AIMA

AIMA Journal - Edition 114

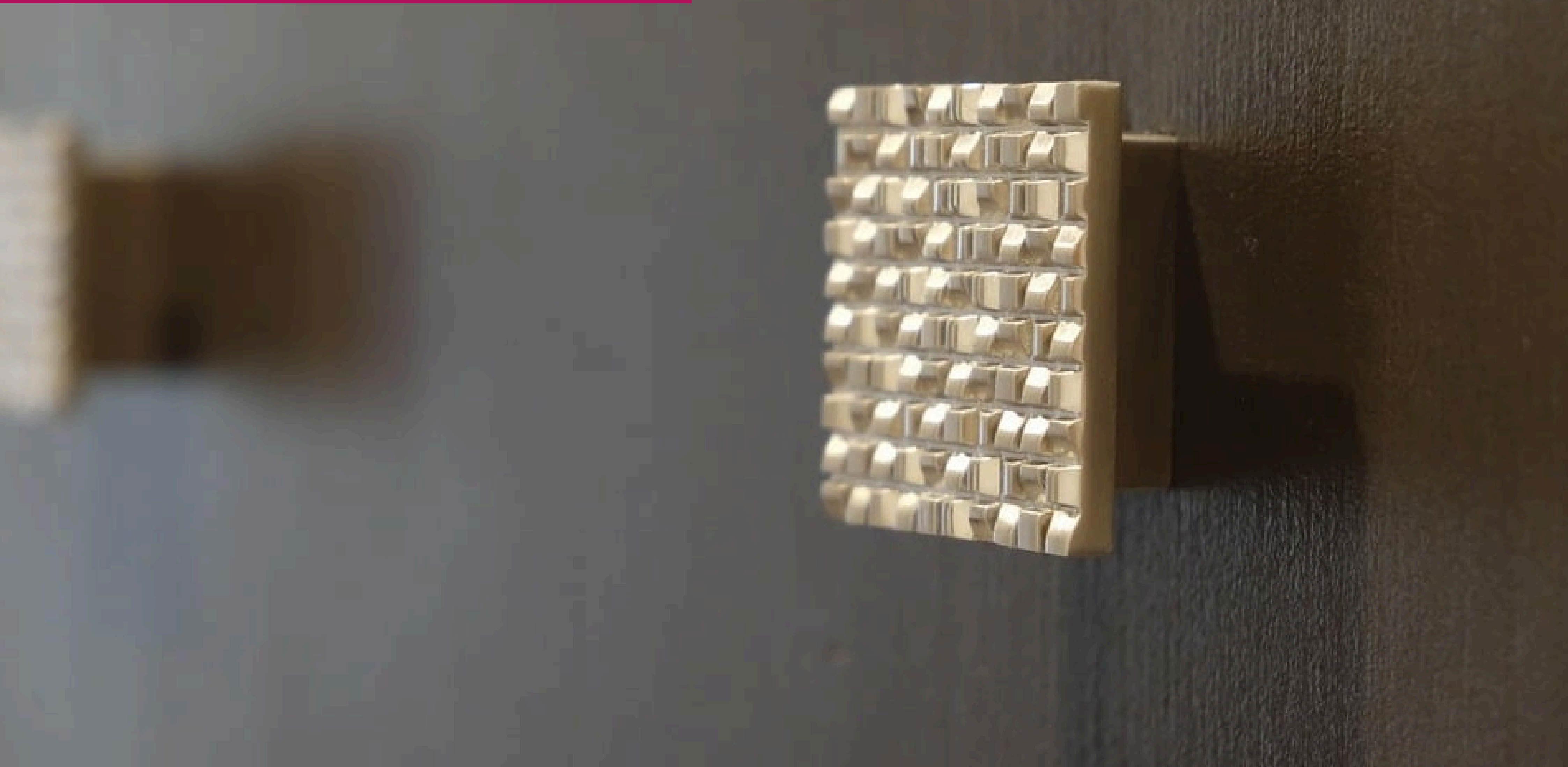
Includes:

- SMCR
- Fundamental Networks
- US debt
- Hong Kong regulation
- Regulating cryptocurrencies
- GDPR

...and more

Message from AIMA's CEO

By Jack Inglis



Jack Inglis

Welcome to our new edition of the AIMA Journal, which aims to help members keep abreast of some of the wide-ranging advancements the industry has to offer as well as developments across the regions we operate in.

I am always delighted to see how many of our members across the world contribute to the Journal, and this edition is no different, with contributions from Europe, North America and Asia covering a diverse set of topics.

For example, with the Senior Managers & Certification Regime on the way, one article looks at how best to manage the process. Another article discusses how systematic techniques are being utilised. Regulatory reforms in Hong Kong are analysed. There is a commentary on the impact of digital technologies. And with cryptocurrencies entering the mainstream, another piece tackles the criticisms digital currencies have faced. But this is only a selection of the articles included.

Meanwhile, we have had a busy start to the year at AIMA. We now find ourselves within a year of Brexit, which was of course discussed at length at AIMA's Global Policy & Regulatory Forum in Dublin and was addressed in our new position paper (here). What is clear is that our members are increasingly mobilising their plans to have an "EU solution", should they require one, once the UK becomes a third country. If you missed the conference you can read about the main discussion themes addressed here.

We became a signatory to the UK Treasury's Women in Finance Charter. The charter asks financial services firms to commit to supporting the progression of women into senior roles. At AIMA, half of our staff are women and over a third of senior positions are held by female staff. But the figures for the industry as a whole show there is still work to be done with only 11% of senior roles across all alternatives firms being filled by women. We fully support more gender balance within our

industry and hope the leadership example of those members that have also signed the charter will encourage other firms to join them in setting diversity targets that are appropriate for the modern age.

In April we launched a new report titled 'Perspectives : Industry Leaders on the Future of the Hedge Fund Industry' and this is well worth a read (here).This paper accumulates the views of 25 leading figures in the hedge fund industry, who collectively account for over 300 years of industry leadership and manager over $500 billion in AUM. It has excellent insights from people who have been doing this for a long time and with considerable success. What is clear is that the industry is adapting at a pace not seen before and that managers are meeting the challenges through innovative products in order to remain competitive and meet investors' needs.

We have also been active in strengthening our team in North America. We have appointed Claire Van Wyk-Allan to head our operations in Canada. Claire joins from RBC Global Asset Management and while there was a member of AIMA Canada's Executive Committee so she know us and the market well. I am also pleased to welcome Uzi Rosha, who has joined our New York office as Managing Director and Head of US Regulation and Compliance. He was previously Chief Compliance Officer at Cargill.

With research papers in the pipeline on responsible investing, liquidity and fund administration, and new or updated sound-practice guides about cyber security, expense allocations and private credit (among other topics), not to mention flagship events including the AIMA Japan Forum in Tokyo, AIMA Spotlight in New York and the ACC Global Summit in London, the next few months promise to be no less busy.

To celebrate 15 years of AIMA Canada, the team opened the Toronto Stock Exchange (video below).

Opening Bell at TMX as AIMA Canada celebrates 15 years

Dangers, data and Darwin: hedge funds face the future

Andrew McCaffery, Global Head of Client-Driven & Multi-Manager Solutions at Aberdeen Standard Investments

Andrew McCaffery

Under pressure from innovation, demanding clients and Old Father Time, hedge funds face their fair share of challenges. A rapidly evolving environment will spell the end for those who fail to keep pace. But in a Darwinian industry, those who innovate and adapt will ultimately benefit – and so will their clients.

In a new report, the Alternative Investment Management Association (AIMA) explores these challenges. It also outlines a vision of the industry's future – one that welcomes the challenge of change.

In recent years, innovative approaches have transformed the investment landscape. Rather than the traditional split between alpha and beta, hedge funds now also have to contend with 'smart beta' and 'alternative beta' – rules-based approaches that created a more complex market environment. This makes hedge funds' main job – extracting alpha – significantly harder.

Technological disruption

Like so many other industries, hedge funds are also contending with technological disruption. Artificial intelligence and machine learning are set to play a growing role in the investment management. Smart-beta strategies, for example, are increasingly harnessing artificial intelligence to create more sophisticated offerings.

There's also the prospect of the technology giants who own the world's largest data sets – like Google and Amazon – moving into fund management. To hold their own, hedge funds have to rely on data and machine learning to drive their investment decisions.

Then there's the challenge of recruiting the right people. Traditionally, hedge funds have recruited from business schools. Today, they need to compete with Silicon Valley for talent. With 'big data' playing an increasingly important role, hedge funds need individuals who can to gather it, clean it up and analyse it – in short, the brightest quantitative minds.

> **“Nowadays, hedge-fund managers can't lurk behind their curtains like the Wizard of Oz**

Hedge funds also face growing demands from their clients. Fees and performance have been put under a great deal of scrutiny in recent years, and clients are much more sophisticated and informed. Nowadays, hedge-fund managers can't lurk behind their curtains like the Wizard of Oz. Their mystique has been torn away, and investors are not prepared to accept unjustifiable costs or excuses for poor performance.

Environmental, social and governance (ESG) concerns are also growing in prominence. That presents an additional performance hurdle for hedge funds by narrowing their potential universe.

And then there's time itself. The industry may be relatively young, but its leaders are ageing. Succession is now a serious concern for many hedge funds. Until recently, institutional investors looked at 'key man risk' as the chances of a manager leaving or falling under a bus. Now, with many hedge-fund managers in their sixties, the industry has to take the risks of retirement or death by natural causes more seriously.

So is all of this bad news? Absolutely not.
The hedge-fund industry has always been fiercely Darwinian, and these increased pressures will simply hasten the evolutionary process.

It would be wrong to say that hedge-fund managers should have nothing to fear, because they should always fear failing to deliver for their clients. But all of these challenges offer opportunities for those who with the adaptability and skill to embrace them.

For the foreseeable future, technology will be an enhancement, not an enemy. As the AIMA report argues, machine learning and artificial intelligence will be used to inform decision-making rather than replace it.

The growing voice of the client should be welcomed too. Hedge-fund firms need to innovate constantly to provide solutions that meet clients' needs at an appropriate cost. But they will also benefit from a closer alignment of their interests with those of their clients – as through co-investment, where clients and hedge funds pursue high-conviction strategies in tandem.

It is easy to think of ESG considerations as a constraint on investing. But they can be an opportunity. ESG should be seen as a set of consideration that can be used in different ways as an investment risk management tool. It can be a lens through which clients analyse their underlying investments to improve returns and understand their impact on the wider world. This trend isn't going to go away and the hedge funds that embrace it will prosper. When it comes to succession, technological disruption may actually provide a solution. As 'star' managers are replaced by broader, more data-focused teams, the reliance on any one individual will decline. That should provide welcome stability for strategies – and reassurance for investors.

In the long run, what's good for investors is good for the industry. If the field becomes less crowded, then so be it; Mayfair property prices will do all right. Those firms that adapt to clients' needs and embrace technological change will thrive. The challenge of the new may be daunting – but it's ultimately positive for the only people that matter: the clients.

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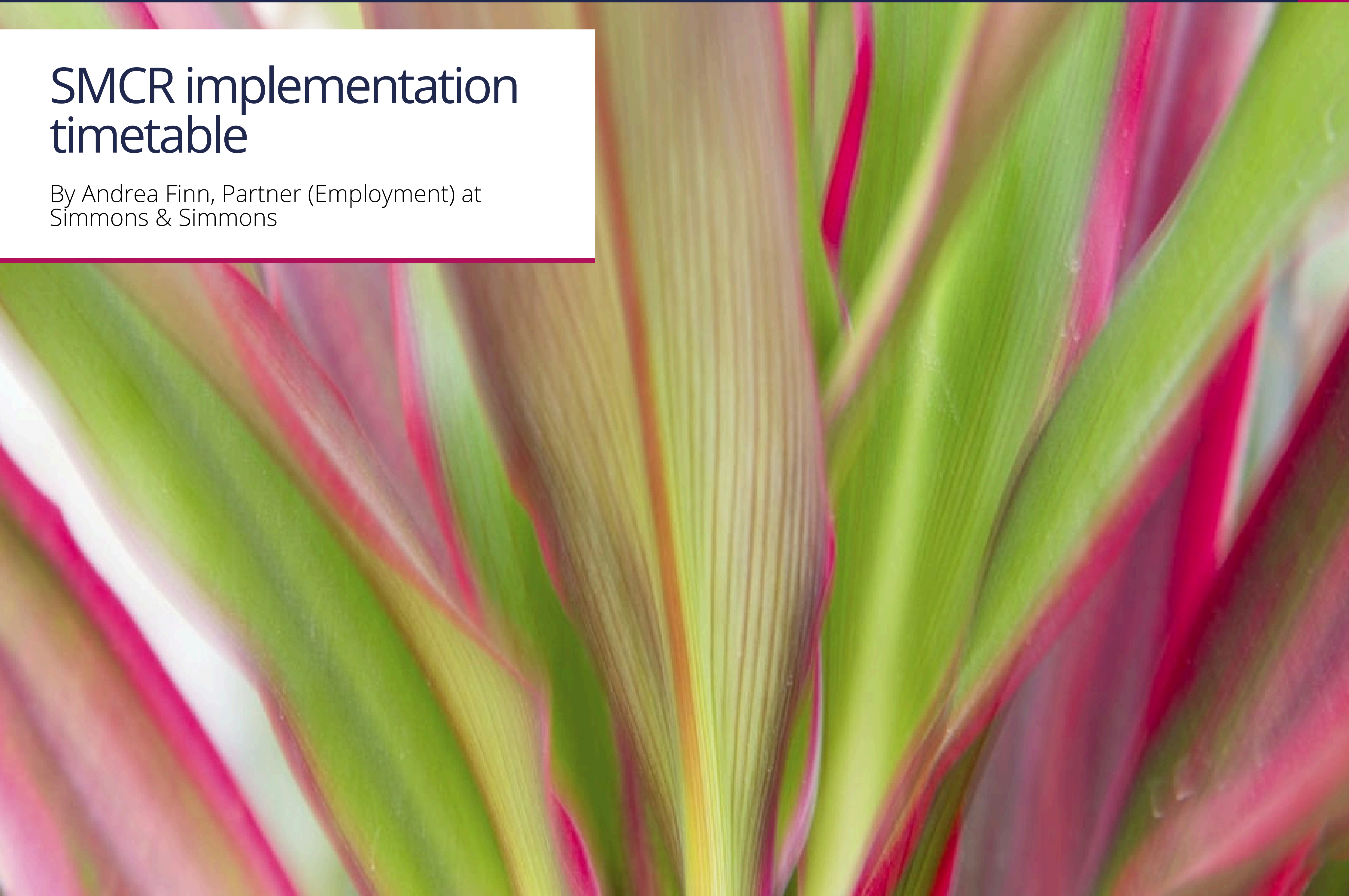
SMCR implementation timetable

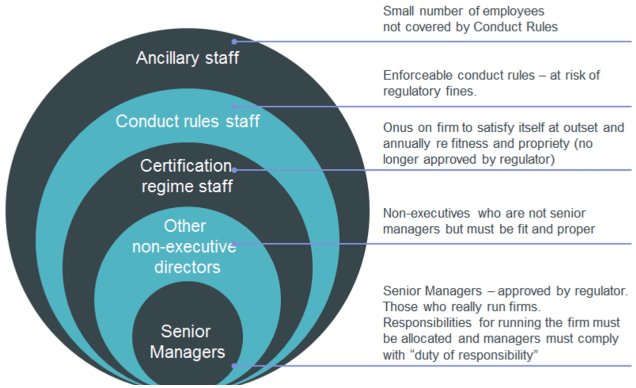
By Andrea Finn, Partner (Employment) at Simmons & Simmons



Andrea Finn

The Senior Managers and Certification Regime (SMCR) is being extended to cover all FSMA-regulated firms.

The most senior individuals within these firms (the "Senior Managers") will have their responsibilities codified and be subject to a positive "duty of responsibility" to avoid regulatory breaches. Firms will be required to certify that individuals in "significant harm functions" ("Certified Persons") are fit and proper on recruitment and annually. New conduct rules will apply to almost all staff ("Conduct Rule Staff") within the firm and breaches of the Conduct Rules must be reported to the FCA and recorded in regulatory references.



While the senior manager element of the regime has attracted most attention, from an implementation perspective, firms will need to put time into designing systems and processes (including effective training) to implement all three aspects of the regimes. The FCA has made it clear that it sees the conduct rules regime as a critical change, designed to drive change in culture within firms.

The final rules are expected to be published in summer 2018 when the FCA responds to industry feedback on its consultation papers (CP 17/25 and CP 17/40] in particular). The exact date has yet to be announced by the Treasury although the FCA anticipates that it will take effect in mid to late 2019 for most firms (insurers will be subject to the regime from December 2018). The FCA has expressed willingness through the consultation process to reflect industry feedback: while the framework derives from primary legislation, following consultation the details of the new regimes may change prior to implementation.

Firms emerging from the huge workload involved in implementing MIFID 2 and thinking about GDPR compliance may be tempted to park SMCR preparation until later in the year. However, even if low key, firms should start to grapple with their SMCR project now by assessing what their firm will need to do and identifying any particular challenges.

- International businesses and groups of companies should look at making SMCR work in practice and whether they wish to make changes to their structures to align better with SMCR. They may also want to think about whether there are aspects of SMCR which should be seen as good practice and applied across the board.
- Managing communications and obtaining

senior engagement and involvement are critical to successful implementation and should start as soon as possible and continue throughout the implementation process and beyond. This is not a “compliance/HR” project – it affects how your business operates at the most senior levels.

- Firms should remember that this is not a tick box implementation project but will represent the “new normal”. It will affect nearly every aspect of dealing with people within the firm. There is an opportunity to use the regulatory change to review and assess the effectiveness of your governance structures, allocation of responsibilities and assessment processes.

With the above principles in mind, a countdown to implementation date is set out below – this timeline is aimed at smaller / less complex firms – large complex organisations will need to bring forward the timetable to allow for the complexities of their businesses.

