

AIMA JOURNAL

AIMA

Edition 140 | Q4 2024 | aima.org

2024 Presidential
election and tax policy
BDO USA

Navigating preferred
equity in private funds
A&O Shearman

and more...

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The Long-Short



Your window to the alternative investment universe, providing the latest insights from special guests from across the industry.



Message from AIMA's CEO



2024 has been a fascinating year on both regulatory and geopolitical fronts, testing the resilience of the alternative investment industry. As we close out the year with this final edition of the AIMA Journal, many of our contributors naturally look ahead, setting the stage for 2025 and ensuring readers are well-prepared for what will undoubtedly be another opportunity for fund managers to demonstrate their value to investors.

Even before President-Elect Trump's election victory, next year was already slated to be pivotal for many markets, including the EU and the US, which will see many new and reformed rules aimed at fund managers. Several contributors detail some likely consequences for fund structuring, reporting rules, tax, and investment strategies in these markets.

Similarly, this edition offers a timely focus on non-financial misconduct regulations, and contributors also provide insights for firms committed to fostering resilient, compliant cultures under increasing scrutiny.

Tech-savvy readers keen to impress their colleagues at this year's festive events with prophetic insights on next year's digital innovations will find details on how AI could be applied to enhance fund administrator selection for fund managers and how digital treasury technology will revolutionise this burdensome operational function.

Elsewhere, readers are treated to helpful guidance on how emerging managers navigate today's challenging market environment, drawing from the research that AIMA and Marex collaborated on earlier this year.

Private credit is, and will likely remain, one of the hottest topics within alternative investments. This edition includes a valuable overview of a sub-genre of this theme that will develop significantly next year: NAV lending.

Aligned with this edition's forward-looking theme, AIMA has a packed events calendar for 2025, most of which are free for AIMA members to attend. At a time when our inboxes can often become flooded with countless invites to events, AIMA's Head of Events provides a thoughtful reminder of the unique value these gatherings bring to AIMA's global membership.

Finally, I want to call on AIMA members to get involved as we update our flagship due diligence questionnaire. Your input is crucial as we strive to lighten the regulatory burden on managers. More details are on page 8.

Thank you to all our contributors for making this journal a valuable resource every quarter.

Sincerely,

Jack Inglis
CEO, AIMA



Upcoming AIMA Conferences

Learn, connect,
collaborate.

AIMA

THE ALTERNATIVE INVESTMENT
MANAGEMENT ASSOCIATION

2025

27 Jan AIMA & ACC Private Credit Investor Forum, Miami

11 Feb AIMA Middle East Forum, Dubai

25 Feb AIMA China Live, Shanghai & Beijing

11 Mar AIMA Global Policy & Regulatory Forum, New York

25 Mar AIMA Singapore Annual Forum, Singapore

24 Apr AIMA Digital Assets Conference, New York

15 May AIMA Japan Annual Forum, Tokyo

11 Sept AIMA Technology & Innovation Day, London

25 Sept AIMA Australia Annual Forum, Sydney

For more information on AIMA's events, to view playbacks and to register for upcoming events visit www.aima.org/events

Staying ahead of the game

The value of attending events



Dawn Angley
Global Head of Events
AIMA
[Email Dawn Angley](#)

AIMA events in numbers

- 220+ annual events
- 15 conferences
- 20,000+ delegates
- 1,000 speakers

No matter what job, role, function, or sector you work in, you are likely going to be required to attend events, whether that is a meeting, client engagement, networking or continued professional development. But deciding which events and allocating your valuable work hours to attend can be a challenge (and a minefield to decide between the many in the calendar), so here is a reminder why AIMA continue to host an extensive event programme for our members.

Professional development through learning and sharing your expertise. Conferences are a vital part of career advancement. You can also showcase your own knowledge and skills by speaking at events which can help you build your professional reputation. There are over 1000 speaking opportunities at AIMA's events each year for the seasoned public speakers and first timers.

