts, or diminishes the significance of, information contained in its prospectus or KID;

• indicate that a prospectus exists and that the KID is available; and

• specify where, how and in which language investors (or potential investors) can obtain the prospectus and the KID (for example, by providing hyperlinks to websites).

ESMA will, by August 2022, issue guidelines on the application of these requirements.

These new requirements are aimed at strengthening investor protection, and apply to marketing communications issued by EU AIFMs (and managers of EuVECAs, EuSEFs or ELTIFs) when marketing to investors in the EU. In practice, these new requirements are not expected to represent a significant compliance burden for EU AIFMs.

Do the marketing requirements differ for communications to retail and professional investors?

The marketing requirements described above apply in the same way, regardless of whether the investor is retail and professional.

Facilities available to retail investors

The focus of AIFMD is regulating the marketing of AIFs to professional investors in the EU. Each member state may, at its discretion, permit marketing of AIFs to retail investors in accordance with local laws – however a harmonised cross-border approach is currently lacking.

The CBDD amends AIFMD and introduces a 'local facilities' requirement to ensure there is, at a minimum, a consistent treatment of retail investors in the EU.

Member states must ensure that EU or non-EU AIFMs make available, in each member state where they intend to market an AIF to retail investors, facilities to perform the following tasks:

• process investors' subscription, payment, repurchase and redemption orders relating to the units or shares of the AIF, in accordance with the conditions set out in the AIF's documents;

• provide investors with information on how orders can be made and how repurchase and redemption proceeds are paid;

• facilitate the handling of information relating to the exercise of investors' rights arising from their investment in the AIF in the member state where the AIF is marketed;

• make the latest annual report of the AIF and pre-investment disclosures under article 23 of AIFMD available to investors for the purposes of inspection and obtaining copies;

• provide investors with information relevant to the tasks that the facilities perform in a durable medium; and

• act as a contact point for communicating with relevant national competent authorities.

These facilities do not need to amount to a physical presence. An AIFM may provide these facilities electronically or by other means of distance communication, or engage the services of a third party to do so.

Where the tasks are to be performed by a third party, the third party must be subject to regulation and supervision governing the tasks to be performed. The appointment of that third party must be evidenced by a written contract.

Facilities must be provided in the official language (or one of the official languages of the member state) where the AIF is marketed, or in a language approved by the national competent authorities of that member state.

Additional requirements when marketing to retail investors
National competent authorities may, but are not obliged to, require prior notification of marketing communications which EU AIFMs (or managers of EuVECAs, EuSEFs or ELTIFs) intend to use directly or indirectly in their dealings with retail investors.

This notification, however, must not constitute a pre-condition for marketing.

National competent authorities that choose to verify marketing communications must do so for the sole purpose of ensuring compliance by fund managers with applicable marketing requirements. Any procedures that competent authorities establish for this purpose must be published on their website and must ensure transparent and non-discriminatory treatment of all AIFs, regardless of the EU member state in which they are authorised. If a national competent authority requires a manager to amend a marketing communication, it must notify the manager within 10 working days of receipt of the notification.

As there is no passport for this notification, it will need to be made in each EU member state in which the AIFM (or EuVECA, EuSEF or ELTIF manager) intends to market where the national competent authorities requires it.

De-notification of marketing in a member state
Under the current rules in AIFMD, it is not clear when an EU AIFM is considered to have ceased 'marketing' an AIF in a host member state and this therefore means it is not clear when the EU AIFM can withdraw its notification of marketing under its passport.

The CBDD aims to address this and introduces a new procedure to follow for de-notifications of EU AIFs.

An EU AIFM may de-notify arrangements made for marketing some or all of its EU AIFs in a host member state, provided all of the following conditions are satisfied:

• the EU AIFM makes a blanket offer to repurchase or redeem (free of any charges or deductions) all units or shares in the EU AIF held by investors in the relevant host member state. The offer must be publicly available for at least 30 working days and must be addressed (directly or through financial intermediaries) individually to all investors whose identity is known to the AIFM in that member state. This requirement to make a blanket offer does not apply to closed-ended AIFs and ELTIFs;

• the intention to cease marketing some or all of its EU AIFs in that member state is made public (including electronically) in a form that is customary for marketing AIFs and suitable for a typical investor in that AIF;

• the public notification and blanket offer clearly describes the consequences for investors if they do not accept the offer to redeem or repurchase their units or shares in the AIF;

• the EU AIFM modifies or terminates any contractual arrangements with financial intermediaries or delegates with effect from the date of de-notification. This is to prevent any new or further marketing of the relevant AIF;

• the EU AIFM notifies the national competent authorities of its home member state of its intention to cease marketing. The national competent authorities must transmit that notification to the national competent authorities of the member state identified in the notification within 15 working days of receipt; and

• for a period of 36 months from the date of de-notification, the EU AIFM must not engage in any pre-marketing of the units or shares of the AIFs identified in the notification – nor of AIFs with similar 'investment strategies' or 'investment ideas', in the member state where marketing has previously been discontinued.

The 36 month blackout period will be problematic for EU AIFMs that wish to cease marketing activities in relation to a particular issue of units or shares, rather than entirely cease marketing activities in an EU member state.

EU AIFMs will need to carefully consider whether it is worthwhile to make a de-notification, particularly as they will be prohibited from marketing another AIF with a similar investment strategy or idea in that jurisdiction, yet will still need to provide investor transparency information on an on-going basis to investors who choose to remain invested in the relevant AIF.

These new de-notification rules do not apply to the cessation of marketing by:

• a non-EU AIFM of an EU or non-EU AIF under NPPR; or

• an EU AIFM of a non-EU AIF under NPPR.

However individual member states may, at their discretion, choose to impose equivalent requirements under NPPR.

When do the new rules apply?
The new rules are expected to apply from 2 August 2021.

The European Parliament adopted the CBDD and CBDR on 16 April 2019, and the European Council followed shortly after in June 2019. The CBDD and CBDR was published in the Official Journal of the EU on 12 July 2019 and (subject to limited exceptions) entered into force on 1 August 2019. Member states must transpose these new rules into national law from 2 August 2021.

Following the 2019 general election, it is not yet clear whether the UK is likely to adopt the CBDD and the CBDR into UK financial services laws. The Financial Services (Implementation of Legislation) Bill 2017-2019 does provide a mechanism for HM Treasury to implement EU financial services legislation that is currently in the pipeline for a period of two years after the UK leaves the EU, and this includes the CBDD and the CBDR.