When?	Action
Now	• Assemble your SMCR core working group including at least HR and compliance with senior management sponsorship. This should be a priority and it is worth investing time now in securing the engagement of senior management and stakeholders • Assess the firm's structure. Identify whether each legal entity is Core, Enhanced or Limited in scope according to the proposed thresholds. Consider the effect of non – UK stakeholders or global reporting arrangements and whether changes should be made prior to SMCR coming into effect. • Review existing systems / reporting procedures. Evaluate how you will comply with the SMCR in practice – in particular; consider recruitment processes and whether appraisal arrangements offer a framework for the annual assessment of fitness and propriety of Senior Managers and Certified Persons. Consider the adequacy of governance structures, management information and record keeping. Firms may wish to consider external help and technological solutions (e.g. updated databases or appraisal systems). • Engage with likely Senior Managers and send them preliminary communications to provide them with reassurance about how the firm is managing the process and will help them discharge their duties.
D-day – 12 months	• Finalise design bespoke project plan, including allocation of responsibilities for implementation. Obtain buy-in for the plan and timetable for senior management. • Identify how staff will be categorised and start communications. • Engage with any external providers, including technology providers.
D-day – 6 months	• If not already completed, finalise provisional identification of all Senior Managers, Certified Persons and Conduct Rule Staff. • Update staff on progress and any changes.
D-day – 5 months	• Identify contractual status of Senior Managers, Certified Person and Conduct Regime Staff by way of audit (e.g. if staff are employed by one group company but act as senior managers for several group companies, their obligations to each group company for which they are a senior manager will need to be captured).

	• Start process of engagement with any non-UK stakeholders and/or any other group entities whose employees will be Senior Managers, Certified Persons or subject to the conduct rules. • Start process of engagement with any third party suppliers whose staff will be subject to the conduct rules. • Identify relevant process requirements and changes (e.g. recruitment, alignment of disciplinary process with determination of fitness and propriety or breach of conduct rules, references, training programmes). Confirm any changes needed and ensure these are embedded into the project plan.
D-day – 4 months	• Draft Statements of Responsibility and start detailed discussions with Senior Managers to agree these. Address any inconsistencies and implement any necessary changes (e.g. changes to reporting lines to give Senior Managers necessary control and resources to discharge their duties). • Draft Responsibilities Map (Enhanced Only). • Engage stakeholders on any process changes and consequential policy changes.
D-day – 3 months	• Ensure that job descriptions, role responsibilities of Senior Managers and Certified Persons and Board/committee terms of reference are up to date, aligned with Senior Managers' Statements of Responsibilities and build structure diagram/responsibilities map (Enhanced Firms). • Engage with: i. D&O Insurer to ensure Senior Managers are covered by the definition of director or officer; ii. any third party recruitment provider to confirm any amendments needed to the recruitment process; and iii. any third party reference provider to identify any changes needed to the reference process.
D-day – 2 months	• Provide training to: Senior Managers, Certified Persons and Conduct Regime Staff and implement programme for ongoing training. • Train F&P Assessors and Conduct Rule Breach Assessors.
D-day – 1 month	• Finalise updated individual documentation, for example: Offer Letters, Employment Contracts, Handbook / LLP Agreement. Consult with staff and finalise. • Finalise Statements of Responsibility and (Enhanced firms) Management Responsibilities Map. • Finalise and submit any Forms to FCA (requirements vary depending on firm's status) • Write to existing staff informing them of changes to their existing terms and conditions.
SMCR in force	Firm-wide announcement email on implementation day.

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Fundamental networks

By Charles Liu, Quantitative Researcher and Ed Fang, Deputy Director of Research at Man Numeric

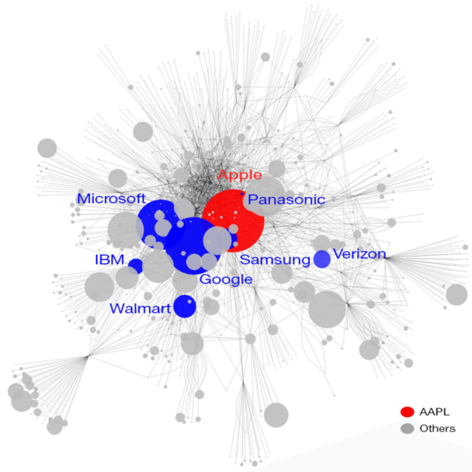
Charles Liu

Ed Fang

It's no secret that today's companies exist in an increasingly complex, interconnected 'ecosystem'. A single organization has multiple relationships across geographical regions: other companies along the supply chain, competitors, and partners. This evolving web of connections poses challenges for traditional investors who have finite capacity and speed to process information, resulting in potentially exploitable mispricing opportunities. These types of relationships are intuitive, and we believe that 'fundamental networks' in markets can help uncover opportunities.

At Man Numeric, our team has developed systematic techniques aiming to extract under-utilized, stock-specific information using fundamental relationship data. Figure 1 gives an example of a fundamental network around a particular company, Apple Inc, where circles (or 'nodes') represent the companies connected to each other and their market cap. This is just one way of illustrating such a network – others include more granular analysis of individual business segment revenues or market cap.

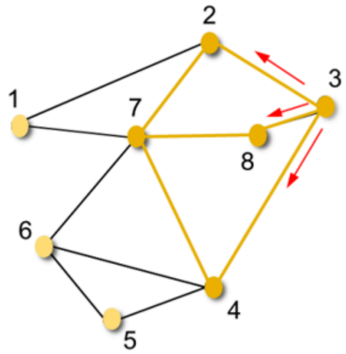
Figure 1: Example of fundamental networks – Apple Inc



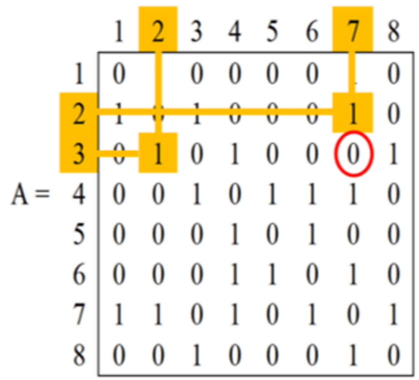
Source: Man Numeric. For illustrative purposes only. The content of this material is not intended to constitute, and should not be construed as, a recommendation or solicitation to transact in the securities of the companies named. The organisations and/or financial instruments mentioned are for reference purposes only. This information is solely used to demonstrate Man Numeric's internal research capabilities.

How do we use this type of information to understand a company's ecosystem? There are three key considerations in using network analysis: record network information, information propagation and node centrality. First, recording network information involves describing precisely how companies interact with each other – for example, the direction of information flow between them, or the properties of each node in a network. Second, information propagation is about the way we observe information from one company impacting another company. For example, two nodes in a network are strongly connected if they are linked by multiple paths. Figure 2 gives an example of both these dynamics, illustrating a simplified undirected global network, comprised of competitors, customers and partners. At top is a representation of a simplified network of companies (1 to 8), connected in various ways. The adjacency matrix in the left shows whether the companies are directly connected ('1' indicates they are, '0' indicates they are not), and the matrix on the right plots the number of two-step routes between companies. We have highlighted the links between companies 3 and 7 on each matrix – not connected directly (hence the 0 in the first matrix) but accessible via three different two-walk paths (via nodes 2, 8 or 4, hence the 3 in the second matrix).

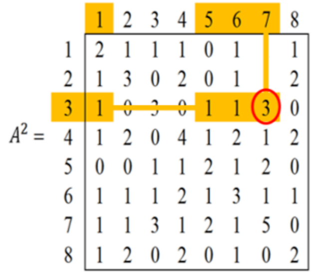
Figure 2: Information propagation in a simplified global network



Competitor, customer, partner ...



Adjacency matrix



Entries of A^2 = number of length 2 walks
Entries of A^3 = number of length 3 walks...

Source: Man Numeric. For illustrative purposes only

We believe these first two steps are important for quantifying the connectivity of companies in a network. But the third area of focus is the importance of individual nodes – which is not always the same as the number of links it has to others. Indeed, equal weighting of nodes in a network may fail to capture the real dynamics at play between companies, where a node is 'central' if it has many connections to others, and where its status can depend on the status of its neighbours. There are multiple ways of quantifying the importance of a company in a network, and the choice between them depends on the specific applications and types of network. For investors, the key question here is about whether they generally look to take positions in more or less 'central' companies – which again depends on the investment strategy to which this analysis is being applied.

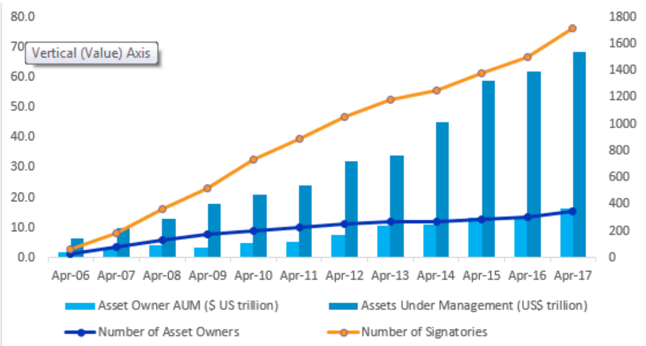
Ultimately, fundamental networks are built on intuitive observations about the way companies interact. Their basis is nothing new, but we believe that this systematic approach to quantifying relationships across markets can help investors understand the equity market universe using a more consistent framework. As interconnectivity between companies continues to increase, advanced network data analysis can be used to complement existing quantitative equity research, and we believe that if used intelligently, it can potentially provide further opportunities to add value.

ESG integration on the rise: And how to implement it in your portfolio

By George Sullivan, Executive Vice President, Global Head of Alternative Investment Solutions, State Street

Over the past 12 years the United Nations' Principles for Responsible Investment (UNPRI) – a set of six responsible investing concepts and a network of investors who have committed to implementing them – has reached 1,700 signatories representing $68 trillion in assets under management[i]. This growth suggests that investors are embracing sustainable investment practices and are increasingly considering environmental, social, and governance (ESG) factors in their investment strategies.

Figure 1 (ii)



However, the true degree of ESG implementation does not match those figures. According to US SIF, a forum for sustainable and responsible investment,

only about one-third of the signatories' assets – $21 trillion – are actually invested in an ESG strategy.[ii] Those who do invest in ESG primarily employ negative screening, which excludes certain types of investments (e.g. alcohol, tobacco, and firearms stocks) and is also the simplest approach. ESG integration, on the other hand, is the most sophisticated ESG strategy, in which investors consider material nonfinancial risk factors throughout the investment process. Our survey of 582 institutional investors worldwide shows that 47% of institutional investors use exclusionary strategies, while only 21% practice full integration of ESG risk factors.

Moving in the right direction

In our 2017 study The Investing Enlightenment: How Principal and Pragmatism Can Create Sustainable Value through ESG, we sought to determine how to close the gap between investors' aspirations and actions in ESG integration by examining the best practices of ESG investors worldwide.

In our study, we identified three major shifts that have set the stage for ESG integration to become mainstream, and therefore showing promise to improve risk-adjusted returns and society as a whole.

The first of these shifts is in **policy**. Regulatory changes have reduced the limitations of public pension funds to incorporate ESG issues into their investment process, opening the door for increased ESG investment opportunities.[iii] Two examples are the Department of Labor ruling on ERISA in the US, and the EU Non-Financial Reporting Directive; the latter of which requires 6,000 companies to report ESG information annually, making more data

available to potential investors.[iv]

The second shift is in **academia**. A growing number of empirical studies show a positive relationship between ESG factors and corporate financial performance, which supports the premise that managing ESG risk factors improves financial returns for companies.[v]

The third shift is the **formation of industry groups** such as the Sustainability Accounting Standards Board (SASB). Founded in 2011, SASB has led efforts to develop standards for companies to measure and report material non-financial sustainability information. Other organizations such as Ceres, Global Sustainable Investment Alliance, and The Investment Integration Project (TIIP) are advocating sustainability and systems-level thinking in asset management.

Removing outdated barriers

Additionally, we discovered that some of the traditional perceived barriers to ESG implementation are now receding. First is the perception that ESG strategies will negatively impact **performance**. In fact, almost half of institutional investors in our survey (48%) don't believe ESG means missing out on returns, and only a third (35%) believe ESG means sacrificing returns.

Second is the perception that **fiduciary duty** prevents ESG integration. Actually, only 10% of our respondents see fiduciary duty as a barrier and furthermore, 40% of asset owners and 51% of asset managers worldwide see fiduciary duty shifting in the direction of supporting ESG integration. These numbers reflect a broader change in perception of ESG investing, from activism or negative screening to accounting for a complex set of non-financial risks.

Third is the perception that investors' **performance expectations** are too short-term for ESG investing. We found that only 8% of institutional investors believe ESG strategies would outperform in less than a year, but 75% expect outperformance after three years. This suggests that investors are willing to soften their focus on annual or short-term returns when it comes to ESG strategies.

Building the case for ESG integration

Based on our study, we expect that ESG implementation is here to stay for three reasons. First, 48% of institutional investors believe ESG integration is associated with **better investment practices**, and two-thirds say it is associated with a longer-term investment mindset. Second, only 18% say that their interest in ESG integration is driven by regulatory requirements, so it is largely not compulsory. Finally, only 10% of institutional investors say that peer pressure is a driver behind ESG integration, which suggests that it is not simply a fad.

So what's holding investors back from ESG integration? Unsurprisingly it comes down to data. The most frequent barrier, reported by 60% institutional investors, is the lack of standards for measuring performance of ESG strategies. The second most common barrier is a lack of ESG performance data reported by companies, cited by 53%. About two-thirds (67%) of institutional investors say that **greater transparency** in ESG reporting from companies would be the most useful thing towards improving ESG integration.

Five actions on the path to success

To help keep the dialogue going we developed a framework for ESG integration that is based on five actions.

First, **take ownership** – meaning to obtain decisive support from the C-suite and board on implementing ESG strategies. Second, conduct **education and training** on ESG across the investment organization. ESG integration cannot be done effectively when there's a dividing line between the sector analysts and a (usually small) group of ESG analysts who handle proxy voting and attempt to influence the decisions of the sector specialists. The most common practice for reducing barriers to ESG integration is providing training on ESG to sector portfolio managers and analysts. This makes ESG factors a part of the investment organization's DNA, so to speak.

Third, ask for **the necessary data**. This primarily occurs through engagement with portfolio companies. Corporations often complain that investors neither give them credit for sustainability efforts nor ask about their ESG performance; but instead focus on short-term financial performance. In turn, investors complain that companies don't report useful ESG data and never talk about it on investor calls. Indeed, 92% of our respondents said that they want companies to explicitly identify what they regard as material ESG factors affecting financial performance. The only way to accomplish that is through engagement. Less directly, supporting industry efforts for increased standardization of ESG data and reporting requirements goes a long way toward better access to data.

Fourth, incorporate a **materiality filter**. Effective ESG integration does not require all the data at all times, but rather the necessary, materially important data. Information can be considered material if "there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investors as having significantly altered the 'total mix' of information made available."[vi] More simply, material information is anything that impacts your investment decisions. We found that two-thirds of institutional investors now believe it's possible to build models that show the relationship between material ESG factors and financial performance.

The fifth and final step is **aligning time horizons**. This means adjusting performance metrics and incentives structure to reflect the long-term nature of ESG investing. While our survey results suggest that ESG investors are comfortable with a longer time horizon, most investment organizations are still evaluating and compensating managers on short-term performance regardless of their stated investment horizon.

We believe that this framework will allow investors to effectively integrate ESG risk factors into their investment decisions and achieve sustainable value creation.[vii]

Footnotes

[i] PRI Homepage – Principles for Responsible Investment. (2017, April). Retrieved February 1, 2018.

[ii] Ibid

[iii] US SIF: The Forum of Sustainable Investment and the US SIF Foundation, "Report on US Sustainable, Responsible, and Impact Investing Trends 2016". (2016) US SIF refers to ESG investing as "sustainable and impact investing."

[iv] "An important purpose of this Interpretive Bulleting is to clarify that plan fiduciaries should appropriately consider fa ctors that potentially influence risk and return. Environmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment. In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices." Department of Labor Employee Benefits Security Administration, 29 CFR Part 2509. October (2015).

[v] The Climate Disclosure Standards Board, "EU Non-Financial Reporting directive – how companies make the most out of it," Climate Disclosure Standards Board News, CBDB.net (2016). Accessed March 2017.

[vi] Subramanian et al, "Equity Strategy Focus Point ESG: good companies can make good stocks," Bank of America Merrill Lynch (2016).

[vii] Sustainability Accounting Standards Board: Why is it important? About Materiality. (n.d.). Retrieved February 1, 2018.

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Exp 2/28/2019

Canadian liquid alternatives: The next market disruptor

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Michael Ginelli

Alexandra Krystal

Robert Lemon

The Canadian mutual fund market, like the markets for European Alternative UCITS, and US '40 Act Liquid Alts before it, is on the verge of historic change with final amendments to National Instrument 81-102 (the "Proposal") to take effect January 3rd, 2019, which introduces a framework for offering greater choice to retail investors. This innovation is an extremely positive outcome for all participants, with strategies that were not readily accessible to retail investors, soon to be made available.

Similar, but Not the Same: Key Differences between Canadian Alternative Funds "Alternative Mutual Funds" under the Finalized Amendments and Private Funds – At A Glance

Even though the framework provides investment flexibility and permits performance fees, the finalized rules still place bounds on the more flexible strategies engaged in by Alternative Investment Managers ("AIMs"). A few of the key restrictions, and obligations, for Alternative Mutual Funds are set out below:

Restrictions & Obligations	Canadian Liquid Alternative Funds
Eligible Investors	Available to the mass market
NAV Calculation	Daily
Redemption Rights	Daily (most common), weekly & monthly could apply as well
Initial Holding Period	Maximum 6-month
Redemption Proceeds	T+2
Performance Fees	Permitted
Borrowing (cash and / or securities)	Limited to 50% of NAV (Borrowing + Short Selling cannot exceed 50% of NAV)
Short-Selling	Limited to 50% of NAV, no cash cover required
Leverage	Maximum of 3X (Leverage defined as (total short securities + short cash + notional size of derivatives) / NAV)
Concentration Limit – issuer level	20% of NAV, subject to carve-outs
Illiquid Assets	10% of NAV at initial investments; 15% hard-cap
Disclosure requirements	Publicly-filed financial statements Top 25 holdings disclosed quarterly Leverage disclosure in annual and interim financial reports

Just because an AIM can theoretically convert its strategy into an alternative mutual fund following implementation of the final rules does not mean it should.