Networking. Any event big or small can be a great opportunity to meet and build relationships and may host ample opportunities and formats for meeting people whether you're a confident conversation starter, or a comfortable introvert. Make sure to use your time wisely and avail of the array of options for building connections beyond chatting over a coffee. Connect via an event app, join roundtables and partake in group networking available at many of our events.

Staying up to date. Industry experts dedicate their valuable knowledge and experience via our events and attending is a great way to learn about the latest innovations and best practices in your field. You may be surprised at the influence and inspiration you can get from listening to speakers.



Sparking creativity. We all need to step outside our comfort zone and be exposed to new projects, people, and technology. This can help you spark new ideas that can lead to real innovation in your role.

Access to key suppliers and tools. Service providers provide access to various resources and tools that could assist you and your company that you may not know you needed. Conferences can be a brilliant one-stop-shop for exploring the latest offerings in your field.

Too busy? Many events now have added free space so that that you can dip in and out of work or take a call in a private area allowing you the flexibility to still plan your agenda and attend the sessions you want.

Did you know that AIMA host over 220 events annually? Most of which are free for members to attend. If you are interested in speaking, sponsoring or attending our events, perhaps for your first time, visit aima.org to learn more, or feel free to get in touch.



Act now!

Your input matters



Jennifer Wood
Managing Director, Global Head of Asset
Management Regulation & Sound Practices
AIMA
[Email Jennifer Wood](mailto:Jennifer.Wood@aima.org)

The Alternative Investment Management Association (AIMA) is in the process of updating its flagship due diligence questionnaire (DDQ), the AIMA Illustrative Questionnaire for the Due Diligence of Investment Managers.

The AIMA DDQ is used by prospective investors when assessing investment managers and is considered to be the industry-standard template. By having a standardised set of questions, the DDQ also helps managers respond efficiently to requests for information from multiple investors. The new edition of the DDQ is due to be published in March 2025. The DDQ was last substantively revised in 2019 and was first published in 1997.

We recognise that updating the DDQ may require managers to devote significant time to filling in the new form. To ease the potential burden, we are endeavouring to remove or consolidate at least as many questions as we add. We will also be providing tools to help managers track where the new version differs from the previous one.

Changes are expected to include at least the following:

- Introducing the ability to add questions to the format and to add explanations to responses otherwise calling for a yes/no or multiple choice response;
- Splitting the basic strategy details module into a version for trading strategies and a separate version for private markets strategies;
- Removing the technical content control text boxes;
- Integrating questions on the use of technology, including cyber security, cloud and artificial intelligence, the manager's approach to sustainability, and the identity of, and relationships held by, the members of the fund's governing body, which all were previously covered solely by separate modules or other questionnaires;
- Removal of some questions calling for information that can change rapidly, like performance, in favour of samples of the types of ongoing reporting that investors may receive that cover those topics;
- Elimination of identified duplicative questions; and
- Revisions to reflect the input of members that is yet to come.

The robust input of members into the update process is vital.

We are calling on manager members and investors to let us know what portions of the DDQ they would like to see refreshed, extended or pared back. Are there topics you get asked about frequently but which are not covered sufficiently, or at all, in the current version of the DDQ? Are there questions you think are redundant or unnecessary? Are there series of questions that do not quite get to the right issues in your view or that you think do not make sense as a group?

All comments are welcome and gratefully received. To assure there is enough time to process any adjustments and finalise the revised DDQ in time for launch, we are asking for any comments to be sent to [Jennifer Wood](mailto:Jennifer.Wood@aima.org) by no later than **Friday, 10 January**.

Logged in members can access the current versions of each of the modules that make up this DDQ on the [AIMA website here](https://www.aima.org).