However in the event of a 'no-deal' Brexit, the UK would be classified as a non-EU country. This means UK AIFMs and UK AIFs would, respectively, be classified as non-EU AIFMs and non-EU AIFs, and the majority of the new rules described in this article would become irrelevant in relation to the UK (unless the Financial Conduct Authority decided to extend the new rules to non-EU AIFMs under the NPPR).

Notwithstanding the uncertainty surrounding Brexit, AIFMs looking to raise capital from professional or retail investors in the EU from summer 2021 onwards should be aware of these new requirements and their potential impact on marketing activities.

A COMPLIANCE FUNCTION DESIGNED FOR THE ROARING 2020'S

James Andrews
Managing Director & Hedge Fund Practice Leader for Europe
ACA Compliance Group

The past few years have proven challenging and complex times for often heavily laden and thinly resourced compliance teams at hedge funds. With a slew of post-crisis legislation, the past decade has presented nothing short of a barrage of implementation deadlines for firms to meet.

While we have not reached the very end of this pipeline, 2020 does at first blush appear to present some much-needed breathing room for firms to take stock of their compliance programmes and think strategically about how they are designed and resourced. With an ever-growing number of interconnected geopolitical, economic and environmental changes and challenges, this will be time well spent as firms face a range of uncertainties that may create business disruptions throughout the new decade.

Uncertain times can be tricky and so a well-constructed compliance programme requires nimbleness in order to scale up or down to pressing business needs. This is where the integration of humans and technology working on a complimentary basis can help achieve efficiency and address business priorities in ways that enable innovation and growth, all while minimising risk.

Heightened levels of global regulation combined with increasing scrutiny and cost pressures place Chief Compliance Officers (CCOs) and compliance teams under mounting pressure. Over-burdened teams that are stretched too thinly are - as mere humans after all - more likely to experience burnout and so are more prone to mistakes, exposing firms to risk. Ultimately this may also contribute to a higher than desired staff turnover.

This is where a pragmatic approach to outsourcing and a move to embrace smart technology can help ease some of the burden, improve efficiency and in real terms amount to a cost saving. Industry research shows:

• Over 48% of surveyed CCOs occupy two or more internal functions and perform other non-CCO/legal roles (IAA/ACA's 2019 Investment Management Compliance Testing Survey).

• 16% of surveyed firms have had compliance personnel go on extended leave (i.e. medical or maternity leave) within the last year impacting on continuity of resourcing and further burdening remaining staff (ACA 2019 Alternative Fund Manager Survey).

• The number of firms choosing to outsource all or part of their compliance function has remained consistent, ranging between 24% and 28%, year-on-year since 2016. 36% of global financial services firms now outsource all or part of their compliance function. (2019 Thomson Reuters Cost of Compliance report).

• 67% of firms use automated or electronic compliance systems, while 56% of firms plan to increase their use of automated or electronic compliance systems. The most common automated compliance tasks are related to personal trading and code of ethics/code of conduct (78%), gifts and entertainment (49%), client guidelines (41%), and cybersecurity (31%) (IAA/ACA's 2018 Investment Management Compliance Testing Survey).

It's clear that, where implemented appropriately, strategic outsourcing remains a highly beneficial tool at firms' disposal to maintain flexibility and continuity of resourcing, and one where we see a few key themes emerging. These include:

• Delegation not abdication: In an era of increasing individual accountability, outsourcing work to a third party doesn't relinquish you from your regulatory responsibilities. Your firm is ultimately responsible for its compliance programme, policies and procedures and monitoring. This is where a 'co-sourcing' approach can come into play; a long-term one-to-one business collaboration with a trusted provider where both partners have a vested interest in the outcome of the relationship. This collaborative approach allows the service provider to support a firm and its compliance activities in a better, quicker, and often more cost-efficient way than the firm doing it itself, without increasing the firms exposure to regulatory risk.

• In or out?: In-sourcing (or secondments) is another option for firms during exceptionally busy times. For example, firms can tap into a large pool of compliance professionals on a contracted basis to work in-house for an agreed number of days per week/month, or even full time for an agreed period. This approach can be used to implement a new regulation or control, to undertake specific projects (e.g. a regulatory reporting or market abuse review) or to simply bolster your team during personnel transitions, support while working to secure a full-time hire or to cover staff absences such as during maternity or paternity leave or for shorter-term illness or holiday coverage.