Strategy considerations

The necessity to honor liquidity demands is a key factor that should be taken into account when deciding to pursue Alternative Mutual Funds as a product option. Alternative Mutual Funds may have far shorter liquidity terms than hedge funds – daily, weekly or monthly, as compared to quarterly or longer, and as such, AIMs may need to adjust portfolio management to meet the more frequent redemption rights. Adjustments may not be difficult in terms of securities liquidity, however, the AIM must consider the impact of redemptions on returns, not only for the Alternative Mutual Fund, but for other portfolios under management.

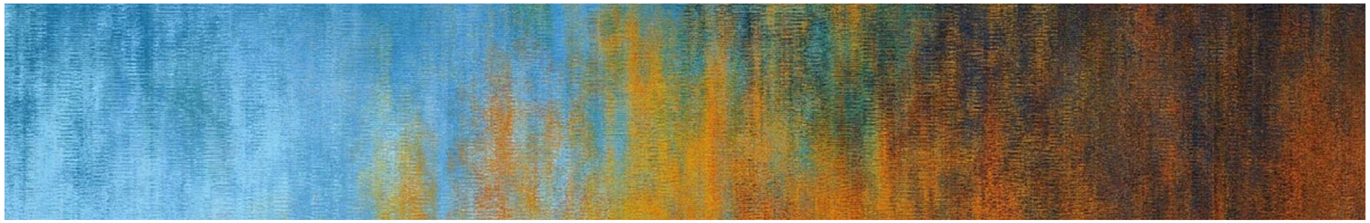
The use of leverage, shorting and derivatives, as well as diversification and transparency requirements should also be included among the AIM's fundamental considerations.

Exemptive relief

Certain strategies may not currently fit under the finalized rules. However, the CSA has indicated that it may support engagement with AIMs who want to launch a portfolio with characteristics that fall outside the finalized rules. Under certain circumstances, AIMs may be granted exemptive relief in order to launch products that currently exist outside the finalized rules. AIMs who would consider an innovative alternative investment product in Canada are encouraged to contact their local securities regulator to discuss the applicable securities law issues.

Enterprise considerations

In addition to determining whether an Investment Manager's strategy is compatible with the Alternative Mutual Fund constraints, the AIM must also establish whether it has sufficient operational infrastructure to meet increased demands on the firm.



To start, entering the Alternative Mutual Funds market will undoubtedly have an impact on the AIM's human capital. For example, alternative strategies are complex, and significant effort will be required to educate investment advisors, financial planners and investors. There is an expectation by Canadian Mutual Fund Managers that AIMs will make Investor Relations personnel available to assist with marketing by participating in road-shows and conferences. Also, with increased regulation and investment restrictions, come additional compliance and order management responsibilities. Servicing this new product type is anticipated to increase the burden on these departments, which at many AIMs, are already working at, or close, to capacity.

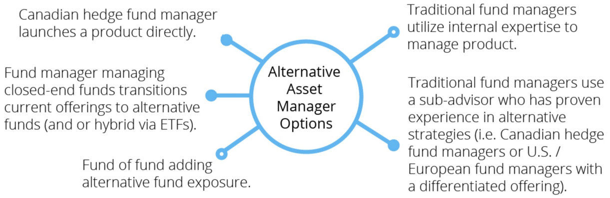
In addition to human resources, information technology costs need to be evaluated, as with increased regulation comes increased need for proper controls. For instance, many AIMs have existing allocation policies and procedures in place to govern the oversight of investment guidelines for multiple portfolios. 'Pari passu' managed portfolios are often eligible for pro rata investment allocations; adding a fixed regulatory framework to a pro rata regime may lead to surprises, and unintended consequences. Consider, for example, the not-uncommon scenario where an aggregated order is placed, and the shares allocated, pro rata, post execution. If the pro-rated portion of the trade allocated to an Alternative Mutual Fund would put the portfolio above a concentration limit, what happens to the 'extra' shares? Are they re-routed to a private fund? Is it fair to the private fund investors, who end up with more shares than the Portfolio Manager intended because of another portfolio's restrictions? Would this be deemed a trade error under Manager policies? This is just one scenario that an AIM should review, keeping in mind, that tools, such as pre-trade compliance modules are available but come with a cost.

Reputational considerations

In addition to the portfolio and operational considerations associated with managing an Alternative Mutual Fund, as stewards of retail investor capital, AIMs should also be comfortable with the potential increase in regulatory interest and scrutiny. As with any new investment opportunity, and change to an existing market, there may be increased regulatory focus, and even inadvertent issues related to policies and procedures can have a damaging effect on a Firm's business.

Who Is bringing alternative funds to market?

There are a number of paths Alternative Mutual Funds can take, on their route to retail investor availability. Alternative Mutual Funds may be launched by a conventional Mutual Fund Manager who introduces their own alternative strategy to the market; Alternative Mutual Funds may also be launched by alternative investment managers who introduce their strategy in the form of a mutual fund. Another potential path to market is a sub-advisory relationship between a traditional Canadian Mutual Fund Manager and AIM. The partnership between Mutual Funds Manager and AIM is designed to provide access to a wider pool of investment talent, increase brand awareness and facilitate training for the Mutual Fund Manager, while reducing the operational and marketing strains on the AIM. These are meaningful advantages that can ultimately benefit everyone – the retail investor above all. However, before blindly embarking on a sub-advisory partnership, it is worth noting that the relationship does not completely eliminate the challenges of distributing an Alternative Mutual Fund. The AIM, for example, will be subject to oversight in the form of unaffiliated Directors, and will be required to abide by the compliance program of the Mutual Fund Manager. The Mutual Fund Manager, for example, will be subject to heightened oversight responsibilities.



Educating the market

Given alternative investments in Canada have historically only been available to accredited and institutional investors, there is a 'knowledge gap' in the Canadian retail marketplace. This gap spans the universe of participants in the market-place, each of which plays a different role in the education process.

- **Retail Investors:** For most Canadian retail investors, everything associated with an investment in alternatives will be new. Investors will need to gain an understanding of, for example, the strategies, the managers, and the risks, benefits and impact of an investment on their overall portfolio.
- **Investment Advisors/Financial Planners:** Distributors, with the most direct relationship with investors, will need not only to mirror the knowledge of investors, but be able to teach investors. Advisors may be subject to heightened scrutiny of investor suitability, and their role in establishing / vetting risk ratings serves to further increase the level of understanding required.
- **Sponsors:** Located at the epicenter of knowledge distribution, Mutual Fund Managers will need to provide insight downstream to Investment Advisors, and upstream to the Regulators. Mutual Fund Managers will likely have the most direct contact with the AIMs, so will be best positioned to distribute intelligence on processes, progressions, challenges and opportunities.
- **Regulators:** Though the Canadian regulators have spent significant time analyzing alternative investments, the launch of the market will require well-informed oversight and knowledgeable management. Ongoing communication with Mutual Fund Managers, Advisors and Investors will increase transparency and provide the road-map for effective supervision.

With demand for liquid alternative funds in Canada estimated to exceed $100 billion, the significance of this transformation cannot be underestimated. It will be the responsibility of all participants across the spectrum – sponsors, investment managers, investment advisors and service providers – to deliver peak performance and quickly substantiate the integrity and veracity of the Alternative Mutual Fund market for the retail investor.

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Hong Kong regulator finds a back door to fund regulation

By Greg Heaton, Senior Consultant at Timothy Loh LLP

Greg Heaton

While retail funds must be authorized by the Securities and Futures Commission ("SFC") before distribution in Hong Kong, the SFC has no authority to regulate private funds. Unable to touch these funds directly, the SFC has instead imposed new regulatory requirements on licensed asset managers, financial advisers and fund distributors, through amendments to the Fund Manager Code of Conduct ("FMCC") and the Code of Conduct for Persons Licensed by or Registered with the SFC ("Code of Conduct").

The amendments are in essence the SFC's response to the Global Financial Crisis, ten years after it occurred and at a time when contrarian commentators are arguing that the lessons of the crisis have been forgotten. While investors, again exuberant, began the year by piling into equities, the sharp correction in early February served as a reminder that the world's financial system might again be dangerously stretched and, some predict, heading for another meltdown.

After the 2008 crisis, regulatory bodies around the world published numerous reports and recommendations about how to avoid its repetition. The International Organisation of Securities Commissions ("IOSCO"), for example, promulgated standards for functionally independent custody of fund assets, while the Financial Stability Board published recommendations on "shadow banking" risks arising from securities lending and repos. Some of those recommendations eventually found their way into the FMCC and the Code of Conduct.

Codes of conduct do not have the force of law – courts sometimes ignore them – but the SFC and industry typically treat their provisions as if they are mandatory. That is because the SFC has broad discretion in licensing decisions and disciplinary actions, and in forming a view of an intermediary's fitness and properness will consider its compliance with all manner of SFC pronouncements, including codes, guidelines, FAQs and circulars.

As a matter of a law, ultimate responsibility for the management of a corporate fund lies with the fund's board of directors. The fund appoints a manager and can overrule it. However, the SFC argues that fund managers typically establish the fund and choose its directors or trustee. Therefore, managers that are "responsible for the overall operation of a fund" ("ROOF") will be expected to ensure that funds themselves comply with the revised codes. The SFC says a fund manager cannot cite the existence of a governing body to conclude that it is not "responsible for the overall operation of the fund" just because it does not formally make final decisions or enter into legal agreements.

The SFC has conceded that a Hong Kong subsidiary of an overseas fund manager cannot dictate how its parent operates a fund. This would appear to blow a big hole in the intended regulatory reach of the FMCC, as private offshore funds are very frequently

structured with an offshore fund manager advised by a Hong Kong subsidiary. Nonetheless, the SFC expects fund managers that are not ROOF to use “due skill, care and diligence to comply with the FMCC requirements to the extent this is within the fund manager’s control”.

FMCC provisions applicable to fund managers generally

Provisions of the updated FMCC that could be applicable to fund managers even if they are not ROOF include the following.

Conflicts of interest

A fund manager must take all reasonable steps to identify, prevent, manage and monitor any actual or potential conflicts of interest. This includes: (a) conducting transactions in good faith at arm’s length, (b) minimizing conflicts to ensure fair treatment of fund investors and (c) disclosing any material interest or conflict to fund investors. The level of disclosure required is uncertain.

Securities lending

Fund managers that are materially involved in a fund’s securities lending activities, or in determining its lending mandate, are expected to ensure there is a collateral valuation management policy and a cash collateral reinvestment policy governing securities lending, repo and reverse repo transactions. The policies should require, among other things, that collateral and lent securities are marked to market daily, wherever practicable, assets held in a cash collateral reinvestment portfolio should be sufficiently liquid, and collateral haircuts should properly manage counterparty risk. The SFC also expects fund managers to provide detailed information on a fund’s securities lending to investors at least annually.

Risk management

The revised FMCC says a fund manager should establish and maintain measures to estimate potential losses from unspecified adverse market movements, and a credit assessment system to evaluate the credit worthiness of the fund’s counterparties. In designing controls to reduce operational risk, fund managers should consider maintenance of proper records, information security, staffing adequacy and segregation of incompatible duties.

FMCC provisions applicable to fund managers that are ROOF

Additional responsibilities of fund managers that are ROOF include the following.

Custody

The SFC has indicated that it expects fund managers that are ROOF, "even though they may not be the party which formally appoints custodians", to ensure a fund's compliance with the custody provisions of the FMCC. If the custodian is appointed by the trustee, the SFC says the fund manager in selecting the trustee should consider whether the trustee would exercise due skill, care and diligence in the selection, appointment and monitoring of a custodian.

Liquidity

Fund managers should manage liquidity risk through techniques such as setting concentration limits and monitoring liquidity mismatches between underlying investments and redemption obligations.

Valuation

The FMCC says valuation methodologies should be consistent for similar types of fund assets. This is controversial, as there may be good reasons for a fund manager to adopt different valuation models for different funds managed by the same manager, for example, depending on whether the fund is closed or open-ended.

Leverage

The revised FMCC says a fund manager should disclose the fund's "expected maximum" leverage, and the basis of calculation of leverage, taking into account its investor base such that it is easy for investors to understand the calculation methodology.

Discretionary account managers

The SFC has also expanded the scope of the FMCC to cover discretionary account managers, who should observe the FMCC provisions “to the extent relevant to [their] functions and powers”. The FMCC now prescribes minimum content of client agreements for discretionary account management, such as a statement of investment policy and objectives (including asset classes, geographical spread and risk profile), and consent to receive soft commissions or cash rebates (if applicable). The manager should also review the account’s performance at least twice a year and provide valuation reports at least once a month.

Code of Conduct

An unusual feature of the Code of Conduct has been its paragraph 1.4, which says the code does not apply to the discretionary management of collective investment schemes. The rationale, after publication of the FMCC in 2003, was that fund managers’ conduct should be guided by that instead. However, the FMCC does not cover all aspects of conduct regulation, and in practice the SFC and industry often looked selectively to the Code of Conduct to fill the gaps.

Now, the SFC has decided that fund managers must comply both with the Code of Conduct and the FMCC. This introduces two problems. First, there is overlap between the Code of Conduct and the FMCC, and their duplicative provisions are not entirely consistent. The second problem is that large parts of the Code of Conduct were drafted only with brokerage firms in mind. How those parts will apply to asset managers is a mystery that the SFC has not yet sought to elucidate.

Regarding fund distribution, due to limited retail investor familiarity with pay-for-advice models and limited availability of independent fund advisory services, there is currently little appetite in Hong Kong to ban commission-based distribution models. Instead, the SFC has amended the Code of Conduct to require better disclosure of benefits payable to fund distributors. Also, distributors will need to disclose whether or not they are independent, and the basis for that determination. The Code of Conduct now says that an intermediary should not represent itself as being independent if it receives benefits “which are likely to impair its independence to favour a particular investment product”. Whilst ungrammatical, the intention of this provision is evidently that intermediaries should not claim to be independent financial advisers if they receive commissions for distributing a financial product.

Conclusion

Although the SFC has characterized new FMCC and Code of Conduct requirements as high-level and principles-based, they will necessitate specific changes to fund structures and operations, including the nature of the services provided by fund managers and fund distributors. While the financial markets are likely to provide some interesting distractions this year, the asset management industry in Hong Kong will also need to keep a close eye on the evolving regulatory landscape.

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Potential market responses to rising US government debt

By Blu Putnam, Chief Economist and Managing Director at CME Group

Blu Putnam

US federal government budget deficits are about to get very large, very soon. Maybe in the long-run, faster economic growth and rising tax revenues can stem this rising tide of red ink, but that may take years and the outcome is uncertain. So, how daunting are the challenges for the next few years and what are the economic and market implications of higher U.S. national debt?

Our basic conclusions can be summarized as follows:

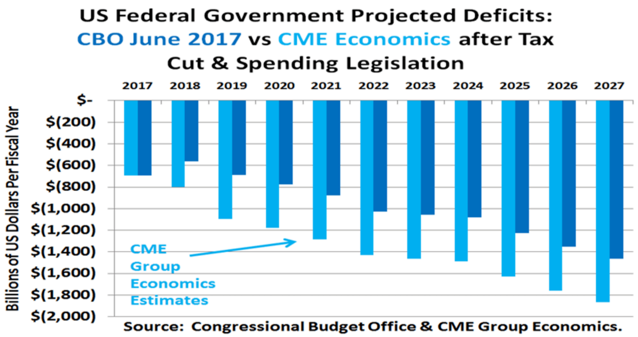
- Rising national debt is only a part of the picture; one should look at total public and private sector debt.
- Rising debt-to-GDP ratios do not predict recessions, but they do tend to make economies much more fragile and markets more volatile.
- If a large portion of the debt is owned by foreigners rather than domestically, or if the debt is denominated in a currency one's government does not control, then the probability of serious problems down the road are exacerbated. In the U.S.'s case, the large foreign ownership of the debt is the challenge and it comes at time of rising risks related to the role of the U.S. dollar as a global reserve currency.

Size of U.S. Debt Challenge

The U.S. private sector debt has been rising in the last several years as deleveraging following the financial panic of 2008 faded into the past. Student loan debt, auto loan debt, especially in the sub-prime category, and consumer discretionary debt have all been on the rise.

What has changed for 2018 is the prospect for U.S. federal government debt to balloon dramatically as well. The U.S. Congressional Budget Office (CBO) prepares regular estimates of the future course of the national debt, and they are required in their mandate to only consider the state of current tax and expenditure laws. That is, the CBO is not allowed to anticipate a large tax cut or new spending legislation. If it makes an estimate in, say, June 2017, as it did, it has to take then existing U.S. tax law and government expenditure plans as a given. Of course, since the summer of 2017, a lot has changed with the U.S. federal government budget. A very large and permanent corporate tax cut was enacted late in 2017 along with a temporary personal income tax cut. Then in early 2018, as part of a bipartisan compromise to extend the funding of the government for two more years, hundreds of billions of dollars were added to a variety of expenditure programs. Figure 1 compares the June 2017 CBO budget deficit projections out 10 years which do not include the tax cut legislation or the new spending programs, with CME Group Economics estimates of the budget deficits after taking into account the tax cuts and spending programs and assuming a modest improvement in long-run growth prospects. That is, neither the CBO nor the CME Economics projections include the possibility of recession, even though that implies a sustained expansion twice as long as any other post-war expansion. Put another way, these are probably underestimates of the size of future deficits if there is any hiccup in the economic growth path.

Figure 1.

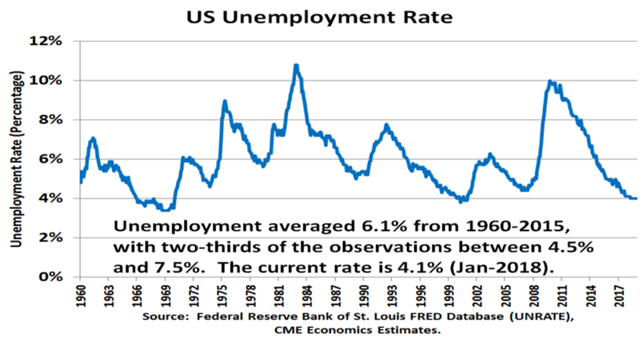


Forgetting about the out years, the change in the picture for 2018, 2019 and 2020 is quite stark. Back in June 2017 before the tax cut and increased spending legislation, the CBO thought the budget deficit for 2018 might decline relative to 2017, and then start to rise modestly for the next few years. Once the tax cut and new spending is considered, though, CME Group Economics estimates suggest the U.S. federal government budget deficit will rise quickly, exceeding $1 trillion a year in 2019 and never look back. If it turns out that down the road in the 2020s, that U.S. economic growth can sustain a consistent 3%-plus growth path, then these budget deficit estimates are likely to be over-stated, but the chance of returning to sub-trillion-dollar deficits even with 3%-plus economic growth is slim to none under the new tax-and-spend legislation.