The anatomy of hedge fund liquidations and key screening factors for investors



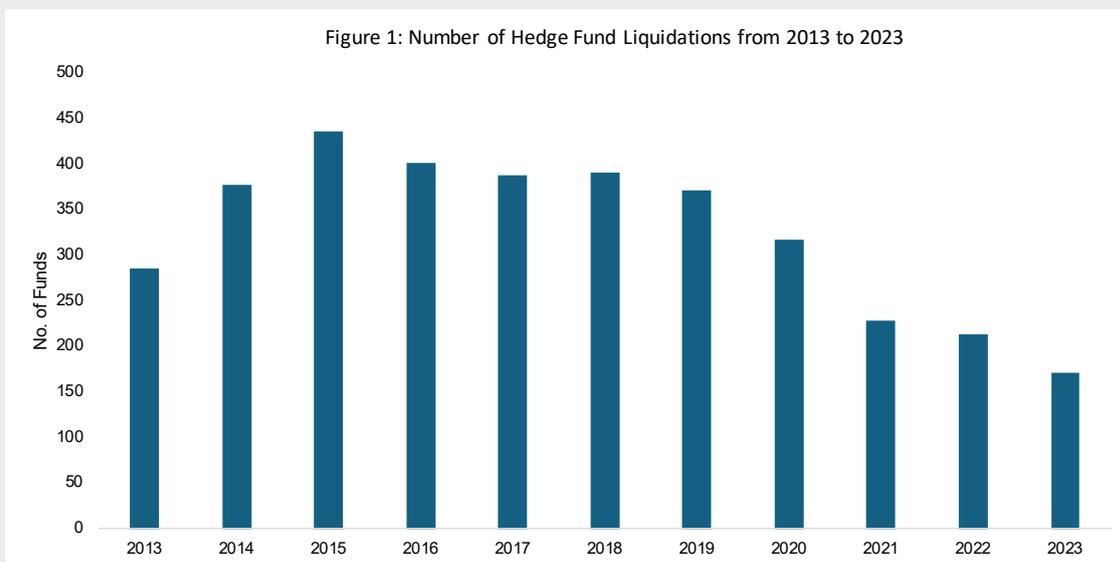
Daniel Huss
Executive Director
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Stephan Paul
Director
Absolute Return
Prime Capital AG

Executive summary

Hedge funds attract investors with the prospect of higher liquidity, uncorrelated returns, low volatility or a combination of these in comparison to other alternative investments. However, this frequently involves the use of complex financial instruments, leverage and trading strategies associated with significant risks which, due to the secretive nature of hedge funds for protecting their competitive advantage, can be difficult for investors to gauge. Based on a dataset from Preqin Pro of self-reported performance data just over 3,500 hedge funds were liquidated between 2013 and 2023. Such liquidations may be involuntary or voluntary at the initiative of the manager and the impact on investors can vary widely depending on the cause and type of investment strategy. In the following we elaborate on causes of failure, differentiating between performance and operational issues to show how each scenario can impact investors through opportunity cost or losses and last what measures investors can take to avoid such cases.



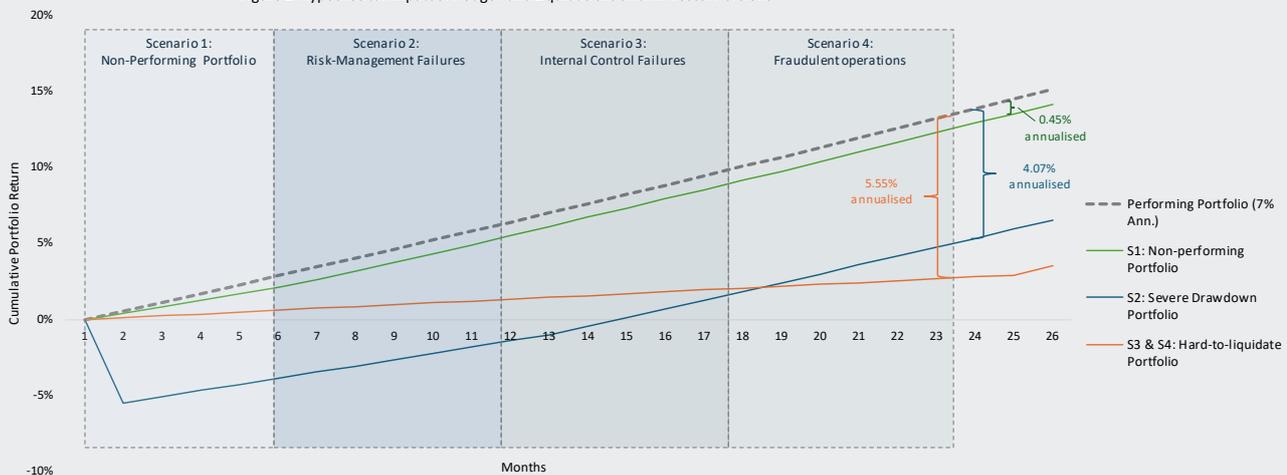
Source: Preqin Pro. Data as of October 2024