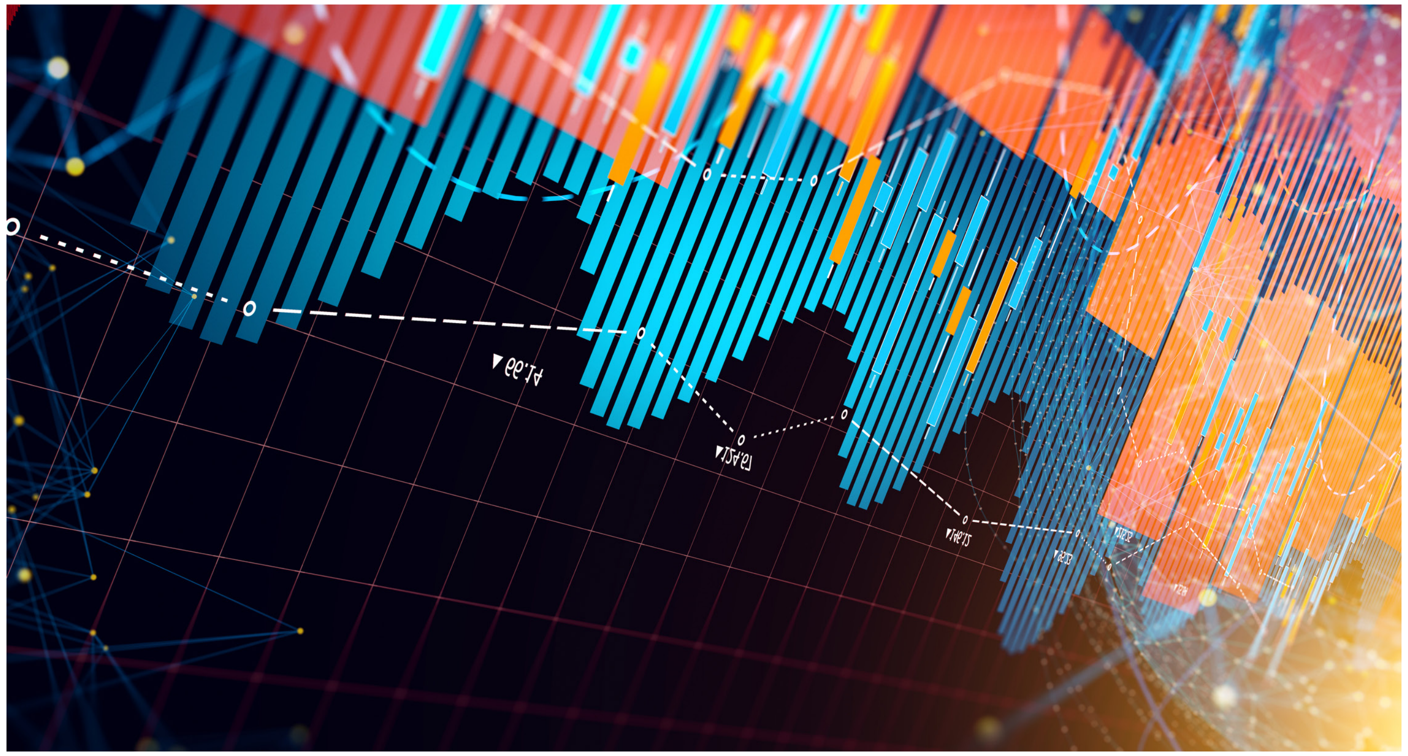
• When it comes to service providers, not all are equal: For quality assurance, seek personal referrals and assess the competence, capability and capacity of potential service providers including whether they are members of the APCC (Association of Professional Compliance Consultants). Enquire as to the attrition rate of the provider's staff, and how many firms they service with the same strategy as yourself and how they can support your firm as it grows.

• With support comes efficiencies and deeper insights: Keeping up with the sheer volume and pace of regulatory change, not to mention the volume of data flowing into and out of a firm, can be a challenge. Fortunately for compliance teams, regulatory technology, or 'RegTech', is here to help. RegTech can bolster operational efficiencies by allowing for the automation of manual tasks, the generation of instantaneous reports, and the capturing of data for recordkeeping purposes. All of these tasks would otherwise be done manually and laboriously and thus consume precious time and resources. Not only this, but RegTech provides an opportunity to connect structured and unstructured data sets in order to derive deeper insights for identifying additional potential risk.

This is something that is being recognised by the global regulators, including the SEC, FCA, and CFTC, who are meeting the pace of evolving regulatory change through investments in data and analytics that can help them more quickly and efficiently perform their supervisory duties. The SEC's Office of Compliance Examinations and Inspections ("OCIE") recently listed

financial technology ("FinTech") innovation as one of its top focus areas for 2020, and the FCA and Bank of England issued a joint statement on their commitment to data and analytics innovation in 2020.

We encourage you to take an enterprise risk view when positioning your firm's compliance function for success throughout the roaring 2020's and beyond. Ensuring your compliance programme is optimally designed allows your resources to be deployed to their best effect and enables your compliance teams to focus on significant areas of risk to your core business. Reviewing your firm's strategic approach to outsourcing and use of technology is a great way to achieve this while reducing risk overall and improving standards in an era of ever increasing accountability.



PORTFOLIO DESIGN: MAKING ROOM FOR ALTERNATIVE INVESTMENTS

Myles Zyblock
B.A. (Hons.) M.A., CFA
Chief Investment Strategist
Dynamic Funds

But divide your investments among many places, for you do not know what risks might lie ahead.
Ecclesiastes 11:2, 450-200 BCE

There has been an appreciation, as far back as ancient times, that spreading one's investments across a variety of assets lowers financial risk. But it still took another 2300 years before this knowledge was formalized with the use of mathematics. Professor Harry Markowitz wrote the landmark research paper, "Portfolio Selection", which appeared in the March 1952 edition of the Journal of Finance. He demonstrated how one can assemble a portfolio of assets such that its expected return is maximized for a given level of risk. These results largely depended on blending into a portfolio several assets which enjoy relatively low performance correlation to one another. In the years that followed, the conventional balanced portfolio – generically referred to as the 60% stock and 40% bond asset mix – began to make its mark on the investment industry.

This portfolio has generated an appealing total return profile over many decades. In part, it was because of the low co-movement between stocks and bonds. The performance mix was further flattered, particularly since the latter-1990s, by the fact that the correlation between equities and bonds was negative, on average. It meant that one cylinder in this two cylinder engine was working more often than not; When bonds faltered, stocks gained in value. And, in troubled periods for stocks, the bonds generated positive returns.

Through time, however, the performance of the balanced portfolio has increasingly struggled to regain its former glory **(Figure 1).** Over the past 20 years, for example, the 60-40 balance generated a total annualized return of 6.1%, which is a far cry from the long-term average rate of 10.5%. In fact, investors now worry that the returns from a conventional stock-bond asset mix will be unable to help one achieve their long-term investment objectives. U.S. pension funds, the world's largest pool of investment capital, have been consistently downgrading their long-term investment return assumptions to the point now where the median stands at 7.3% from just over 8% a short few years ago. That might still be too optimistic.

Investors are facing a truly unique situation. There is nothing from the past which even loosely resembles many of today's developments: U.S. corporate leverage is at an all-time high; Global central banks have been actively buying trillions of dollars in assets from the secondary market and have pushed their policy-set interest rates towards 0%, or below; And, quantitative, passive, and other forms of systematic investing dominate the trading volume in public markets. Meanwhile, valuations for stocks and bonds have never been more expensive at the same time since at least the late-1800s **(Figure 2).**