Increased Treasury Supply and Rising Inflation Expectations Spell Higher Yields

Bond yields in the U.S. Treasury marketplace have already risen to absorb some of the coming onslaught of supply, but the story is complicated and intertwined with economic growth and inflation expectations. Back in June 2017, the U.S. Treasury 10-year Note was yielding around 2.3%, and even in December 2017 as the tax cut was passed into law, the 10-year Note was only yielding around 2.4%. That changed in January-February 2018 as the Treasury Department ramped up the size of its debt auctions and 10-year yields powered up to the 2.85%-2.95% range. The other parallel story impacting bond yields was inflation expectations. With the U.S. economy at very low levels of unemployment, as shown in Figure 2, the additional fiscal stimulus from both tax cuts and spending increases set in motion upward revisions in growth and inflation expectations. The new chair of the Federal Reserve Board, Jerome 'Jay' Powell, affirmed that these increased growth and inflation expectations supported the case for potentially more short-term rate rises in 2018 than had been previously anticipated by the Yellen-led Fed before the tax cut and spending plans became law.

Figure 2.



Happening as well, and not to be ignored, is the shrinking of the balance sheet of the Federal Reserve (Fed) by curtailing its re-investment activities associated with the U.S. Treasury and mortgage-backed securities portfolios. That is, while the public markets are facing sharply increased supply of U.S. Treasuries, they are also coping with reduced demand from its biggest client over the last seven years – namely the U.S. Federal Reserve. Note that the Fed is not planning to sell anything; the Fed only knows how to buy. But the Fed will be buying much less than in previous years as it shrinks its balance sheet from $4.5 trillion in 2017, perhaps, to around $3 trillion by the early 2020s.

Increased equity volatility and economic fragility and consequence of higher debt loads

With increased debt loads, both public debt as documented here and private debt as well, the U.S. equity markets are likely to become much more volatile and the economy more fragile. Again, we stress that rising debt loads in and of themselves do not suggest a recession is imminent; rising debt merely increases the fragility of the economy and probability of a future recession if there is a policy mistake or economic disruption down the road.

The reasoning is straightforward. Rising debt means rising interest expense, paid in part from current income or by drawing down savings and investments. If the Fed, as it has done more than a few times in the past, pushes short-term interest rates too high too fast, then the rising interest expense can be a catalyst for a recession and even more likely, equity market volatility. If there is a trade war with tit-for-tat tariff increases, then uncertainties over future exports could lead to more volatility in the share prices of companies that participate in the global economy – that is, virtually all large U.S. companies. Basically, any headwinds that an economy faces bring with them increased probability of recession or share price declines relative to an economy with less debt.

As with most things in economics, it is all relative. Economies virtually always take on more debt (combined public and private) to grow. The question is whether the expansion of debt gets out of hand. There are a couple of known warning signs. If a large part of the debt is owed to foreigners, then the rising debt loads may represent a bigger challenge to future prosperity. If the debt is denominated in a currency not under the control of one's own central bank, then the challenges are greater. In the 1970s, the debt-driven crises in Latin America were exacerbated by the large part of the borrowing being denominated in U.S. dollars and not in the national currencies of the borrowing countries. In 2011-2012, the European sovereign debt crisis, led by Greece as the poster child, was in part the unintended consequence of the single-currency system. No one country could control the pool of euro-denominated liquidity. And the eurozone countries within the European Union had no process for reining-in out-of-control fiscal policies and borrowing habits of wayward member countries while simultaneously requiring the financial system to treat all sovereign debt as equal credit risks, which they most obviously were not.

For the U.S., its debt is denominated in U.S. dollars which allows for higher debt burdens; but much is held by foreigners, which increases the fragility factor of rising debt loads. This is complicated by the role of the U.S. dollar as a global reserve currency. A global reserve currency means lower interest rates than there otherwise might be, representing lower risk premiums. This advantage of the U.S., however, may be diminishing. In 2017, the U.S. commenced a foreign policy of pulling back from the role of global leader regarding multi-lateral free trade agreements and other world economic policy initiatives. The result was that despite the Fed raising rates while the European Central Bank (ECB) and the Bank of Japan (BoJ) held their short-term rate close to zero, and despite the shrinking of the balance sheet at the Fed while the ECB and BoJ continued to expand their balances sheets, the U.S. dollar lost ground against both the euro and yen. If one was forecasting exchange rate movements purely on the basis of relative monetary policy, then one would have gotten this all wrong – and many analysts certainly did. The culprit was the failure to consider the rising risks associated with holding U.S. dollars from first, a retreat from global leadership and secondly, from rising debt loads.

We are only in the early stages of understanding the full implications of the new directions in U.S. policies. The transitions are impressive. The Federal Reserve is raising rates and unwinding quantitative easing. The U.S. federal government is embarking on tax cuts and spending increases virtually guaranteeing sharp near-term increases in the national debt. And, diplomatically, the U.S. is taking a strikingly different posture on trade agreements and stepping back from the world leadership role it has played in the entire post-war period of economic prosperity. When one puts it all together, it is not hard to see why equity markets are increasingly more volatile even as unemployment is low and consumer confidence is high while market participants contemplate how to manage changing risks given a very uncertain and fragile future.

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Footnote:

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

Reshaping the industry: Digitise or jeopardise

By Anthony Cowell, Partner, and Claire Griffin, Director, Asset Management, KPMG in the Cayman Islands

Anthony Cowell

Claire Griffin

Digital technologies are radically reshaping the alternative investment industry. But a large majority of hedge funds firms appear to be too slow to respond. This is the key finding of a new report, Alternative investments 3.0 – digitize or jeopardize, based on a global survey conducted by KPMG International and CREATE-Research.

Alternatives face disruption

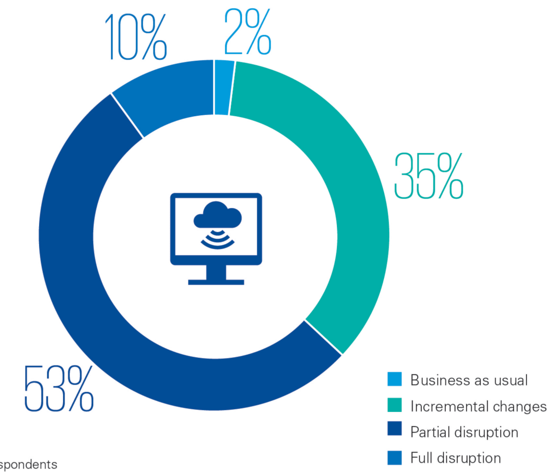
Like most other activities in finance, alternative investing is information intensive. Data is its lifeblood. Digitization is thus emerging as its new 'heartland' technology, with the potential to penetrate every activity in its value chain — core and non-core alike.

Previous waves of information technology mainly automated routine manual processes to reduce costs and enhance accuracy.

The current wave, on the other hand, seeks to deliver end-to-end solutions within more joined-up businesses via speed, connectivity, insights, transparency, personalization and disintermediation.

Unsurprisingly, on a 10-year view, the current business models will most likely face disruption. While 98 percent of respondents say 'business as usual' is not an option, at least three out of five respondents said they are still at the early stage of 'awareness raising' with respect to revolutionary technologies that could potentially transform their businesses.

Figure 1.1 Which scenario summarizes your view on the impact of digitization on the alternative investment industry over the next 10 years?



Percentage of respondents

Source: © KPMG/CREATE-Research survey 2018

Alternative Investment 3.0

Digitization may well be driving the alternative investment industry into the third phase of its evolution.

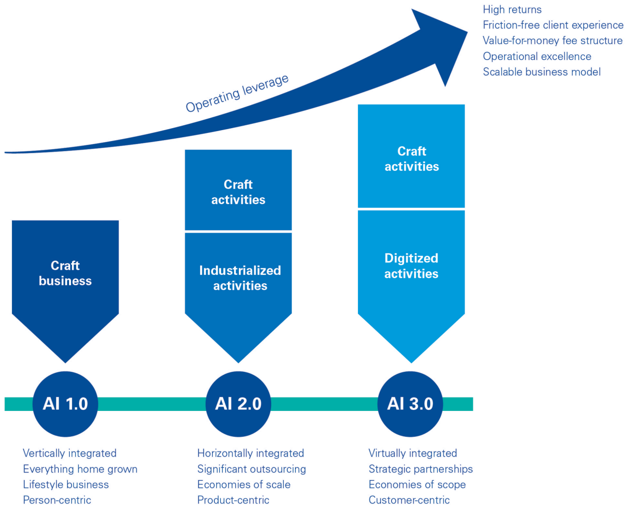
Prior to the 2000s, autonomous lifestyle businesses run along craft lines dominated the alternative landscape.

In the last decade, the search for uncorrelated absolute returns intensified, following the success of iconic investors such as the Harvard and Yale Foundations. The new wall of money from institutional investors ushered the industry into its second phase, where economies of scale and robust operations became fresh imperatives (AI 2.0).

The front office retained its craft nature but routine activities elsewhere in the business were increasingly automated

or outsourced via a new horizontal integration. The aim was to enjoy economies of scale: unit costs fell as AuM rose.

Now the industry is transitioning to its third phase to create joined-up businesses via digital innovations that can deliver operating leverage, within strategic partnerships with the best-of breed external service providers and FinTechs (AI 3.0).



The latest phase redefines its heritage via a new human–machine interface that combines the best of both. It also seeks to create new opportunity sets by widening the scope of the business. Above all, it reflects the transition from being a supply-led industry to being a demand-led industry.

Drivers of digitization

Whereas our respondents accept that digitization of their industry is inevitable, their own approach will be marked by small steps rather than giant leaps.

Less than a third of respondents said they are at the implementation stage for key innovations, while advanced technologies such as blockchain and robo advisors have been implemented by three percent or fewer.

Factors accelerating the pace of innovation

Indeed, when asked which factors will accelerate the pace of digital innovation in their business over the rest of the decade, respondents cited market-driven factors, including growing cost pressures (58 percent), changing investor needs (51 percent) and fees and charges, becoming a major differentiator (30 percent). They also cited client-driven factors such as growing social acceptance of digitization, and end-investors becoming more demanding (37 percent) and more financially and digitally savvy (36 percent).

Factors moderating the pace of innovation

Holding back the pace of digitization are a number of technology and business-related factors. On the technology side, they include cyber security (58 percent), legacy IT systems (43 percent), and the high cost of digital innovations (42 percent). On the business side, they include senior executives being too focused on day-to-day matters (40 percent), regulatory issues (39 percent) and low risk appetite in the corporate culture (31 percent).

The survey identified activities that are especially ripe for disruption in the front, middle and back offices. They include portfolio risk management, research and securities selection, alpha generation, deal flows, risk & compliance and fund accounting.

Sources of disruption

That disruption is inevitable is not in doubt. But opinions differ on its potential source.

- 34 percent expect internal disruption, as alternative investment managers themselves get on the front foot and digitize their businesses in order to pre-empt competitive threats — from both inside and outside their industry. This group included many large managers in our survey.
- 44 percent expect joint disruption, as incumbents collaborate with potential external rivals. This group includes many medium and small sized managers who want to stay in the driving seat.
- 22 percent expect external disruption, as current internet titans and FinTech start-ups venture into alternative investments, especially into areas where they have a dominant digital advantage and brand presence. This group included many medium sized managers.

Digital leaders make the difference

Business transformation is as much about leadership as about technology — if not more so. It requires digital leaders who can navigate the transition alternative investment managers have to realign their businesses to meet the emerging needs.

This is all the more necessary, since our survey respondents envisage three outcomes as digitization progresses over time in their industry. The outcomes are as follows.

- **Client context:** a better investment proposition — based on fees, returns, engagement and experience — will mark the shift from a product-centric to a client centric business.
- **Industry context:** competition will intensify

and profitability will erode. Those able to deliver the required proposition will do well, in what may well turn out to be a ‘winner takes all’ world.

- **Corporate context:** improvements are expected in process efficiency, time to market, investment capabilities, client base and skill sets.

Concluding remarks

Our research suggests that the Alternative Investments Industry is already in the midst of a tectonic shift, with significant consequences over the next decade.

History shows that at the dawn of each major IT innovation, ex ante predictions about its adoption and impact have invariably been proven wrong. They overestimated the adoption pace and underestimated the magnitude of the impact. The pace turned out to be slower but its eventual impact much larger.

By any measure, the industry has been highly profitable. But its members now face a stark choice: digitize or jeopardize.

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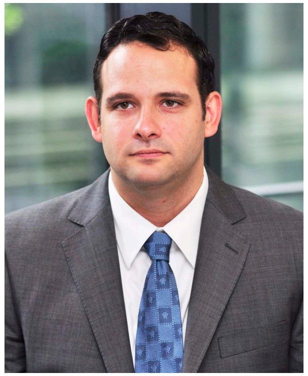
The full report can be found at kpmg.com/ai3.0

Observations for European-based investment managers under US tax reform

By Damon Ambrosini, Tax Partner, US Tax and Ted Dougherty, National Managing Tax Partner, Investment Management at Deloitte



Damon Ambrosini

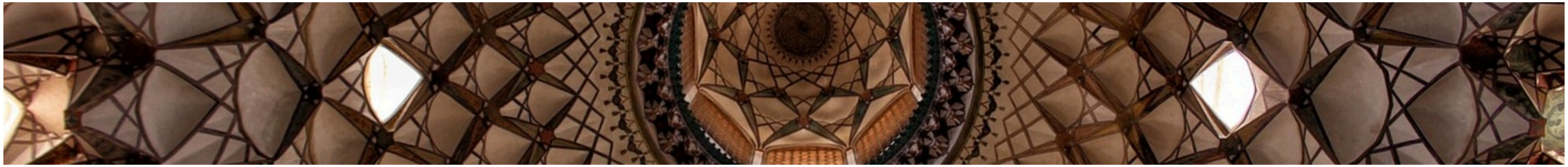
Edward Dougherty

In a widely reported on process in December of 2017, the Congress of the United States approved and President Donald Trump signed into law what is widely regarded as the largest US tax reform legislation since that brought in by then President Ronald Reagan in 1986. The legislation, officially known as An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (the "Act") contains a number of provisions that fundamentally alter the taxation of individuals and corporations. Further, the Act impacts the taxation of certain economic activity conducted through pass-through entities as well as seeking to impose a transition tax on deferred overseas earnings while implementing a new set of rules related to the taxation of overseas activity commencing on 1 January 2018; the U.S. is in effect moving towards a participation exemption system of corporate taxation. For the purposes of this article, we have focused on the application of rules related to US individuals, US domestic corporations and owners of entities treated as a pass-through (i.e. a partnership) for US tax purposes. Unless otherwise noted, the changes we discuss herein are effective for tax years beginning on or after January 1, 2018.

Taxation of US Domestic Corporations

In one of the more prominent features of the Act, the federal level of tax is reduced from a graduated scale of up to 35 percent to a flat rate tax of 21 percent and fully repeals the corporate alternative minimum tax. Furthermore the Act permits certain tangible property that is depreciated or amortized under current law to be fully expensed in the year placed in service until 2022, providing for a phaseout thereafter. These provisions in particular may make investment into the US marketplace more attractive to European based investment managers seeking to expand their US presence.

For non-US shareholders that have financed an investment in a US domestic corporation with debt, new restrictions are placed on the deductibility of net business interest expense that may require a review of the US domestic corporation's capital structure. Unlike other provisions in Act, the interest expense restrictions apply to retroactive arrangements rather than solely for arrangements entered into post-enactment. As another example of a prior favourable position being curtailed, the Act reduces the dividends received deduction which applied to applicable corporate shareholders receiving a dividend from certain domestic corporations.



For US domestic corporations maintaining "net operating losses" from prior tax periods, prior to the Act's passage these were permitted to be carried back two and forward twenty tax periods. On an onward basis, the carryback of net operating losses is eliminated while the carryforward position is expanded indefinitely; however the use of the net operating loss is limited to 80 percent of taxable income in a subsequent tax year computed without regard to the deduction of the net operating loss.

Taxation of individuals

US individual income taxpayers saw the top graduated rate of 39.6 percent reduced to 37 percent under the Act while the preferential rate of 20 percent remains intact for long term capital gains and qualified dividend income. In an effort to help reduce the complexity of the US individual income tax rules, the standard deduction was nearly doubled thereby limiting the usage of itemized expenses recorded; indeed, most itemized deductions were eliminated entirely by the Act.

In addition to this, additional limitations have been imposed related to the deductibility of state and local income or property taxes as well as the home mortgage interest deduction. With respect to the deduction of state and local taxes, a limitation of up to $10,000 has been imposed as a deduction against income for federal tax purposes for taxes related to (1) state and local property taxes, and (2) state and local income taxes not attributable to a trade or business or an activity associated with the production or collection of income, or sales taxes. Non-business non-US real property taxes are no longer deductible. There is a fair amount of uncertainty as to how some of the provisions limiting the deduction of state and local taxes are to be applied. Mortgage interest is now limited to that generated on home loans of $750,000 or less for new loans entered into, with older loans being grandfathered with a $1 million indebtedness limit. The provision allowing a deduction for interest on a home equity loan was eliminated. Importantly, almost all of the Act's individual income tax changes expire after 2025.

Taxation of owners of pass-through entities

The Act seeks to provide greater parity between the tax treatment of owners of pass-through entities (such as a partnership) and corporations, but also institutes provisions intended to prevent pass-through owners from recharacterizing wage income as more lightly taxed business income.