Opportunity cost

When managers underperform against benchmarks or expected risk-adjusted returns, investor confidence erodes and key talent may depart, leading to redemptions and potentially forcing the manager to liquidate the fund. Continuous underperformance ultimately results in opportunity costs for investors, which is further exacerbated over time and directly impacted by the redemption terms and asset liquidity.

Whilst performance-related issues play a significant role, with 86% of liquidated funds in the available data that reported target returns having underperformed prior to liquidation, operational factors also come into play. High prospective management and performance fees have historically driven individual managers to override risk-management or internal controls, pursue strategies at odds with laws and regulations or conduct outright fraud to the detriment of investors. As illustrated through different hypothetical scenarios in Figure 2, these operational failures can have a significantly larger financial impact on investors.

Figure 2: Hypothetical Impact of Hedge Fund Liquidations on an Investor Portfolio



Source: Prime Capital AG

Scenario 1 (S1) assumes a non-performing portfolio with 0% rate of return on the affected portion and a 6-month liquidation period with no cost to liquidate. Scenario 2 (S2) assumes a risk-management failure leading to a 25% drawdown on the affected portion followed by a 6 to 12-month liquidation period assuming a 5% cost to liquidate. Scenario 3 (S3) assumes an internal control failure leading to a 0% rate of return on the affected portion of the portfolio with an 18-month liquidation period and 10% cost to liquidate. Scenario 4 (S4) assumes fraudulent operations leading to a 0% return for the affected portion of the portfolio with a 24-month liquidation period and a 10% cost to liquidate. The affected portion of the portfolio is 25% in each case with the benchmark portfolio earning a 7% annualised return.

Scenario 1: Non-performing portfolio

Liquidation involves selling the portfolio to pay investors, with timelines varying by asset liquidity. Liquid assets such as listed equities can be sold in minutes or days, while illiquid assets like private securities may take weeks to months. In rare cases such as a severe liquidity mismatch, liquidation can exceed 1-2 years. In a normal winddown the manager can exercise control over the timing of portfolio liquidation to ensure minimal cost, and the best outcome for investors. A fire sale can disrupt markets, hence from an investors' standpoint an extended sell-off period can be preferable to protect the value of the portfolio, especially for illiquid assets and low-volume markets.

Scenario 2: Risk-management failures

Failure to capture complex instruments within the risk-management systems or to establish an effective risk control framework can result in drawdowns. These can be significant and unexpected,

leading to the fund being so far below its high-water mark that earning performance fees in the foreseeable future becomes unlikely. This often causes investors to rush for the exit, requiring managers to liquidate and potentially discontinue operations. Investors should reasonably assume a 6 to 12-month liquidation period, as the outsized drawdown and redemptions may trigger gating provisions or extended sell-down periods to ensure adequate pricing. While an effective risk-management system capable of measuring and aggregating all risk exposures over the portfolio as well as subjecting these to historical and scenario-based analysis is intended to prevent such drawdowns, black swan events do occur, and some managers may override risk-management warnings and underrate the probability or impact of adverse outcomes. Frequently, the risk-management team cannot directly intervene to reduce risk, which is where clear escalation lines and communication channels to senior management and the board of directors are required.