Figure 1: Rolling 20-Year Annualized Total Return for a Balanced Portfolio

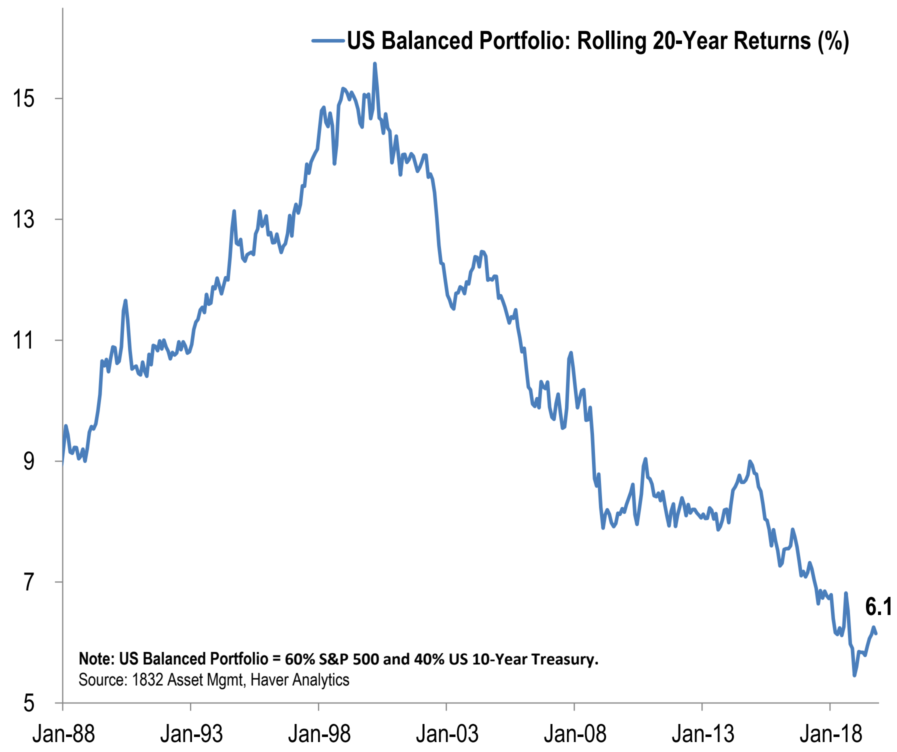
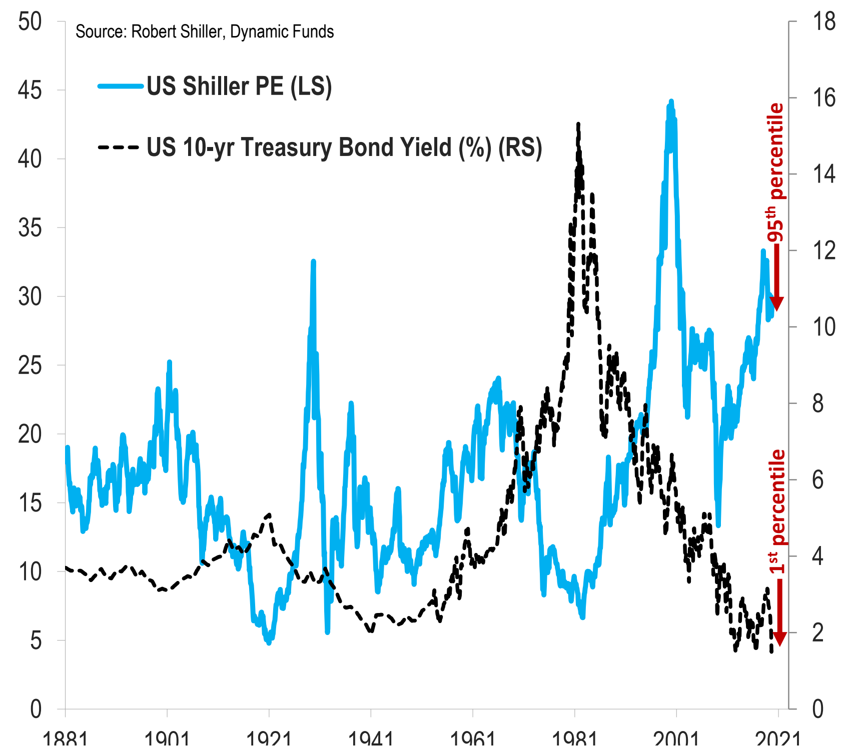


Figure 2: Historic Equity and Bond Market Valuations



The reasons for our present state remain a hotly debated topic. It appears to be the result of some complex interplay between policymakers, corporations, technology, and human psychology. Regardless of the causes, there is a growing chorus of concern about the risks of crowding within the traditional asset classes. That this exceptional set of external conditions could lead to new sources of error, some of which have yet to be experienced, thereby making them even harder to anticipate.

At the same time, the conventional stock-bond portfolio is facing its own set of endogenous threats. Three of the more obvious ones are as follows:

• The possibility for much greater performance variability. The stock market's annualized volatility has been about 75% higher during the decade following periods of elevated valuations relative to all other periods. And, the low coupon attached to today's longer-dated bonds all but assures much greater sensitivity of a bond's performance to small changes in interest rates.

• Lower prospective returns. It takes no forecasting ability to understand that a 10-year bond yielding, say, less than 2% will deliver a total return of less than 2% annually over the next decade. As for stocks, 3-6% annualized total returns over the next decade are consistent with today's starting valuations. The opportunity set looks less enticing than it has in the past.

• The diversification benefits of owning stocks and bonds might fade. The correlation between stocks and bonds has been slightly negative over the past 20 years, which has helped a balanced fund's risk-return profile. But it wasn't always that way. In the three prior decades, there was a consistently positive – and sometimes meaningfully positive – performance relationship between the two asset classes. The rewards from including stocks and bonds in a portfolio would weaken on an inversion of the prevailing correlation structure.