Perhaps the most prominent attempt to establish parity relates to the 20 percent deduction of domestic qualified business income earned by a

passthrough entity. In particular, an individual, estate or trust taxpayer generally may be able to deduct the sum of:

Twenty percent of the US domestic qualified business income with respect to a qualified trade or business from a partnership, S corporation or sole proprietorship (subject to certain significant limitations based on the passthrough's employee wages and assets), and
Twenty percent of aggregate qualified real estate investment trust ("REIT") dividends, qualified cooperative dividends and qualified publicly traded partnership income.

While the rules are more complex than the scope of this writing, it is worth clarifying that qualified business income does not include any amount paid by a partnership to a partner who is acting other than in his or her capacity as a partner for services rendered with respect to the trade or business and does not include any amount that is a guaranteed payment for services actually rendered to or on behalf of a partnership to the extent that the payment is in the nature of remuneration for those services. Furthermore, qualified business income does not include certain investment-related income, gain, deductions or loss. With respect to these new rules, "specified service businesses" are not considered a qualified trade or business. In particular, this means the performance of services that consist of investing and investment management trading or dealing securities, partnership interests or commodities do not generally qualify for the passthrough deduction. However, even owners of passthrough entities that are engaged in specified services businesses such as investment management may realize some small benefit of the deduction based on an exception provided which is based a taxpayer's adjusted gross income; these thresholds are relatively low compared to earnings in the investment management industry.

As a final thought on the application of the 20 percent deduction of domestic qualified business income, this may suggest that investments into REITs or structuring using REITS may now be more attractive.

The Act repeals the concept of a "technical termination" which occurred for partnerships that, within a 12-month period, had a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. Previously when a technical termination occurred, the business of the partnership continued in the same legal form, but the partnership was treated as newly formed requiring short reporting periods and providing for new elections to be made.

For owners of pass-through entities received in the context of carried interest, a new provision requires a holding period of three years in order to benefit from preferential long-term capital gains rates. This holding period applies both to the assets held within a partnership as well as to the partnership itself.

Finally, the codification of Revenue Ruling 91-32 by the Act provides that gain or loss from the sale or exchange of a partnership interest is effectively connected with a US trade or business to the extent that the transferor would have had effectively connected gain or loss as if the partnership sold all of its assets at fair market value as of the date of the sale or exchange. In addition, the transferee of a partnership interest is required to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a non-resident alien individual or a foreign corporation. Further guidance on the collection and remittance of the withholding tax is expected imminently despite the law currently being enforced. However a temporary exemption from withholding on distributions to holders of publicly traded partnership units was recently announced.

Conclusion

As discussed at the beginning of this writing, US tax reform has produced an impact for taxpayers of nearly all tax profiles. We have sought to highlight those that may touch upon the European based investment management community; however, the coordination of the new rules necessitates the use of complex modelling due to the challenging interaction of the newly introduced rules.

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G20 derivatives regulation – equivalence or divergence?

By Sinead Walley, Senior Associate at aosphere LLP (an affiliate of Allen & Overy LLP)

Sinead Walley

Since 2009, G20-initiated regulatory reforms have fundamentally altered the over-the-counter (OTC) derivatives market. Trading standardised derivative transactions on specified venues and/or clearing them through a central counterparty (CCP) is fast becoming the norm. Transparency and risk mitigation are key, with minutiae now being reported to trade repositories and margin requirements often applying to uncleared transactions.

These reforms have proven to be a major new area of focus for asset managers as they assess, firstly, whether they (or the funds they manage) are in-scope of the requirements and, secondly, the extent of any such legal obligations. This is a challenging task. The global nature of the derivatives market and the extraterritorial reach of some of these rules means that multiple, complex regulatory regimes (the terms of which may vary considerably) may apply.

This is a far cry from what the G20 leaders had envisaged, which was consistent global standards reforming the derivatives market, ensuring a level playing field and avoiding fragmentation of markets, protectionism, and regulatory arbitrage. Whilst this may seem a long way off, thankfully, there is a glimmer of light at the end of the regulatory tunnel in the form of cross-border recognition, the much sought after 'regulatory equivalence' (otherwise referred to in jurisdictions such as Canada, Japan and the US as 'substituted compliance').

G20 Regulatory Background – Does it matter to me?

- The G20 regulatory requirements focus on strengthening regulatory oversight of the OTC derivatives markets following the 2008 financial crisis and may, in some jurisdictions, apply to buy and sell side market participants.
- The global nature of the market means that market participants have to grapple with a range of applicable foreign requirements as well as their own domestic obligations. Further complexities can arise in scoping out applicable regulations when managers and their funds are located in different jurisdictions.

- Benefitting from equivalence decisions can significantly reduce the regulatory burden on market participants as regulators deem compliance with equivalent foreign rules as compliance with their own rules. This avoids the need to comply with duplicative or conflicting rules and, in the context of margin, avoids double collateral posting obligations.

In this article, we explore regulatory equivalence in some key G20 nations, including its take-up and the differing frameworks. We identify some important equivalence decisions (referred to in the US as 'comparability determinations'). We assess whether regulatory regimes are working in harmony or are diverging across G20 nations and consider the possible impact of Brexit.

Regulatory equivalence frameworks

The process

By incorporating a regulatory equivalence framework into its regulatory regime, a jurisdiction's regulators recognise and can give due regard to comparable regulatory regimes. There are some divergences in the processes used in different jurisdictions to achieve this but similarities are emerging.

In the EU, the European Commission assesses the equivalence of rules in foreign jurisdictions to those applied in the EU and checks that those rules, amongst other things, have the same substantive outcome as the corresponding EU rules in respect of the regulatory objectives they seek to achieve.

In the US, traditionally, the United States Commodity Futures Trading Commission (CFTC) has adopted a rules based approach to comparability determinations. Each rule was assessed for comparability resulting in the CFTC approving only portions of foreign regulatory regimes. However, we have seen recent margin comparability determinations which indicate that the CFTC seems to be moving to a more favourable outcomes-based approach. Technically, substituted compliance is available when a comparability determination has been made.

In Canada, an unusual framework exists for substituted compliance in respect of collateralisation. Comparability is determined on a case-by-case basis through a consultation process between the in-scope entity and the Office of the Superintendent of Financial Institutions Canada (OSFI).[1] At the time of writing, we are not aware of any such determinations having been made.

Recognition of overseas trading venues or CCPs should be distinguished from regulatory equivalence/substituted compliance. Where available, market participants established in a particular jurisdiction can comply with the trading or clearing obligation in that jurisdiction if they trade on a third-country venue or clear through a third-country CCP, which has been recognised (EU) or exempt from registration (US).

The beneficiaries

The entity who benefits from the equivalence decision or comparability determination varies from jurisdiction to jurisdiction. In some cases, it is particular counterparties who benefit (e.g. in the US it is certain eligible counterparties and, for the

Australian reporting rules, it is the foreign reporting entity) and in others, it is both parties who benefit (e.g. in Japan), in each case provided that all relevant conditions are met (such as the in-scope transaction being subject to the relevant rules in both jurisdictions and that the competent overseas authorities conduct 'appropriate' supervision over the relevant entity).

Overview of equivalence decisions and comparability determinations

Fig. 1 identifies the equivalence decisions and comparability determinations made by key G20 nations who have taken the lead in regulatory change for their OTC derivatives markets.

Fig. 2 takes a closer look at those decisions for uncleared margin. It identifies some milestones that have been reached including the mutual recognition of certain margin regimes.

It is clear from the tables below that the number of regulatory equivalence decisions and comparability determinations is currently low. This is expected to rise as regulatory regimes continue to develop in line with the international standards agreed by the G20 nations.

Fig. 1 Equivalence Decisions / Comparability Determinations of Key G20 Nations

Jurisdiction	Clearing	Trade execution	Trade Reporting	Dispute resolution Portfolio reconciliation Portfolio compression	Collateralisation	Documentation	Valuation
Australia	Yes	N/A	Yes	No	Yes	No	No
Canada (Ontario)	Yes	N/A	Yes	N/A	Yes*	N/A	N/A
EU Member States	No	No	No	Yes	Yes	Yes	Yes
Japan	No	No	No	No	Yes	N/A	N/A
United States	No	No	No	Yes	Yes	Yes	No

Key:
Yes indicates that one or more equivalence decisions/comparability determinations apply to this G20 requirement.
No indicates that no equivalence decisions/comparability determinations apply to this G20 requirement.
N/A indicates that there is currently no G20 requirement applicable and so the question of equivalence is inapplicable.
*Comparability for margin purposes is determined in Canada (Ontario) on a case-by-case basis through a consultation process between the in-scope entity and the OSFI. At the time of writing, we are not aware of any determinations having been made.

Fig. 2 Margin Equivalence Decisions/Comparability Determinations

Jurisdiction	Margin Equivalence Decisions/Comparability Determinations made by the Jurisdiction in column 1
Australia	Canada EU Hong Kong Japan Singapore Switzerland United States
Canada	See * in Fig.1.
EU	United States (CFTC rules)
Japan	United States (CFTC rules) Canada (OSFI rules) Australia (Australian Prudential Regulation Authority rules) Hong Kong (Hong Kong Monetary Authority rules) Singapore (Monetary Authority of Singapore rules)
United States	With respect to CFTC Margin Rules only: EU Japan (with the exception of inter-affiliate swap treatment)

Brexit

There are a multitude of EU laws and regulations that assist in the smooth functioning of the derivatives and collateral markets. Following Brexit, consideration must be given to the effect of these regulations in the UK. Certainty will only come following negotiation of the post-Brexit derivatives regulatory regime and the market hopes that agreement can be reached in respect of how existing UK laws will be treated after the UK has left the EU. In light of the fact that so much work has been undertaken in the UK in developing these regulatory requirements, we believe it is unlikely that the UK would want to disapply these requirements after Brexit.

With respect to regulatory equivalence decisions and comparability determinations, following Brexit, UK counterparties may no longer be able to benefit from the European regime being recognised as 'equivalent' by third-country regimes. As part of its negotiations, the UK would need to negotiate whether it could continue to benefit under the existing EU regime or whether it needs to start on its own cross-border recognition framework by having equivalence discussions with the EU and other third-country jurisdictions (including the US).

Conclusion

The derivatives market is global in nature and, for its smooth functioning, relies heavily on cross-border recognition of regulatory requirements. Regulators in jurisdictions with the biggest financial centres appreciate this and have embodied regulatory equivalence frameworks into their derivatives regulatory regimes to ensure an avoidance of duplicative and conflicting cross-jurisdictional rules.

Regulatory equivalence is a complex topic. Equivalence decisions and comparability determinations have been slow to emerge, but thankfully, some milestones have been achieved.

Footnotes:

[1] Guideline E-22 Margin Requirements for Non-Centrally Cleared Derivatives as published by the OSFI in February 2016 (updated in June 2017).

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Disclaimer:

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Appropriate regulation of digital currencies

By Cedric Jeanson, Founder and Chief Executive Officer at BitSpread Ltd

Cedric Jeanson

There has been some extraordinary language used by leading central bankers concerning digital currencies recently. Yves Mersch, a member of the European Central Bank's executive board, likened them to a "will-o'-the-wisp, a malignant marsh dwelling creature of European folklore that lured travellers from their path to their untimely death and a watery grave".

Agustin Carstens, general manager of the Bank for International Settlements, the central bank of central bankers, meanwhile labelled bitcoin as "a combination of a bubble, a Ponzi scheme and an environmental disaster." He argued that central banks should clamp down on digital currencies before they become "a threat to financial stability".

As the founder and chief executive of the world's biggest digital currency market maker, I take a strong interest in these accusations, which I believe are mistaken. Let me address each claim individually.

Is bitcoin a bubble? Every time the price of bitcoin falls, sceptics claim that the bubble is about to burst, but they should not mistake the volatility inherent in a nascent asset class with a bubble doomed to failure. Since Mr Carstens' comments were made the value of bitcoin has recovered from around $6,000 to around $10,000. The truth is the volatility of digital currencies is principally because of a lack of liquidity in markets, something we are working to change, and as liquidity is added to the market the volatility will become less pronounced.

It is sometimes said that there is no intrinsic value in digital currencies, and therefore that their value must fall to zero. It is true that many digital currencies will surely fail, but it is equally true that those that provide utility will retain value, and indeed may rise in value. And I would suggest that enabling people to transfer value to each other instantly, without the cost of using a bank to do the transaction, or the difficulty of exchanging different national currencies, has tremendous utility.

The second accusation is that bitcoin is a Ponzi scheme. Those who make this do not suggest it is literally a Ponzi scheme a la Madoff, but rather that because those who entered it very early have profited and those who enter it late may lose out, it is like a Ponzi scheme. But you could make this case for any investment which has risen dramatically in value before falling again, such as the London housing market.

The most valid claim is that mining digital currencies is environmentally harmful. However, you could still make the case that digital currencies are less environmentally harmful than traditional currencies (think of the environmental impact of manufacturing and distributing physical currencies). And digital currencies are evolving rapidly – it is likely that the successful currencies of the future will not require the same amount of processing power that the current ones do.

It is understandable that central bankers have been so critical of digital currencies. Traditional central banks tend to significantly debase the value of their national currencies over time. Today's US dollar, for example, is the same value as around 4 cents around a century ago. Digital currencies have defined limits on the amount in circulation and therefore cannot be inflated, which makes them a threat to central banks.

Indeed, banks as an industry are also threatened by digital currencies. They have historically played the role of middleman in transactions, but digital currencies eliminate the need for that middleman. Credit card firms face similar disruption, and it is not surprising that they have been hostile to digital currencies either.

Unfortunately, this chorus of criticism has distracted policymakers and regulators from the real task at hand, which is sensible regulation of digital currencies. The digital ecosystem has sometimes been characterised as 'crypto-libertarian', inherently opposed to regulation of any kind. But we and many other members of the ecosystem firmly believe that there is value in regulation, not least preventing fraud and making sure investors can have confidence in institutions and markets in the space. It is extremely important that exchanges, for example, have strict anti-money laundering and 'know your customer' provisions. Ensuring this would go a long way to assuaging the concerns of central bankers about financial stability.

Ultimately, those authorities which would seek to eliminate digital currencies should remember the level of support these currencies are generating among members of the public. The most prominent example of this is in South Korea. After initial bans, the government was forced to backtrack by people power. The central premise of digital currencies is that they are networks of the people, by the people, for the people. Central bankers, policymakers and regulators should work with, rather than against, ordinary citizens in order to achieve sensible and effective regulation of the digital currencies space.

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This article was first published in Financial News in March under the heading 'Why I reject the cryptocurrency criticism'

ETFs: Guidelines for distribution in Switzerland

By Luis Pedro, CEO at Oligo Swiss Fund Services

Luis Pedro

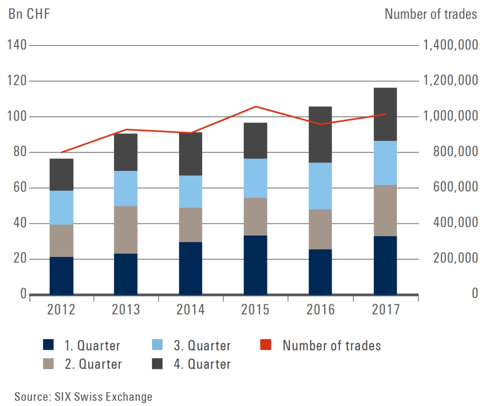
ETFs (Exchange Traded Funds) have been available in Europe since 1999 and over the last years they have become one of the most successful financial products.

Compared to traditional investment funds, they offer lower transaction and management costs, can be traded throughout the day on regulated exchanges at or close to the NAV and are available for investing in a wide range of assets (stocks, bonds, commodities, etc.). From less than 100 ETFs in 2012, their number has grown to 1600 as of November 2017 just in Europe, with assets increasing from less than $80bn in 2002 to $750bn in November 2017, according to ETFGI.

Switzerland, an attractive market for ETFs

Switzerland is a politically neutral and stable country. Two-thirds of Swiss adults have assets of at least USD 100,000. At the end of last year, Switzerland was home to about 600,000 millionaires and an estimated 4,000 ultra-high-net-worth individuals (assets over USD 50m)[1]. It is then not a surprise that the Swiss fund market is the fifth-largest in Europe, with assets totaling CHF1,073bn (October 2017), up 17% for the year[2].

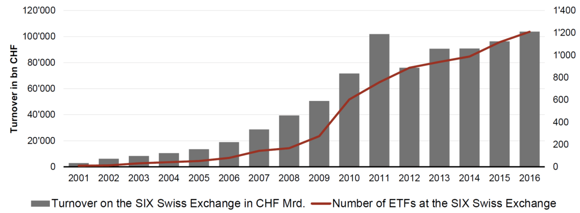
Figure 1: ETF turnover development



Source: SIX Swiss Exchange

These facts make the Swiss market an attractive location for selling investment funds, including ETFs, and at the end of 2017 more than 1,200 ETFs were listed on the Swiss stock exchanges, with total AUM of CHF116.4bn, up 11% year over year. During 2017, the number of transactions on the Swiss exchanges was up by 6%, to just over 1 million, while 114 new ETFs were listed, bringing the total to 1,278 products from 22 issuers: a record[3] as shown on the charts.

Figure 2: ETF trading turnover and the number of listed ETFs on the SIX



Source: SIX Swiss Exchange, data as at end-December 2016

Distribution of ETFs to retail ("non-qualified") investors

The Swiss Collective Investment Schemes Act ("CISA") groups the country's investors into "qualified" and "non-qualified" investors, this latter term being used to describe retail investors. Regular investment funds can be sold to non-qualified investors after the appointment by the fund or its promoter of a Swiss representative and a Swiss paying agent plus the authorization of the fund by the Swiss regulator FINMA, a process that is handled by the Swiss representative. For ETFs, there is the additional requirement of a listing on a Swiss stock exchange ("SIX"), and the Swiss regulator requires the listing of all share classes of an ETF.

Obtaining approval for retail distribution involves providing FINMA with a set of documents, some of which in one of the country's official languages (German, French or Italian).

The Swiss representative, possibly with the support of Swiss legal counsel, guides the ETF provider through this process, in order to ensure compliance with all requirements. The approval process usually takes up to four weeks.

The prospectus of the ETF as approved by FINMA will be used as the listing prospectus, with FINMA requiring the ETF prospectus to include specific information about the type of ETF, the replication method applied and the product's liquidity (market making).