Scenario 3: Internal control failures

Investment activities using material non-public information, market manipulation, front running or sanctions circumvention have been used to try and gain an edge. Once authorities become aware, assets may be frozen and investors must await the results of legal proceedings which, in severe cases, become liquidation proceedings in which investor gains may be clawed back by liquidators as ill-gotten. The length of the legal proceedings will depend on the capacity and efficiency of the courts as well as the complexity of the case. Prosecution may be prolonged due to the need for evidence of collusion, proof of the use of material non-public information or dependence on collaboration with foreign authorities when identifying alleged sanctions circumvention. These generally are shorter than in the case of fraudulent activities as funds have not been embezzled.

Scenario 4: Fraudulent operations

Fraudulent operations are those wherein investors are deceived about the nature of the business and range from the use of misleading marketing materials to cases where no actual investments were made, and capital was raised solely with the intent of misappropriation. While easier to prosecute than internal control failures, since existence and performance of assets can be quickly confirmed by the fund brokers and custodians, the potential losses investors face may be significantly higher as spent embezzled funds can be difficult to recover.

Mitigating measures for investors

To avoid lengthy capital lockups from liquidating funds or becoming the victim of fraudulent investment schemes investors should evaluate the following aspects of the business in conducting their due diligence.

1. Strategy evaluation

The strategy and financial instruments used should be examined to avoid having capital locked up for extended periods in winddown proceedings. A liquidity mismatch between traded instruments and offered redemptions can be the first warning sign. Furthermore, investors should monitor whether and to what extent illiquid level 3 instruments are held. These might come with stale prices and lack of an active market meaning a bilateral buyer must be found. Lastly, investors should review the managers' track record, whether at a previous firm or their current one, to determine whether they have successfully implemented this strategy in the past.

2. Third-party verification and oversight

Under best practices fund administrators confirm 100% of the existence and value of the entire portfolio independently and maintain the official set of books and records to prepare the funds financial statements. The fund administrator should have direct lines of contact with the fund's counterparties and oversee all transfers of cash and assets. In some instances, the fund manager may need an independent valuation agent to price complex instruments and investors should understand the parameters and assumptions used in models as well as the process for valuation overrides. Measures such as independently confirming managers' relationships with counterparties and service providers are simple and effective, but still not done by every investor. Auditors serve as the 4th line of defense, nevertheless investors should enquire whether these have adequate resources such as valuation specialists.

3. Risk, legal and compliance framework

An experienced and sufficiently staffed risk, legal and compliance department with established processes is essential to prevent misconduct. Archiving of trading communications, monitoring of personal account dealing, and market abuse surveillance systems make up the baseline repertoire of detective controls used by compliance managers to identify suspicious activity. Effective internal controls when processing financial positions and onboarding new products should ensure that positions are captured in a timely manner and risk-management systems cannot be overridden. Some strategies carry higher inherent risk of manipulation such as those involving infrequently traded or hard to price securities, whereas strategies surrounding highly liquid and regulated products like listed index futures are less at risk, therefore the control framework should be tailored to the inherent risk.

Conclusion

While hedge fund investments offer attractive returns and liquidity, they require a tailored due diligence approach to mitigate the risk from drawdowns or liquidations. Hedge fund failures related to operational factors can lead to more complex liquidation proceedings and higher opportunity costs for investors. Evaluating factors such as the service providers, risk-management and compliance function as well as a thorough evaluation of the strategy are therefore crucial.

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What does it take for emerging managers to succeed in today's high-stakes environment?

In recent years, market volatility and mounting pressures have profoundly impacted most industries, and alternative investment managers are no exception. Investors are more selective, seeking managers who not only deliver risk-adjusted returns but also show agility, operational proficiency and transparency.