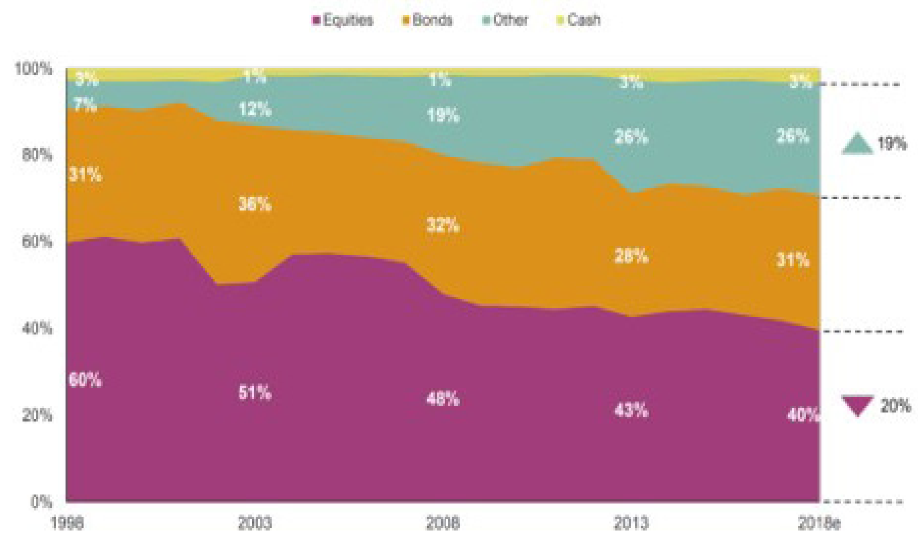
Some simple numeric simulations show that it now requires a 90-95% allocation to equities (allowing 5-10% of the remaining room for bonds) in order to generate a similar annualized long-term return stream to what had been historically generated by a 60/40 allocation. This is attributable to the declining prospects for both stocks and bonds. The drawback for many investors holding what is effectively an all-equity portfolio is obvious – the exposure to large-scale portfolio drawdowns would be significant.

Amendments made to National Instrument 81-102 Investment Funds in early 2019 in Canada similar to 40 Act Funds in U.S. helped create a new category of prospectus offered investment funds for Canadian retail investors called liquid alternative funds. This brings wider access to many of the performance enhancing and risk reduction tools used for decades by accredited investors and institutional money managers such as pension and endowment funds.

At its most basic level, an alternative asset is one which is neither a stock nor a bond. It can be better categorized by asset type (e.g., currencies, commodities, real estate, or infrastructure), or by strategy (e.g., long-short, market neutral, volatility, or macro). Liquid alternatives are simply alternative investments which offer the benefit of daily liquidity.

To most investors, alternatives might seem new. But, this is not the case. Many of us already have experience with alternative investments through our ownership stakes in private business, rental properties, or land. In fact, exposure to alternative investments for most people has meaningfully increased over the past few decades. The global pension fund industry, for example, has raised its allocation to alternative investments from 7% in 1998 to about 30% more recently **(Figure 3).** At least in the pension world, the old 60/40 equity-bond portfolio has been replaced by a 40/30/30 equity-bond-alternatives model. Canada's own Canada Pension Plan Investment Board (CPPIB) now allocates even more than the global average to alternatives, at roughly 50% of its $401 billion in assets under management. Alternative investments are growing in importance and now represent a sizable $10 trillion pool of global capital.

Figure 3: Global Pension Industry Allocation to Alternatives through Time



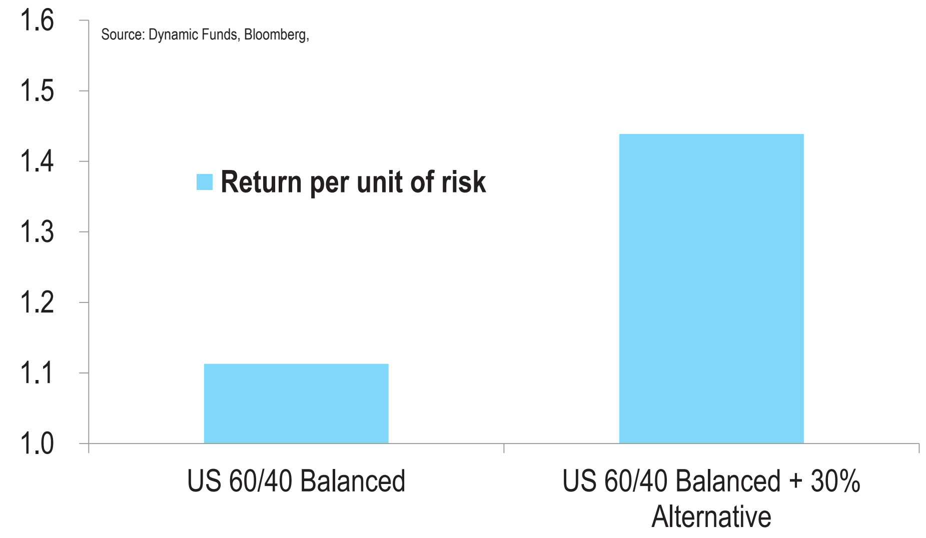
Thinking Ahead Institute and secondary sources

Why are more investors considering a shift toward alternative investments? The key reason, going back to the lessons passed on from the ancients, is diversification. The accelerated pace of the move in recent years is probably tied to the performance headwinds faced by traditional asset classes. This year's change in the Canadian regulatory landscape has allowed for much easier access to an expanded diversification tool kit for retail investors.

But, just because a product is marketed as a liquid alternative does not make it so. Keep in mind that an effective diversifying instrument needs to display low performance correlation to the traditional assets like stocks and bonds. And, it should generate a positive return contribution over long periods of time. This means that any alternative one considers should include a multi-year performance track record in order to be able to gain a better understanding of how that particular investment has behaved through various economic and market cycles.

Once we have located one or more liquid alternatives with track records, positive returns over time, and low performance correlation to stocks and bonds (and to each other), we have assets that need to be considered for inclusion in the portfolio. These investments will probably help to dampen volatility and enhance the long-term return stream of the portfolio. In the lingo of that early modern portfolio pioneer, Harry Markowitz, the inclusion of liquid alternatives is likely to enhance the portfolio's return per unit of risk (Figure 4).

Figure 4: Alternative Investments can Enhance Portfolio Performance



Equities and bonds are not going away. They will continue to form an integral part of most well diversified portfolios. However, it is important to be open to the idea of including other assets in a portfolio given historically low bond yields and high equity valuations. This is not to say we can predict the future for stocks and bonds with a high level of certainty. We cannot. In fact, it is precisely because of this appreciation about an uncertain future that makes portfolio diversification so important. Liquid alternative investments have arrived on the scene as a potentially new source of diversification for the Canadian retail investor. The benefits they can deliver to a portfolio's long-term success – such as uncorrelated sources of performance, risk mitigation, and volatility dampening – should not be overlooked.

PE, PRIVATE CREDIT AND REAL ESTATE FUNDS TO BE REGULATED IN CAYMAN

Andrew Linford
Director
Five Continents Partners Limited

Rolf Lindsay
Partner
Walkers Cayman

Matt Taber
Partner
Harneys Cayman

2020 will see the introduction in the Cayman Islands of the registration and regulation of closed-ended funds and other investment vehicles that are used to invest in unlisted or 'private' assets such as private equity, private credit, real estate and infrastructure, through what will be known as the 'Private Funds Law'.