The listing application must be submitted to SIX at least 20 days before the intended listing date by a recognized issuer representative. It must - inter alia - include a short product description and mention the first day of trading. In the case of a new collective investment scheme/issuer one should allow an additional five exchange days for the SIX for their respective approval of the new collective investment scheme/issuer.

The SIX listing application and FINMA request can be filed in parallel ensuring that FINMA give its approval in advance of the intended first trading day.

Distribution of ETFs to institutional ("qualified") investors

According to the CISA, institutional investors fall into one of two groups:

- regulated qualified investors, which include banks, insurance companies and other regulated companies as listed on the FINMA website;
- non-regulated qualified investors such as high-net worth-individuals, pension funds, independent asset/wealth managers and family offices.

While distribution to regulated qualified investors is not subject to any restrictions, the CISA requires the appointment of a Swiss representative and a Swiss paying agent before fund promoters are allowed to market their fund products to non-regulated qualified investors. This also applies to investment funds structured as ETFs and/or with the ETF designation in the product name.

Choosing a Swiss representative

There are currently about 15 independent firms offering representation services for foreign funds in Switzerland. They fall into two groups:

- firms that are licensed to represent funds distributed to qualified investors only;
- firms that are licensed to represent funds distributed to all types of investors, including retail investors and ETFs authorized by FINMA and listed at SIX.

A manager wishing to distribute ETFs in Switzerland should carefully consider which investor segments to address and choose a Swiss representative with the appropriate license.

Representatives that are licensed to represent funds for distribution to retail investors will have a deep knowledge and experience about how to proceed in the best possible way, including providing resources such as professional translation services and direct communication channels with FINMA, SIX and with big distribution platforms.

The Swiss representative, a long-term partner for ETFs distribution

The role of the Swiss representative is to ensure that the fund's distribution complies with the Swiss regulations.

While it is a legal obligation to appoint a Swiss representative for distribution in Switzerland, some Swiss representatives guide and support the fund promoter's marketing efforts in Switzerland. In addition to the legal and procedural expertise, they can provide guidance and help with the fund's distribution in Switzerland.

Today, Swiss representatives can:

- help build relations between fund promoters and Swiss investors and distributors;
- organize capital introduction events and conferences to introduce fund promoters and their products to investors;
- administer and pay retrocessions, if these are part of the distribution process. This can include the calculations of fees on behalf of Swiss distributors such as wealth managers and family offices. This support function is sometimes called "global distribution";
- assist the fund/promoter with managing and organizing cross-border registrations in European countries and other geographies;
- publish fund information and documents on electronic platforms dedicated to Swiss investors;
- facilitate communication between the involved parties and act as a point of contact between potential investors and the fund/promoter.

This makes the Swiss representative an ongoing point of reference, source of business and long-term partner for a fund's distribution in Switzerland.

Involvement of legal counsel

The application for the listing of an ETF on the SIX must be submitted in writing by a recognized issuer representative. This function is usually assumed by an experienced local legal counsel who is an officially recognized legal representative for the listing of ETFs on the SIX. The Swiss representative can propose a suitable local legal counsel and manage the process.

The appointed local counsel acts closely with the Swiss representative whereas both parties provide best-in-class services based on their core qualification and expertise in a well-established and reliable setup. ETF providers benefit of a well-coordinated cooperation between the Swiss representative and the Swiss legal counsel.

In summary

Switzerland is a large and attractive market for foreign investment funds with very specific, yet easy to fulfil, requirements for distribution. The main points to retain are:

- addressing a Swiss institutional investor for distribution of an ETF requires appointing a Swiss representative and a Swiss paying agent;
- addressing a Swiss retail investor for distribution of an ETF requires, in addition, the listing on a Swiss exchange and FINMA approval.
- there is a large market for retail distribution;
- foreign collective investment schemes (exchange-traded funds, exchange-traded structured funds, investment and real-estate funds) domiciled in one of 17 FINMA-agreed countries[4] are eligible to apply for retail distribution;
- the Swiss representative plays a key role and is the gate keeper for authorization by the Swiss regulator as well as the distributors and investors in Switzerland, as defined in the Swiss Collective Investment Schemes Act;
- the relation between the ETF provider and the Swiss representative is an active one, with an ongoing exchange of useful contacts and information.

For any question concerning funds representation and distribution in Switzerland, please feel free to contact Oligo Swiss Fund Services (a regulated Swiss representative for funds addressed to both qualified and retail Swiss investors) at info@oligofunds.ch.

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Footnotes:

[1] Credit Suisse Research Institute, Global Wealth Report 2016

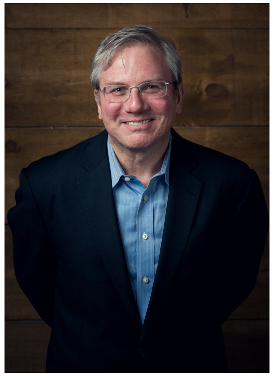
[2] Swiss Fund Data – Swiss Fund Market Statistics, 31 October 2017

[3] SIX Swiss Exchange – ETF Q4 2017 report

[4] https://www.finma.ch/en/finma/international-activities/supervisory-cooperation/agreements/

Preparing for GDPR

Eldon Sprickerhoff, Chief Security Strategist and Founder at eSentire



Eldon Sprickerhoff

The General Data Protection Regulation (GDPR) comes into effect on May 25th, 2018.

In anticipation of this and the changes it will mean for compliance rules, AIMA recently released a GDPR Implementation Guide with the purpose of assisting AIMA members in preparing for the upcoming implementation of GDPR.

While this guide explores the background of GDPR and provides a summary of key rules and questions as well as a compliance checklist, the guide also discusses the ramifications of GDPR on cybersecurity—which is where we'll focus.

What are the GDPR rules around cybersecurity?

Article 25 of the GDPR contains minimum data-protection rules for organizations that process personal data. It requires they implement technical and organisational measures to ensure the protection of personal data during processing and that data is only accessible by authorised parties.

Article 32 outlines the requirements on controllers and processors for the security of processing activities. Organisations must implement technical and organisational measures to protect personal data from accidental or unlawful destruction, loss, alteration or unauthorised disclosure. To do so would require regular testing and evaluation of controls, as well as the proven ability to recover in a timely fashion from a natural or technical disaster.

GDPR compliance considerations

The flexibility of the GDPR means that firms should evaluate and be clear in what they believe is sufficient to comply with the requisite standard of data protection and security. Firms should consider undertaking the followings steps:

- **Conduct a risk assessment to identify critical data risks** – the first step is to create an inventory of critical assets (here, personal data), identify top risks (cyber threats and vulnerabilities associated with technology and processes) and determine which of these risks can be eliminated, offset, mitigated or accepted.
- **Conduct a security gap analysis** – firms should conduct a security gap analysis to determine the firm's current security posture, which GDPR requirements the organization already meets, which programs must be augmented and what systems need to be implemented to comply with the GDPR fully.
- **Develop security policies and procedures** – the risk assessment and gap analysis should assist a firm in developing the policies and procedures which form the foundation of its GDPR cybersecurity program. Such a program could include:

1. *Access to data* – the firm can implement controls to restrict/audit access to personal data;

2. *Encryption of data at rest and in motion* – encryption can reduce the risk of negative consequences resulting from unauthorised access. This means that data must be stored on encrypted systems and, when transferred outside the network, should move through encrypted thoroughfares such as a Virtual Private Networks (VPNs);
3. *Data back-up and redundant storage locations to enhance resilience* – resilience can be achieved through data back-up systems with offsite redundancy. As part of a firm's disaster recovery plan, all data should exist in dual locations with plans for authorised personnel to access the data and conduct regular business operations from an alternative site;
4. *Real time monitoring* – firms can mitigate the likelihood and damage caused by an undetected data breach through continuous (24/7) monitoring of systems to detect unauthorised activity and to respond to security events. This is known as Managed Detection and Response;
5. *Incident Response (IR) and Disaster Recovery (DR) planning and drills in the event of breaches* – in addition to the above monitoring, firms should also develop an IR and DR plan that outlines: (i) triggers for the IR plan; (ii) relevant team members; (iii) notification and other legal obligations; and (iv) technical and business activities during and following a breach. The IR plan should ideally include more than just IT functions and involve legal, HR, investor relations and the executive suite. Once in place, the plan should be tested and augmented to foster continual improvement.

MDR prepares you for GDPR

Perhaps the most challenging requirement of the GDPR is the prevention of loss, alteration, unauthorized access or disclosure of sensitive personal data. Often, the prevention of unauthorised access to data involves the use of technologies, such as Intrusion Prevention Systems, Endpoint Protection and Logging. Given the complexity of these systems, organisations may choose to rely on managed security service providers (MSSPs). MSSP services provide the management of network and security technologies, with frequent reporting of performance and events. These services provide a means of managing complex security systems, but unfortunately do not typically provide firms with real-time monitoring to detect and then react to cyberattacks.

As previously mentioned, there is a new category of outsourced solution called Managed Detection and Response (MDR).[1] This service acknowledges:

1. the shortage of in-house expertise needed to scan for threats and to take action to stop any attack before it leads to a data breach or other compliance violation;
2. the device-management limitations and liability-averse approach of the traditional MSSP model. MDR typically provides 24/7 monitoring by security experts who use a combination of automated detection and mitigation, with human investigation of attacks that can evade technology-only defenses. Once detected, a human security analyst takes measures to halt the attack, capture forensic evidence and prevent further exploitation. Quick detection is key to mitigation, and creates the ability to respond to threats and to report material breaches within the GDPR required timeframe, while limiting potential damage caused by the breach.

When it comes to your cybersecurity provider, be proactive. Evaluate your current cybersecurity practices and consider switching to a MDR provider. As previously mentioned, MDR vendors not only detect and analyze threats, but also stop them. Cyber-attack methods will continue to increase in complexity and frequency, surpassing the capabilities of many in-house cybersecurity solutions. MDR can both protect your confidential data from being breached, while also meeting the growing compliance requirements of various regulators.

[1] Gartner: Market Guide for Managed Detection and Response Services, available online: https://www.gartner.com/doc/3314023/mark...

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GDPR – the challenges for an asset manager

By Michelle Bedwin, Compliance, BTG Pactual

Michelle Bedwin

On 25th May 2018 the EU General Data Protection Regulation (GDPR) will come into effect and with only two months to go, Asset Managers should now be concluding their GDPR projects. The GDPR covers all EU member states and will apply to all companies including FCA Approved Firms holding or processing the data of individuals. Most Asset Managers are already subject to the Data Protection Act (1998) so should already have robust controls in place. It is important for Asset Managers to review their controls with the maximum fine for a breach of GDPR being equivalent to 4% of global revenue for the organisation as well as consider any additional implications of the new requirements.

The intention of GDPR is to protect the rights of EU citizens in respect of their data and companies systematically holding or processing the data of individuals such as mobile phone companies have been preparing for this new EU Regulation for years. Although alternative asset managers are obviously not dealing with data in the same manner and generally have very few 'individual clients', all Managers should have identified the data that they are holding and processing, in line with suggestions contained within the 'AIMA GDPR Implementation Guide' published in January 2018.

The GDPR project should have been fairly straightforward for most Managers but there are several important questions that all Managers should ask themselves before signing off on their implementation projects.

Investors

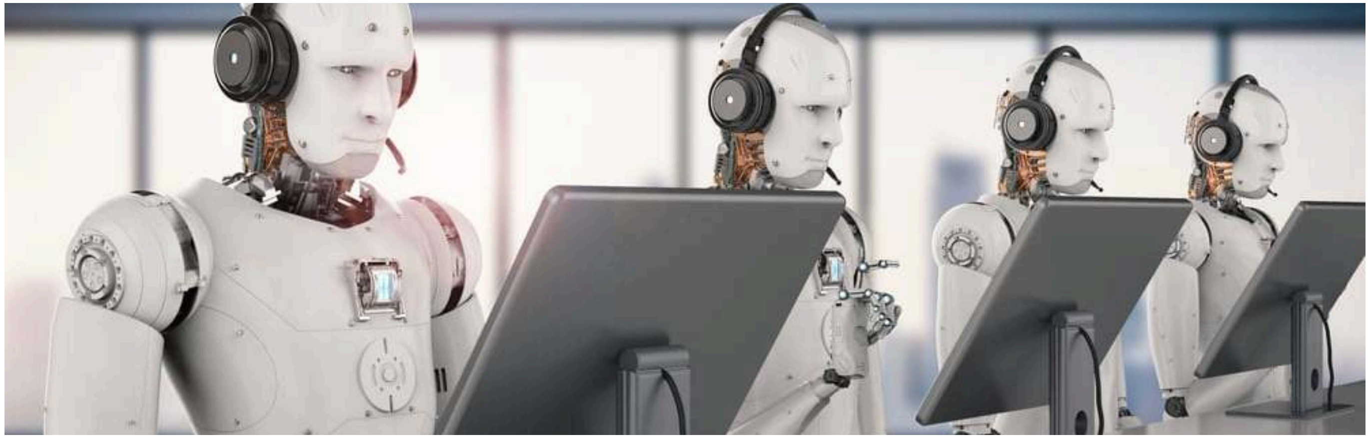
Many AIMA members will have very few individual investors and by the time you have worked out whether the Manager or the Fund Administrator are 'data controllers' or 'data processors' or both, these individuals may have been forgotten about. You should have already discussed GDPR with the Fund Administrator(s) before any administration agreement is changed and considered the controls in respect of keeping investor data secure and what would be the process if there happened to be a data breach in respect of an investor. The new administration agreement may be finalised, but firms should think about what will happen if there is a data breach in early June? Will the Administrator contact you and will you notify the respective Regulators in both jurisdictions if the Administrator is based in the EU? Who at your Firm should the Administrator contact? Do you have a Data Protection Officer (see below) or will the Administrator just contact their main operational contact? Will their main operational contact know what to do if there is a breach?

Marketing

This subject may not be high on the agenda for asset managers considering the client base of most AIMA members. However, GDPR protects the data rights of individuals irrespective of if they are ultra-high net worth or have opted up to be a professional client. You should not just think about your current client base for your GDPR project, but think about any individuals who may be in your CRM database and how you can allow any individuals to 'opt into' marketing going forward as per the GDPR requirements.

Staff

All EU asset managers, and many non-EU asset managers, will be in scope of GDPR and as part of your projects, you will have already considered the sensitive personal data such as sickness records held about staff by your HR department. However, you also need to consider other records held about your staff as other departments may hold data about your staff. Your Compliance team will hold PA dealing account records for your staff and your BCP Coordinator will hold personal telephone numbers. Also, do any external providers hold data about staff? A firm's ARM will hold passport numbers for MiFID 2 reporting and even MTFs have been requesting such passport numbers for Traders. Don't forget about prospective staff too - it is prohibited under GPPR to retain a CV in case a role turns up in the future for a promising candidate unless that individual has provided his or consent for the CV to be held.



Data Protection Officers

Asset Managers have a Data Protection Officer currently and there may be discussions as to who will be the Data Protection Officer post GDPR but do you actually need a Data Protection Officer? Under GDPR, only companies which regularly and systematically monitor data subjects on a large scale or process on a large scale special categories of data. Only a tiny number of AIMA members will fall into this category so ask yourself why you are opting into further requirements of GDPR unnecessarily before you appoint a Data Protection Officer. Even if you don't have a Data Protection Officer, you need a Data Protection Coordinator who should understand the requirements and act as the Manager contact point for all data related questions.

Data Subject Access Requests

Data Subject Access Request can be an administrative burden and expensive. GDPR provides more rights to the individual about accessing their data and when the first big fines are issued, individuals will become more aware of their rights. Have a think about what you would do if a disgruntled ex-employee makes a request and how easy it would be compile. If the thought fills you with horror, then you should probably as a Manager work through a mock request and see how you do.

You may be pleased that the end of yet another regulatory project is in sight, but don't forget about future compliance. Is GDPR covered in your product governance processes and will you even know if an IT function changes a server? Staff should be trained on their obligations but they cannot just be trained once and all staff will need to know exactly what to do if there is a breach rather than it simply being covered in a policy.

GDPR needs to be part of your compliance monitoring programme and you should prepare for a visit by the Information Commissioner Officer just like you would do with any other Regulator making sure policies are kept up to date and staff remained trained. Remember GDPR is going to be with us for a long time even with BREXIT!

Why outsourcing makes complete sense under MiFID II

Jerry Lees, Chairman at Linear Investments

Jerry Lees

While MiFID II is designed to offer greater protection for investors, and provide more transparency across asset classes, it also creates a tougher market to successfully operate in.

MiFID II covers equities markets, fixed income commodities, currencies, futures, exchange-traded products and derivatives such as CFDs; it affects us all. Banks, fund managers, exchanges, trading venues, high-frequency traders, brokers, and pension funds. Put simply, the increased regulatory burden can translate directly into a greater drain on resources if you're not smart about how to tackle and manage it.

With respect to starting a hedge fund, today's financial environment creates a mighty challenge where margins are being squeezed. The cost of office or desk space, accessing Bloomberg terminals, front end systems, increasing administration and compliance requirements, and salaries can often be a step too far for a hedge fund in its infancy, especially when investors are demanding lower fees.

Now is the time to take a logical approach by outsourcing as many operational functions as possible. By freeing up time and reducing costs to focus on income in a fast-changing market can be the most effective solution to ensure a successful business outcome.

The MiFID II directive makes it clear that regulatory expectations are high when important operational functions are put out to third parties. Yet the requirements for increased transaction reporting can be overwhelming and will drive an uptake in outsourcing. It is therefore key that fund managers seek out an experienced outsourcing partner to collaborate with, and that is where a specialist firm comes in.

Outsourcing firms have been ahead of the MiFID II curve for some time now, providing solutions for those who MiFID II will mean a significant change to their business. Paul Kelly, Chief Executive Officer at Linear Investments comments: "MiFID II will put huge pressure on small and medium sized funds – and even some larger entities. Reporting requirements, proof of execution value, IT infrastructure, tracking and recording transactions are all an issue. Client data, conversations and interviews, and administrative and management overheads in compliance and reporting will also be affected. MifID II combined with imminent GDPR constraints on client data management will force many to look at outsourcing their operations, mid and back office, IT compliance and trading."