As the jurisdiction of choice for the establishment of such funds outside of the US, the Cayman Islands remains at the forefront of legal and regulatory developments in this area and AIMA Cayman is proud to continue its part in the furtherment of best practice in the alternative funds industry. We expect fund sponsors, investors and regulators to benefit from the alignment of law and best market practice in this regard.

On 8 January 2020, the Private Funds Bill, 2020 was published (the "Bill"), and we expect that the Bill will become law by the end of January 2020. Whilst the timetable for implementation of the Bill is yet to be determined, and certain points of detail remain to be confirmed by regulations and guidance, the key provisions relevant to fund sponsors and investors are now sufficiently settled for those impacted to begin to make the substantive arrangements necessary for compliance with the new regime. We expect that ample time will be provided to permit any necessary compliance steps to be undertaken in a measured way.

This summary is based on the Bill as published. We do not expect that the final form of the legislation will deviate materially from the Bill. AIMA Cayman will continue our work with the Cayman Islands Government, the Cayman Islands Monetary Authority ("CIMA") and other key local professionals in the spirit of cooperation in drafting new regulation that is fit for a best practice future.

The close cooperation and coordination between private and public sector in Cayman was commented on by the Honourable Tara Rivers, Minister of Financial Services at a recent meeting attended by over 400 practitioners, "It is through our constructive and cooperative working relationship, which has significantly strengthened over the past two and a half years, and your commitment to doing what is in the best interests of the jurisdiction as a whole (which in turn, will have a direct positive impact on your respective companies and firms), that we can meet the challenges facing Cayman's financial services industry; and succeed in ensuring that the Cayman Islands remains as one of the best and highly sought after places to do business in the world," Rivers said.

Which funds does this apply to?

The Bill applies to 'private funds', so named as the majority of new vehicles caught by the legislation are those investing in unlisted, or 'private' assets. It should be noted that the primary investor-facing vehicle offered to investors are likely to be the majority of entities caught by the legislation with other vehicles depending on structuring. The major change is that closed-ended funds, including most private equity, infrastructure and real estate fund structures are covered by the new law. However, securitisation and other structured finance vehicles are excluded from scope.

Whilst alternative investment vehicles are required to register, they are recognised as not requiring duplicative oversight or reporting, and the Bill exempts more structural entities and certain other 'non-fund arrangements' from its application. The exact scope of these non-fund arrangements is expected to be clarified in further rules and/or guidance issued by CIMA in due course.

The key features of the Bill

- New private funds will be required to register with CIMA prior to calling capital for purposes of investment, and to pay a modest annual fee.

- Existing private funds will be required to register with CIMA in due course.

- We expect that registration will follow the well-established online submission procedure that is applicable to open-ended funds.

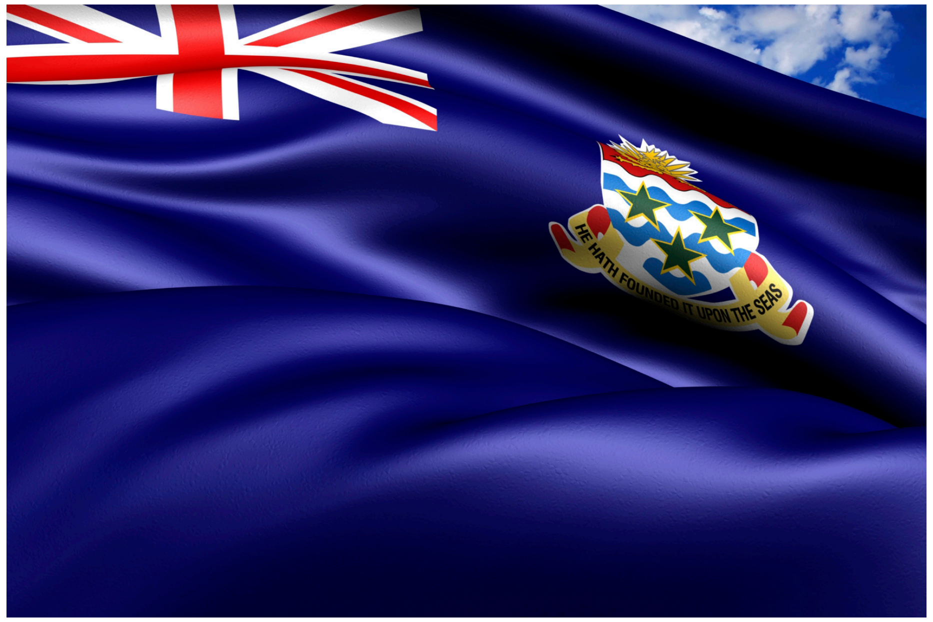
- Audited financial statements will have to accompany an annual return to CIMA and will need to be audited by an approved firm.

- Private funds will be subject to requirements in relation to:
  o valuation
  o custody
  o cash management and the identification of certain securities

In practice we expect that most fund sponsors will be able to discharge these obligations with minimal impact on their existing operations, relying on their internal capabilities and making certain straightforward disclosures to investors.

Changes to the scope of the Mutual Funds Law

The start of this year also saw the scope of the Mutual Funds Law extended to require pooled vehicles with fifteen or fewer investors to be regulated. We expect the resulting Mutual Funds (Amendment) Bill, 2020 also to become law by the end of January.



Funds currently relying on the fifteen investor exemption will therefore need to register with CIMA in due course, although the timing by which they will need to do so has not yet been confirmed. That in turn will require its directors to register with CIMA (should the vehicle be a corporate) as well as subject it to annual audit with local sign-off.

Where these closely held investor vehicles have master funds established in the Cayman Islands, these master funds may also be required to register with CIMA.

A YEAR INTO THE LIQUID ALTERNATIVE FUND MARKET IN CANADA

Belle Kaura
BCL, LLB, LLM, ICD.D
Chair AIMA Canada
VP Legal, Chief Compliance Officer
Third Eye Capital

Liquid Alternative Regime

The game changing liquid alternative regime came into force January 3, 2019. Retail investors, for the first time in Canada, gained access to alternatives. Liquid alts can employ leverage through cash borrowing, short selling and specified derivatives.

The democratization of alternatives gives retail investors access to strategies institutional investors long had at their disposal. Liquid alts are filling a gap between long-only strategies and private be-spoke investments. The new rules levelled the playing field with the US and UK.

Market

A year into the launch of liquid alts in Canada the market is already at ~7 billion. There are a flood of products and a burgeoning market with a growing suite of funds and strategies to choose from. Early entrants, through exemptive relief, launched before January 2019. There are now ~100 funds, including ETFs, launched by over 30 managers.[1] Market entry is dominated by bank-owned and large fund companies, accounting for over two-thirds of AUM. Boutique managers are bringing in the rear. The vast majority are internally managed with only a small proportion sub-advised by hedge fund managers. Entry into the Canadian marketplace by foreign managers is anticipated.

Product Strategies

Most of the products are equity focused with alpha generating objectives to produce risk-adjusted returns that outperform benchmarks, followed by multi-strategy funds with absolute return objectives. Fewer credit-focused strategies were introduced, making it a potential growth area in a low-rate environment. The greater number of alpha strategies, compared to market neutral strategies, is likely due to restrictions on maximum shorting (50% NAV).[2] Liquid alts are in essence "hedge-lite"- the short selling limit doesn't allow pure market neutral strategies, a total leverage limit of 300% restricts some managed futures, and a 10% liquidity restriction precludes offering private debt funds. Investors would benefit from lifting of these restrictions and broadening types of strategies available.

Fees and Features of Products

Liquidity, hold periods, minimums and management fees are in line with mutual funds. Low minimums make products broadly accessible. Management fees are around 1%, performance fees are between 15%-20%.[3] In contrast to mutual funds, liquid alts can charge incentive fees based on performance, consistent with typical hedge fund compensation structures. Fee models range from standard perpetual high-water mark, to fixed hurdle rates, and relative benchmarks. Education about the role of performance fees in alignment of interests would give advisors comfort.

1. Industry Data (Fund Data and other sources) 2. CIBC – Alternative Mutual Funds Growth Potential Looks Solid Coming Out of The Gate (July, September 2019) 3. Ibid.

Challenges for Hedge Fund Managers

We will see evolution with growth and diversification in types of strategies, which will bring new challenges of distribution and market saturation that may lead to erosion of hedge fund sales. 81%[4] of advisers prefer liquid alts,[5] advisers may opt for enhanced liquidity, transparency of reporting and ease of entry of these structures. Hedge funds able to adapt strategies to fit the new rules expanded offerings to the retail world. To be successful, managers used to operating in the private space, need to adhere to more frequent reporting and overcome operational/distribution challenges. Accessing distribution channels continues to be a challenge with promotion of internal funds and a declining number of products approved for distribution on large dealer and bank-owned shelves. If boutique managers cannot scale operations, a greater level of convergence and consolidation between hedge fund managers and conventional mutual fund manufacturers can be expected.

Risk Ratings

It is imperative, especially late in the economic cycle, that investors are not denied access to benefits of alternatives by simplistic rating of alternatives as high-risk. Widespread adoption hinges on fair and accurate ratings. While ratings continue to a be a barrier to broad distribution, we are seeing positive traction with increasing adoption of AIMA/CAIA Risk Ratings.[6] Distribution channels will expand as dealers implement fair ratings and funds build a multi-year performance history. The notion that all alternatives are high-risk must be dispelled with information about how alternatives can reduce risk. Dealers can then allocate to alternatives outside of the typical 10% high-risk bucket.

Proficiency Requirements

Another barrier to distribution is MFDA dealers' inability to sell liquid alts due to proficiency requirements under the framework. Until suitable proficiency standards are adopted, many Canadians will continue to not have access to these products. AIMA is working with regulators to solve this issue.

Market Environment

In this late-cycle, as we head into a more challenging market environment, with global quantitative tightening, trade wars and escalating macro-economic concerns, investors need to prepare for volatility of equity markets and declining fixed income returns by turning to investments that are uncorrelated to traditional markets. Investors can no longer rely on the traditional 60/40 model. Negative equity market returns will bring into sharper focus alternatives as both defensive and offensive solutions. History has proven that unlike public markets, alternatives deliver returns in positive and negative economic conditions. With the advent of liquid alts, investors are now better able to achieve financial goals by building a balanced portfolio that preserves capital and protects against downside risk to deliver risk-adjusted returns.

Strategies for Late-Cycle Investing

The landmark change came at a time when investors are looking

4. AIMA Canada & Scotiabank Alternative Mutual Fund Market Impact Report (2019) 5. Ibid. 6. Risk Rating Guidelines for Alternative Investments in Canada (January 2019)

for uncorrelated returns, interest will heighten as market conditions worsen. Alternatives act as a diversifying tool to reduce volatility by generating attractive returns with low correlation to markets. Products that preserve capital and enhance yield will be favoured as we head into a downturn, particularly with an aging demographic. Products offering diversification from interest rate sensitivities will multiply. Volatility will create opportunities for tactical strategies exploiting market inefficiencies (short-term statistical arbitrage, factoring). Relative value strategies are designed to perform in uncertain market conditions. Managers with experience navigating through cycles will have an advantage.

Directional and Non-Directional Strategies

Strategies can be directional or non-directional to broad market movements. Directional strategies seek outperformance by amplifying returns through timing or shorting. Even strategies with underlying exposure to equities deliver returns independent of market movements. Performance of absolute return funds at 6-8%, with bond-like volatility and low correlation, demonstrate funds are functioning as designed.[7] Returns of equity and income alpha funds with low correlation to long-only indexes will not be as strong as long-only funds in bull markets, but investors gain hedging protection. Non-directional strategies unlock value in pricing/idiosyncratic assets. Investors who want no underlying exposure to equities can opt for these alternative beta products.[8]

Portfolio Allocation and Right Mix of Alternatives

As we near the end of a decade-long bull market, a pivot to the right mix of alternatives in a diversified portfolio can provide resilience and returns. Greater diversification across alternative asset classes is a foreseeable trend. Strategic and disciplined allocation serves to reduce risk, manage liquidity and target desired returns – which is fundamental to alternatives achieving their desired objective. There is a broad universe of strategies across a spectrum of risk/return profiles with unique characteristics and exposure to different assets. A real understanding of strategies and trade-offs is needed to tailor allocation to investment objectives. Alternatives can enhance return, diversify risk, hedge inflation, match long-term liabilities or generate cashflow. Risk tolerance, liquidity constraints and time horizon will dictate how much of a portfolio is allocated to alternatives. A global survey[9] found 35% of advisors invest in liquid alts and another 16% plan to. Canadian advisers predict 10% of their book will be allocated to liquid alts. A new model for portfolio construction will emerge with alternatives making up 5-10% of portfolios.