Outsourcing firms package everything together using a MiFID and FCA compliant platform. For smaller managers, the option to start off with a managed account that can be validated with an independently audited track record makes sense. The manager will only pay brokerage fees (without paying for any fund structure) and when it has all its ducks in a row it can migrate the track record to a fund structure.

Outsourcing is a means of optimising the fund manager's strategic business plan and managers should identify the outcome required from outsourcing as the first step towards finding the best solution. Outsourcing has an impact on the efficiency of a business, as well as the bottom line. Working with an outsourcing partner provides access to a larger pool of skilled resources, improved transaction quality, plus product and service innovation. It allows the manager to focus on the core function of their own business and treat partners as an extension to their in-house team for everything else.

Information Technology is also proving a challenge under MiFID II and GDPR will further exacerbate this. Outsourcing IT requirements and using an outsourcing infrastructure leaves the fund manager confident they are working within MiFID II regulations, without the headache of sourcing and managing expensive relationships with multiple providers. This includes transaction reporting, best execution, call recording, market abuse oversight as well as complying with Global Data Protection Regulation (GDPR), which comes in to effect in May 2018.

Outsourcing works, with transparency and trust being a standard part of service delivery. For a business considering outsourcing, change must be owned at the top level it is clear that more COO's and CEO's are understanding the benefits of outsourcing.

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Think twice, it ain't alright...ALIS clarified

By Michael Oliver Weinberg, Chief Investment Offcer at MOV 37 and Protege Partners

Michael Oliver Weinberg

In "The Intelligent Investor in an Era of Autonomous Learning", Jeffrey Tarrant delineated the concept of Autonomous Learning Investment Strategies (ALIS), the new AI and data-driven strategies he argued would disrupt today's fundamental and quantitative managers. This was followed by an article I wrote, "What a long strange trip it's been…on ALIS", which explained the best and worst traits of ALIS managers. This brief article is called "Think Twice, It Ain't Alright…ALIS Clarified", repurposing the title of Bob Dylan's 1963 song, "Don't Think Twice, It's Alright".

For those familiar with our earlier works, we continue to borrow our papers' titles from the counter-culture, because we see ALIS managers as being akin to a counter-culture that is springing up from universities (as the original counter-culture did), public and private thought-leading technology companies, and to a lesser extent from the world's top quantitative firms.

The catalyst for this paper was a recent news article naming hedge funds that were the most advanced in using artificial intelligence. The article, like similar articles preceding it, listed some of the "top" AI funds. The reader may be tempted to think these funds share a fundamental similarity to ALIS. The list was a "who's who" of well-known funds, but the vast-majority were NOT ALIS managers. They were what we would refer to as academic finance, traditional quant firms, Quant 1.0 or old school CTAs, trend followers.

So what does an ALIS manager look like? An ALIS manager is typically a small emerging manager, though over time there will, of course, be larger, established ALIS managers. These managers are usually run by a PhD or two and have been launched within the last 5 years, though some much more recently and a handful marginally longer ago. They are man (or woman) plus machine, where the PhD(s) create a fully autonomous system that uses unstructured non-financial data, data science, record-low processing and storage costs, and machine learning that is constantly improving based on incremental data.

Of the 200 or so ALIS funds we have identified and met (of which only a fraction is listed in industry databases), we are only aware of literally a couple, as in two, ALIS funds running more than $1Bn. A very small number are running in the hundreds of millions, and the vast-majority are running sub $100Mn. ALIS managers are not what we refer to as "Alpha Hogs". They don't feel a divine right to charge fees at the rate of 2&20 or far more. In fact, some are at 1&10 and many others are at 1/10/20, a fee structure we created and detailed in a paper we wrote and which was published by Pensions & Investments. (To briefly explain, 1/10/20 are 1&10 fees at net returns below 10% and 1&20 fees at net returns on all assets provided that the investor achieves a net return above 10%, an ideal alignment of incentives, and more net returns for investors.)

Why do we say Think Twice, It Ain't Alright? It's because there are managers that may seem to be like ALIS or may represent themselves as such, but are not. Why is this? Artificial Intelligence and Machine Learning are the buzzwords of the day, and we believe rightfully so. For example, we currently are working with the World Economic Forum on a research paper they are writing on The Fourth Industrial Revolution, the impact of artificial intelligence on Financial Services. As we have stated in prior papers, due to factors such as machine learning now working well after having been around for nearly 70 years with various disappointing fits and starts, the record growth and types of data which is available, the ability of data science to cleanse, normalize, parse and organize the unstructured data and lastly the record low processing and storage costs, we do agree - AI is the Fourth Industrial Revolution.

Why are they not ALIS? To put it simply, they are legacy firms. Let us clarify. Legacy firms are large, established firms that have often been around for a decade, sometimes even multiple decades. They typically have hundreds, and in some instances over 1,000 employees. They may have their own in-house servers and storage and often maintain multiple offices around the world. They are systematic and generally rely on either academic finance, i.e. fundamental data, and/or old fashion technical models, such as trend following and/or mean reversion, i.e. linear regressions, and price/volume data. These firms often are very large in terms of AUM, i.e. minimum $5Bn, and often range from $10Bn to over $100Bn AUM. They don't typically use much if any alternative, unstructured or nonfinancial data.

In light of what are usually 2&20 fees, and even 3&30 fees, these firms are often Alpha Hogs. We are aware of one of these non-ALIS firms, a traditional old school quantitative finance manager, admittedly with a superb long-term track record, who was up last year approximately mid-teens. After 3&30, the net return to investors was approximately HALF of the gross return! Similarly, in light of what are often high and sometimes egregious fees, these managers are extraordinarily profitable.

Even worse for investors, some of the largest, most successful legacy firms save the best alphas, highest frequency, most scarce capacity and therefore highest returning alphas, strategies and funds for the founders and employees. Even if one were willing to pay Alpha Hog fees, the funds could be hard closed to external investors. The funds that are open to investors can be the antithesis of these hidden gems. The open funds are typically lower quality alphas, lower frequency, not capacity constrained and therefore lower returning alphas, strategies and funds. The closed funds typically derive 100% (or near) of their returns from idiosyncratic alpha, whilst the open funds typically are factor, risk premia or alternative beta driven.

Less knowledgeable or sophisticated investors may not even know this is transpiring as these firms often keep the track records of these high returning, high alpha funds confidential. It would be akin to thinking that because Volkswagen owns Rolls Royce, buying a Volkswagen is similar qualitatively and technologically to the Rolls Royce.

Let's go back to how the teams compare. The traditional quantitative firms typically have many PhDs; however, sometimes these PhDs are in economics and finance. This contrasts with ALIS managers whose PhDs are often in Machine Learning, Robotics, Particle Physics, Applied Expert Systems and other scientific fields that are accustomed to dealing with immense amounts of data and separating out the signal from the noise.

Shifting gears to CTAs, we have met with some large and successful ones who say they are using AI and Machine Learning terminology in a manner suggesting ALIS. Almost consistently, we see the same phenomenon – they have a PhD or sometimes a few PhDs focused on machine learning. They have unstructured non-financial data in a research phase, though it is not used in production. Each time, when our PhDs in mathematics, machine learning, data science and robotics met with their PhDs, we came to a similar conclusion: immaterial ALIS usage.

This is not surprising. They have a or 'the' legacy problem. They are built on old technology, often with monolithic immense models. They use the Henry Ford, early 20th century production technique where each quant or PhD only works on a very small percentage of the model, trading, execution, alphas, risk management, a particular strategy, asset class or security. It is not in the management firm's best interests for any PhDs to know the whole system soup-to-nuts for fear of a departure and subsequent replication of the system, thereby purloining or crowding out the mother ship's alpha generation.

Similarly, we would pose the question: if they built these firms today, would they really own all of their own storage and processing power, which depreciates and becomes uncompetitive at the rate of Moore's law? Or would they rather use one of the oligopolistic cloud computing firms, such as Microsoft, IBM, Google or Amazon's solutions? They already have a large in-house team who is not incentivized to suggest making their roles obsolete

in the name of cost, efficiency or process power and speed, thereby becoming unemployed in the name of the greater good of the management company and investors.

And at the extreme, even if these firms did believe that the right thing to do would be to acknowledge that ALIS is the disruptive future to existing systematic, quantitative or trend following firms, what could they really do? Would anyone be so altruistic to say, "We have a legacy system. If we could build this systematic firm over today, we would fire most of our existing staff, close our multiple locations, shift to the cloud, use unstructured non-financial data, machine learning, not regressions or traditional academic finance, and return the capital to investors in the interim until we have accomplished this. Then we would need to build a track record to prove that we have gotten it right. This would take at least a year, possibly two to three years, to convince investors. We will give up 2&20 or 3&30 fees in the interim, and then re-launch at 1/10/20."

A true ALIS firm has no such conundrum or dilemma. It is, by definition, relatively new and for the aforementioned reasons suffer from none of these legacy issues. In summary, our recommendation to ALIS investors is to make sure there is at least one if not more PhDs in an ALIS related field evaluating managers. As the old Russian proverb goes, Trust but Verify.

We have titled this article "Think Twice, It Ain't Alright…ALIS Clarified" because, though many of the world's leading quantitative and CTA investors may seem to be going in the same direction as ALIS, only after an investor Thinks Twice and does a deep research dive can it be realized that It Ain't Alright, and that some managers are merely selling investors what they want to hear; not what they actually are delivering.

That said, there are what we believe to be world class ALIS investors out there, if one is willing to devote the time, effort, research and resources to go around the world finding them. And when we find these top ALIS managers, it is akin to watching our favorite six hour Richard Wagner Operas; time goes by at hyper speed and it is similarly sublime. The ALIS managers, like the Wagner operas, are Gematkunstwerk; total and ideal works of art.

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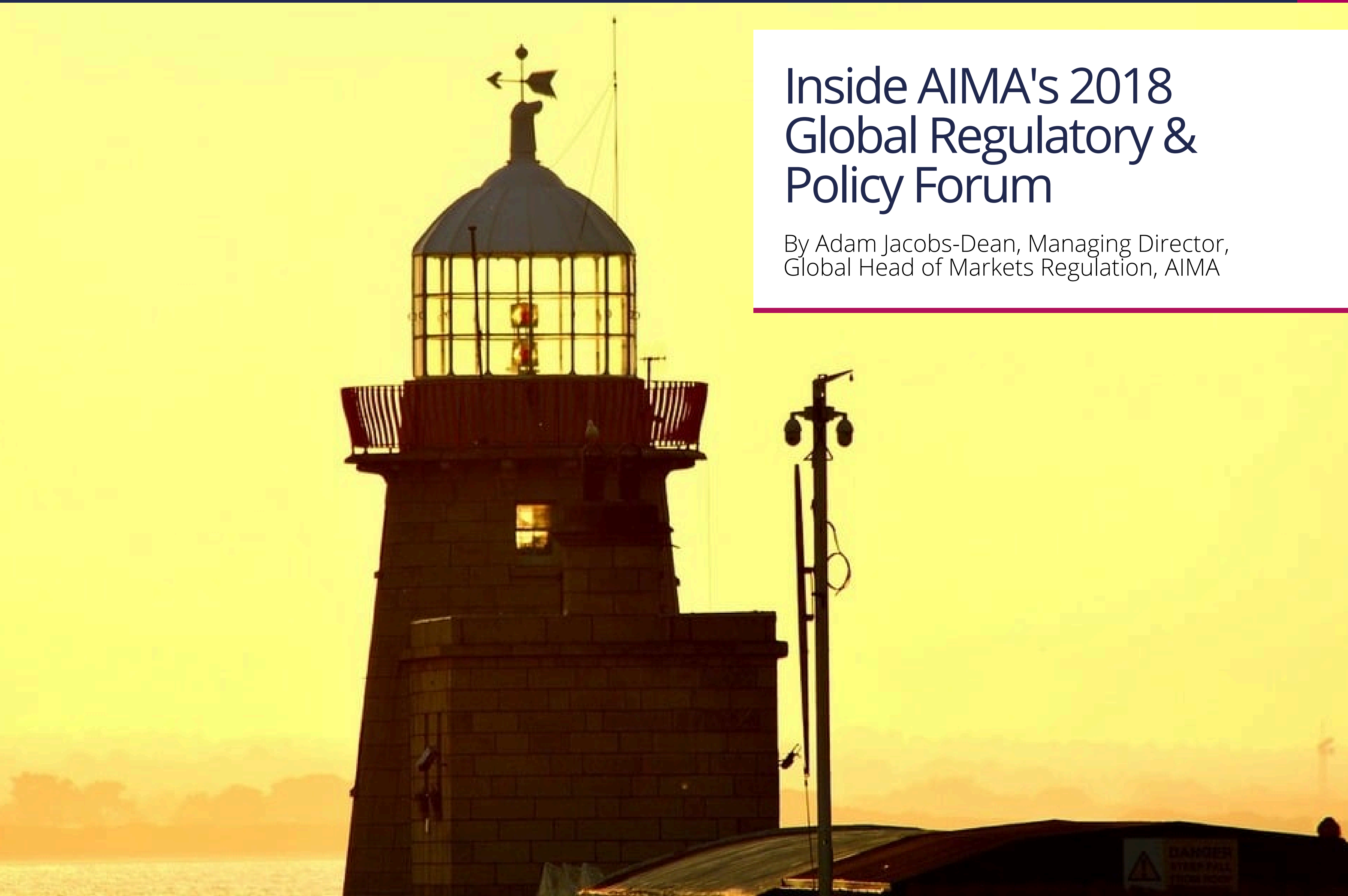


Inside AIMA's 2018 Global Regulatory & Policy Forum

By Adam Jacobs-Dean, Managing Director, Global Head of Markets Regulation, AIMA

Adam Jacobs-Dean

The global alternative investment industry this year descended on Dublin to mark AIMA's flagship Global Policy and Regulatory Forum (GPRF) 2018. This year we welcomed some notable keynote speakers, including Deutsche Bundesbank board member Andreas Dombret, Michael D'Arcy, Minister of State at the Irish Department of Finance, and Conor O'Kelly, CEO of Ireland's National Treasury Management Agency, all of whom provided insightful comments and provoked lively debate. As usual, the event was held under the Chatham House rule, but some of the key areas of discussion are summarised below. Dr Dombret's speech is also available online.

Brexit uncertainty continues

Once again you could be forgiven for thinking Brexit-related announcements were timed to coincide with AIMA's annual GPRF, with last year's forum being held days after the UK Government invoked Article 50. This year the event was held two days after the 21-month Brexit transition period was announced, which prompted plenty of discussion among delegates; it was clear that nearly two years on from the referendum, cross-border concerns still weighed heavily within the alternative investment industry. Dr Dombret delivered a passionate speech, highlighting that countries should avoid panic and "not to embark on nationalism" that would "only lead to trade wars and a race to the bottom." He stressed his view that mutual recognition was off the table as it would undermine the ability of supervisors to address financial stability concerns effectively. The associated panel discussion explored the potential ways to ensure that UK investment managers can continue to service EU investors, as well as the implications of the recently-announced transition period. There was a broad expectation that progress towards an overall Brexit agreement would be slow and that regulatory uncertainty would remain a reality for the time being. Some panellists felt that the prudent course of action for firms was to assume a no-deal scenario and prepare on that basis.

Accountability higher up the agenda

Fears that the UK's extended Senior Managers & Certification Regime is aimed at taking the scalps of senior managers have now eased. Industry is now gearing up for implementation of the new regime, whilst also turning its attention to broader questions of culture. In their discussion of the differing perceptions of the right culture, speakers explained how firms needed to understand what culture they wanted and compare that with what they had. To do this they needed to look at leadership at every level – experience in managers did not automatically translate into effective management – as well as considering how governance, incentives (including non-financial ones) and HR practices could influence outcomes. Recommendations included addressing cultural issues at appraisals, understanding how likely whistleblowing was and ensuring protocols were in place to allow whistleblowers to remain anonymous. The panel also explored the role of fund directors and whether directors were spreading themselves too thinly. It seems there are no easy answers to determine an adequate time commitment to enable a director to deliver effectively on their responsibilities.

Leverage: questions remain

Panellists provided an insight into global work on leverage, looking at the different approaches that are on the table and their benefits and shortcomings. There remained disquiet on the part of some audience members that global work on leverage is still too focused on what has been done in the banking sector, with one member of the audience asking whether the focus on leverage in the fund management context is justified.