Future of Liquid Alternatives in Canada

We are still in early stages of the liquid alts story in Canada – the space has a lot of runway to grow.

7. CIBC – Alternative Mutual Funds Growth Potential Looks Solid Coming Out of the Gate (July, September 2019) **8.** Alternative beta products - credit arbitrage, relative value, commodities, currencies, private credit, real estate, infrastructure, idiosyncratic strategies. **9.** Alternatives in 2019, Preqin

This is an unprecedented time of innovation and opportunity for Canada's investment industry. Fuelled by a need to shelter capital and demand for yield, the global alternative market is expected to hit $14 trillion by 2023[10]. The liquid alt market is forecasted to be $100 billion by 2025[11] – a meaningful share of the $1.5 trillion mutual fund market in Canada.

The fund-of-funds market is ~$550 billion.[12] Greater take-up by fund-of-funds, which can invest 10% in liquid alts, has the potential to significantly accelerate market growth. More ETF launches are anticipated, which will make alternatives more accessible and spur growth of the sector.

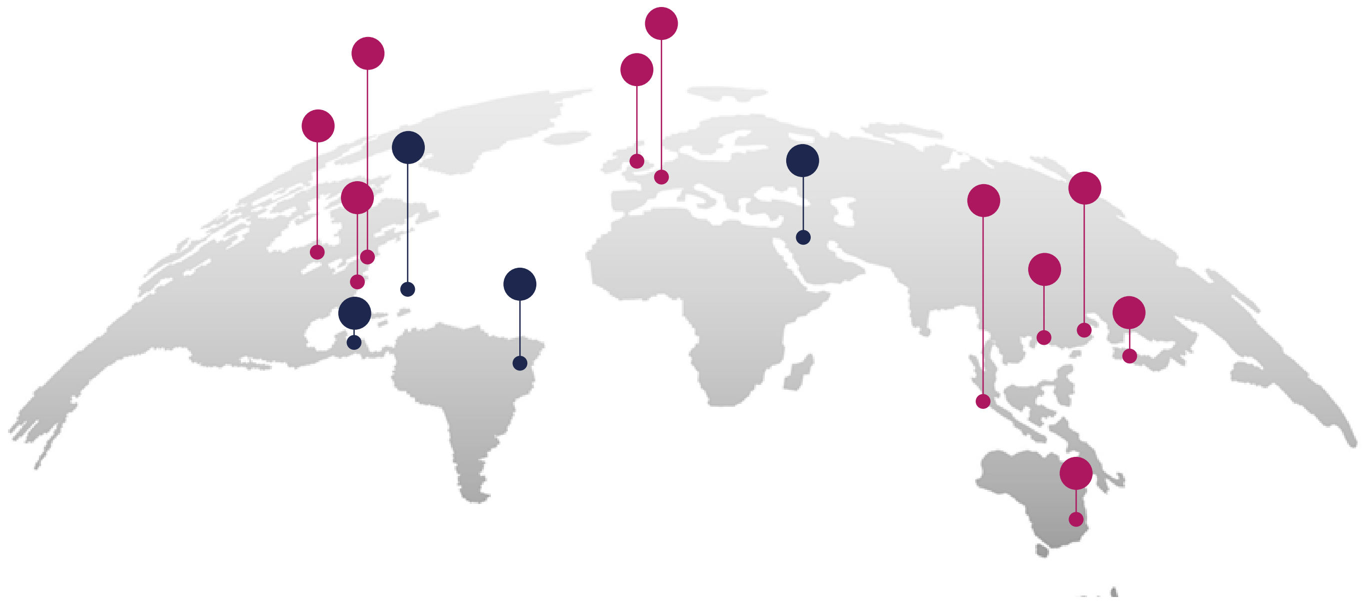
Alternatives are increasingly becoming an integral part of institutional portfolios with allocations making up 30%[13] to 50%[14], and rising across a broader investor base. Alternatives continue to gain momentum with more than half of institutional investors planning to increase allocations over the next year.[15] We can expect to see this trend carry into the retail space. Products will become more mainstream and cater to a wider demographic as distribution channels widen with changes to ratings and opening of MFDA sales channel of ~80,000 advisors.

Popularity will gain traction as familiarity with complexities of alternatives and how to assess products grows. Sales are expected to ramp up once there are proven track records and dealers become more attune to the compelling investment case and how to best allocate alternatives as part of a balanced portfolio.

Regulatory sentiment supports growth with short sale collateral limit and other relief granted and collaboration with AIMA to address proficiency requirements. AIMA will continue to advocate for a flexible framework promoting innovation to provide Canadians a suite of products to help them realize their investment goals. The Canadian alternative market is poised for greater expansion with world-class talent and new channels for growth in retail markets.

10. Preqin Data (2018) **11.** Scotiabank and CIBC **12.** CIBC – Alternative Mutual Funds Growth Potential Looks Solid Coming Out of the Gate (July, September 2019) **13.** https://www.piacweb.org/publications/asset-mix-report.htmltheyear-2006 **14.** CPPIB Annual Report 2018 (and other industry data) **15.** CIBC Mellon "The Race for Assets Canada vs. the World"

CONTACT US



Bermuda
usa@aima.org

Brazil
info@aima.org

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

Cayman Islands
cayman@aima.org

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

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

Middle East
info@aima.org

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

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

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

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

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

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

Washington
1875 K Street NW, 4th Floor,
Washington DC 20006, USA
+1 202 919 4940
usa@aima.org

THANK YOU TO OUR SPONSORS

Allen & Overy
Citco
Clifford Chance
CME Group
Dechert LLP
EY
Guotai Junan Securities
K&L Gates
KPMG
Man Group
Maples Group
PwC
RSM
Scotiabank
Simmons & Simmons
SS&C
State Street

Thank you for reading edition 121 of the AIMA Journal. If you would like to contribute to the next edition, please email cgiordo@aima.org

AIMA