Tech coming to the fore

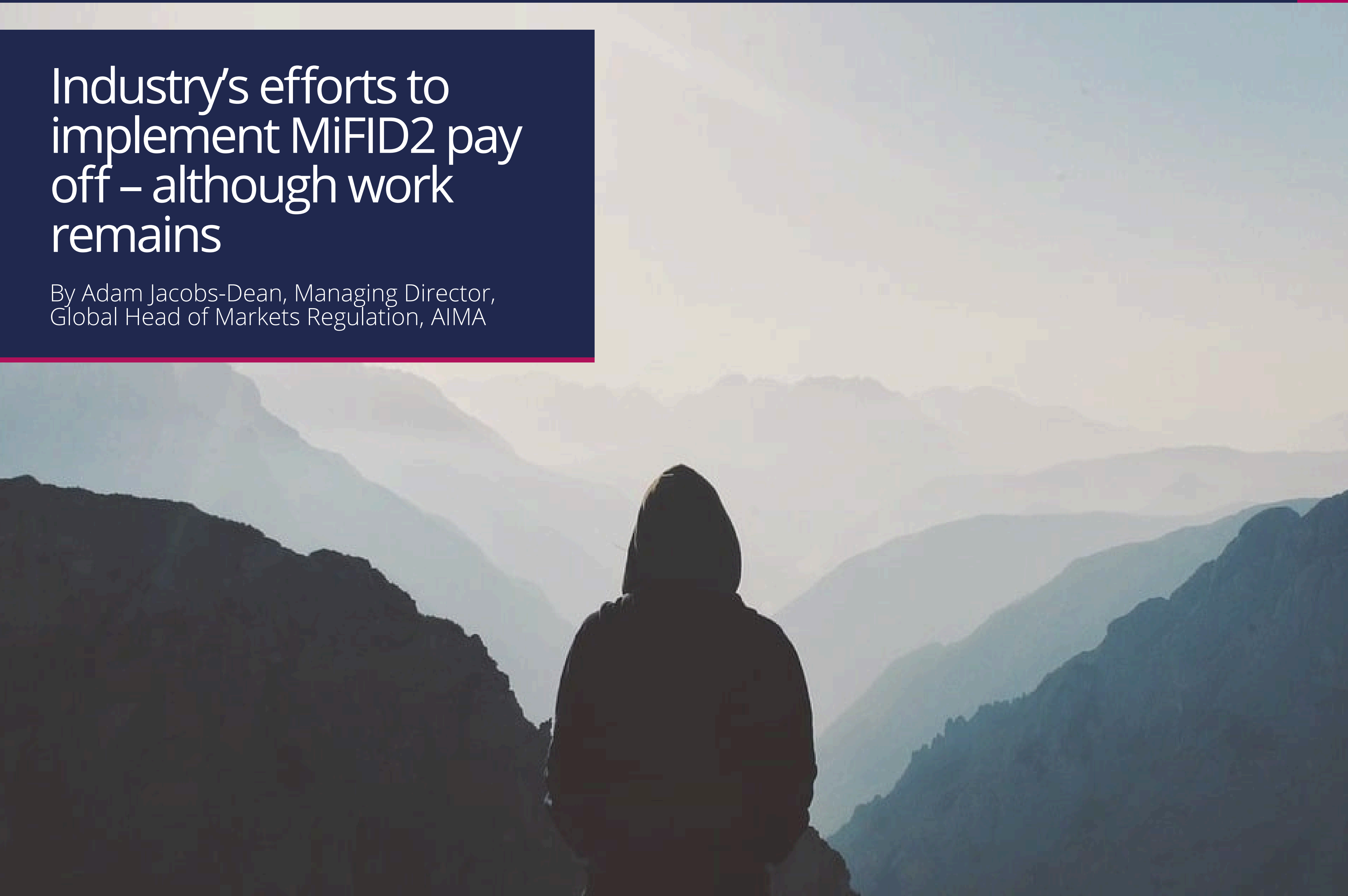
Cryptocurrencies have in recent years gained in prominence and attracted the attention of the media, broader public and now regulators. At the GPRF, AIMA announced it has now set up its own Digital Asset Working Group. Speakers highlighted that cryptocurrencies present opportunities but also come with their own unique set of challenges, including cyber security and the fact that they continue to evolve in a rapid fashion. This creates additional challenges in the regulatory context: how do you effectively regulate this space when the main distributed ledger technology firms are developing in different directions? Naturally with increasing and high profile cyber-attacks, cyber security was also a prominent discussion point. Panellists warned firms to take seriously their responsibility to ensure data is secure, regardless of whether functions were outsourced or remained in-house. Regulators expected firms to document cyber protection processes and keep records, but there was recognition that it might take an obvious breach for authorities to become aware of shortcomings. The next, most immediate challenge was to comply with the General Data Protection Regulation that comes into force on 25 May 2018.

Delivering more value for investors

Our panel featuring investors and consultants, as well as an asset manager, agreed that communication was key to a successful relationship between investors and managers. Increased discussions between them had already delivered greater alignment of interests and had allowed investors to better understand their managers' performance and to take a long-term outlook. Equally, when constructing a portfolio, one investor said they stayed away from managers who couldn't explain when performance was good, as they were unlikely to be able to explain when performance was bad. Another investor agreed and noted the importance of transparency and also due diligence in the asset allocation process. There was a willingness to buy into a particular strategy rather than focusing on short-term performance. Yet, they identified situations where managers had moved away from their strategy brief as industry became more innovative. There was an acceptance of this provided this had been communicated properly. The best managers were defined as those that could generate ideas that added value to the portfolio and didn't focus on raising too many assets. Fees too were debated. The industry was providing flexibility around fees as exemplified by longer lockups or a "zero and 30" model.

Industry's efforts to implement MiFID2 pay off – although work remains

By Adam Jacobs-Dean, Managing Director, Global Head of Markets Regulation, AIMA



Adam Jacobs-Dean

The go-live date of MiFID2 has been and gone and it's clear already that the market has managed to adapt to the new regime without major disruption. That is a reflection, ultimately, of the enormous level of resources that firms devoted to their implementation work in 2017 – as well as the significant ongoing compliance resource that they are devoting to the regime.

But two months in, it's also clear that there are aspects of the regime that haven't fully bedded in. 2018 will see the go-live of additional aspects of the regime, as well as a gradual shift in firms' approaches.

The standout challenge is on the reporting front – noting that this is an aspect of MiFID2 that doesn't extend to AIFMs. While T+1 transaction reporting to regulators seems to be operating reasonably well (notwithstanding the FCA's concerns that firms are still getting basic fields like price and volume wrong), post-trade reporting to the market for non-equity instruments is proving more of a challenge.

The number of reports being made is overall very low for the buy-side – most firms are finding that in most situations they can execute on venue or with a systematic internaliser, which gets them off the hook when it comes to reporting. But in situations where the buy-side firm is the reporting party, the brutally short deferral windows for publication make it hard to put in place a workflow that guarantees timely and accurate reports. The providers of the reporting plumbing work – APAs – are themselves struggling with the scale of the challenge.

Other than reporting, rules on payment for research and other third-party inducements continue to occupy a significant amount of time for managers. Firstly, there's the challenge of policing the material that you receive to ensure that you are not unwittingly breaching the rules. Then there is the difficulty of deciding whether material is "research" as defined in the rules – it's not just a case of relying on how the material is labelled, unfortunately. For compliance officers, the goal is an internal framework that is as straightforward to apply as possible, something that is a challenge given the way the rules are drafted. When it comes to research, though, the impact of MiFID2 rules has not been as painful as we might have originally feared – the challenge to brokers' established pricing models seems to be prompting a better focus on clients' needs.

Sticking with the inducements rules, the treatment of gifts and entertainment has also rapidly advanced up the agenda as firms seek to balance the need to comply with the rules with maintaining important ways of interacting with brokers and other third-party vendors. We've seen a spread of approaches on the part of members and the approach that a firm follows in this space needs to reflect the specificities of that firm's business. As with research, the onus is ultimately on the investment manager – rather than the provider of the service – to get things right.

At this stage, we're also looking ahead to aspects of MiFID2 that haven't yet gone live, the most obvious requirement being annual public reporting on best execution (first reports are due in April 2018 for the 2017 calendar year). It's evident that most firms will not have been able to collect data for 2017 exactly as expected – either it wasn't available or supervisors were not consistent in their expectations of how that data should be processed. The first round of reports will definitely be a learning process and regulators recognise this.

A question that crops up often is: which parts of MiFID2 will the FCA be focusing on in its supervision? Its 2018 business plan will shed more light, but some of the FCA's recent statements suggest that reporting, payment for research, and best execution will all be in the spotlight. Algo controls have already been scrutinised, so follow-up work on this topic is also likely.

Hence the work on MiFID2 continues. One firm mentioned to me that their MiFID2 project resourcing has been kept in place until mid-2018 to make sure they are properly on top of the new regime. AIMA continues to support firms' efforts through education, peer discussion and engagement with regulators, so please get in touch if there is any way we can help.

This article first appeared in HFMWeek.

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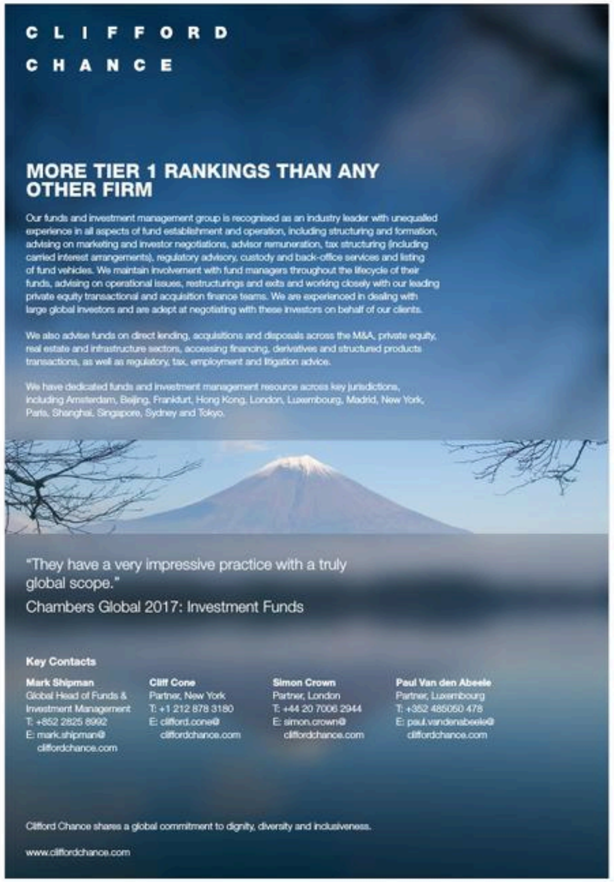

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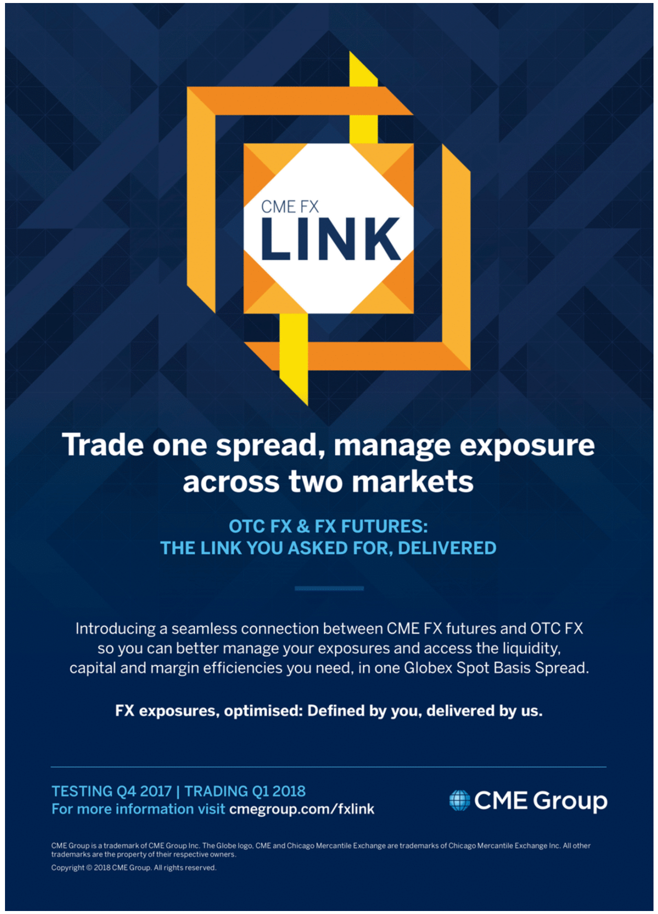

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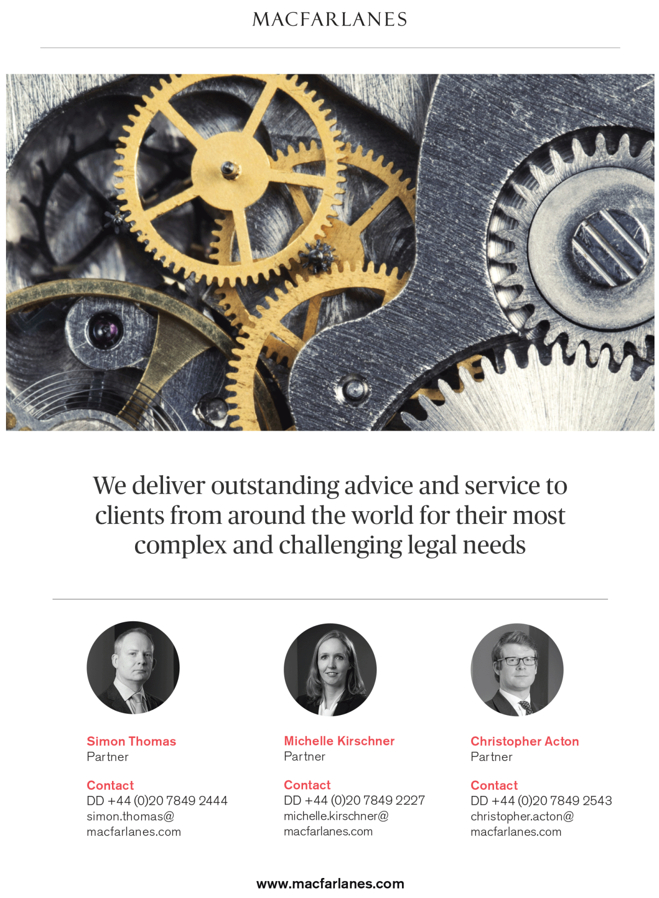

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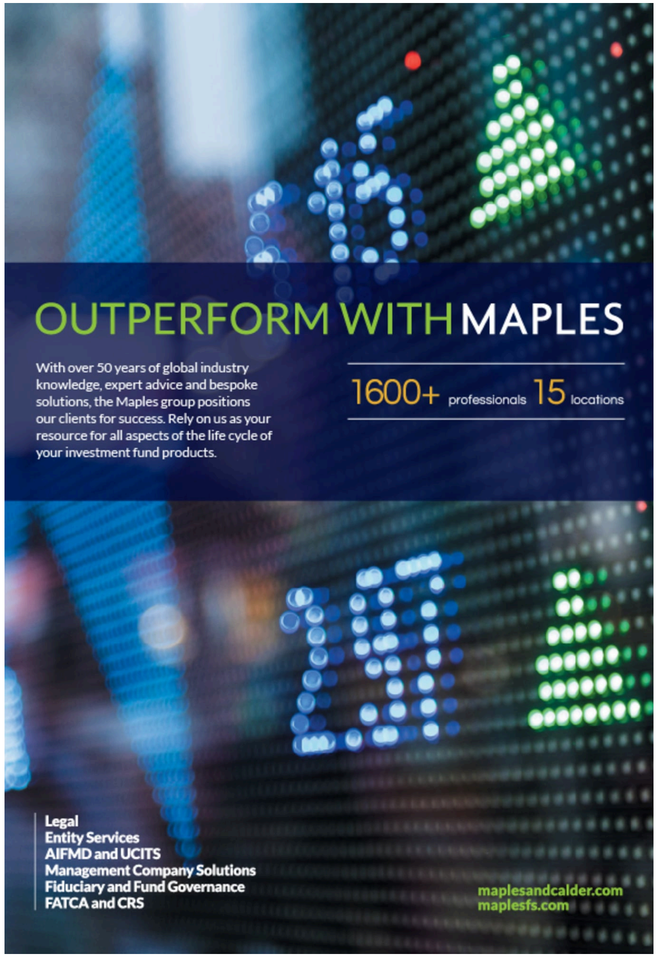
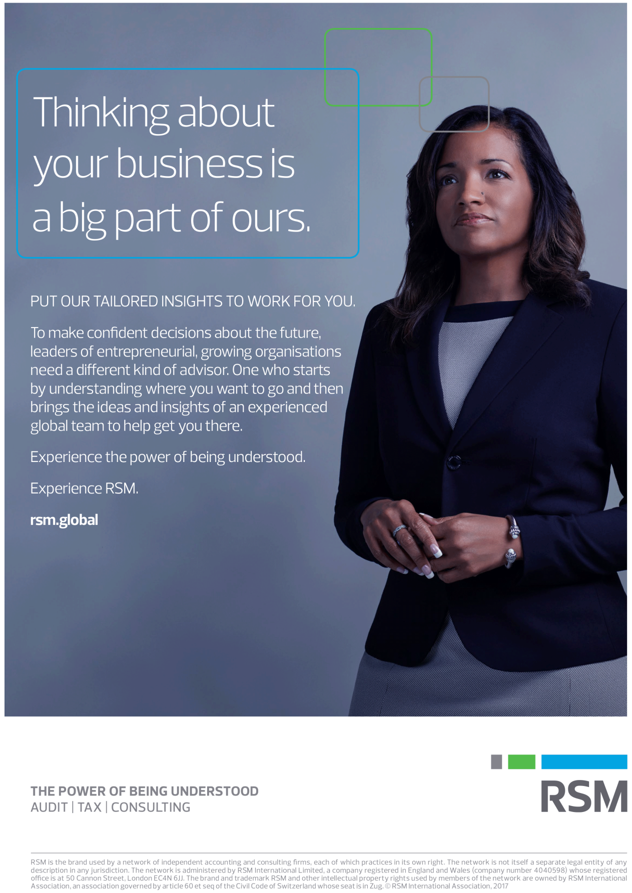


PWC

RSM



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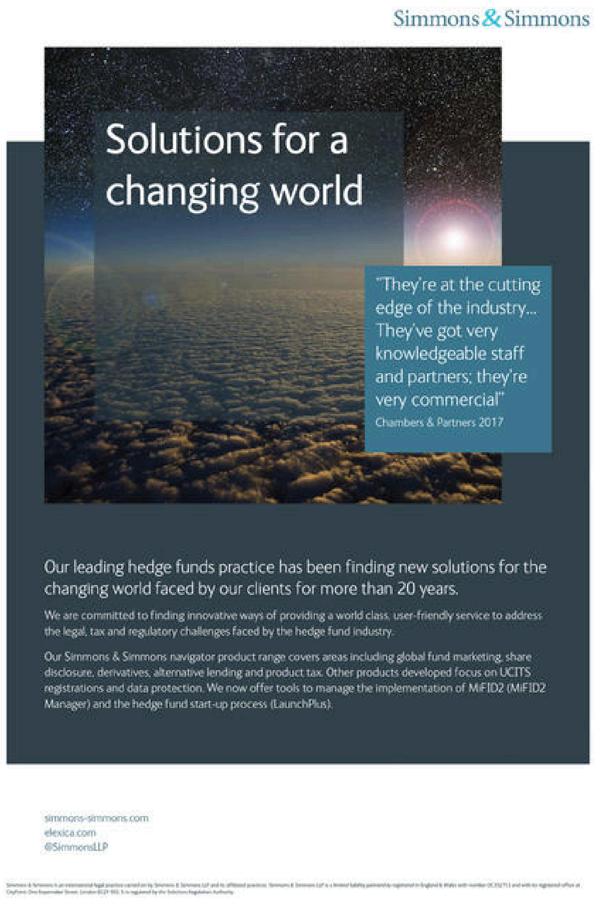

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