Staying ahead takes more than strategy - it requires adapting to these trends and anticipating what's next. For emerging hedge fund managers, who often operate with lean resources, the stakes are even higher. So, how are they navigating these complexities while continuing to attract capital and grow?

Marex's latest research report, "[Standing Strong: Emerging Manager Survey 2024](#)," co-authored with the Alternative Investment Management Association (AIMA), dives into the strategies that are helping these managers stay competitive, from cost control to operational efficiency, revealing how they are positioning themselves to thrive in today's market.

This edition is the fourth report produced over the past seven years by Marex Prime Services (formerly Cowen Prime Brokerage) and AIMA on emerging managers - those managing up to US\$500m. The report is unique in its depth and continuity of data, enabling emerging managers to gain unparalleled insights into the unique challenges and opportunities they face. It also sheds light on investor interests and concerns in this segment of alternative investments.

This year's theme, 'Standing Strong', highlights how emerging hedge fund managers are navigating a challenging environment. They are showing resilience by balancing various factors, such as competitive fee models and lean operating practices, which helps them stay appealing despite economic and market pressures. By focusing on costs and efficiencies, smaller and emerging hedge funds are able to succeed in a challenging economic climate.

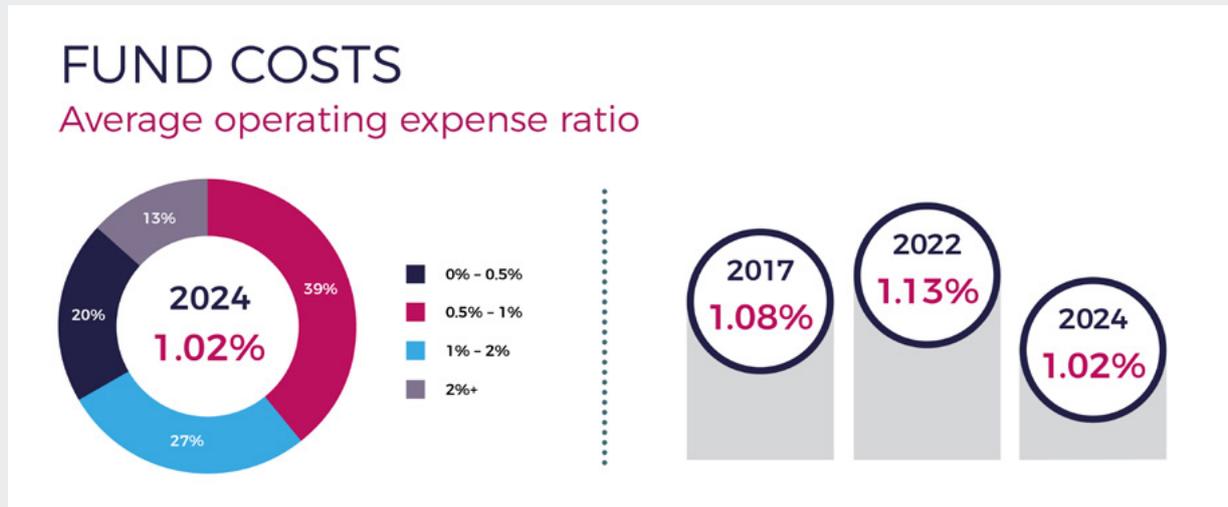
A focus on operational efficiency: Doing more with less

The research highlights the sustained impact of COVID-era operational practices and efficiencies. Against a macroeconomic backdrop of rising costs, emerging hedge funds have kept operating expenses



Lawrence Obertelli
Head of EMEA Prime
Service Sales
Marex Prime Services

and breakeven costs below pre-pandemic levels. The findings also underscore the significance of outsourcing, enabling managers to control costs while leveraging specialist expertise and scalability.



Source: Standing Strong: Emerging Manager Survey 2024

According to the research, managers are offering fees significantly lower than the traditional 2&20 model, making their funds more attractive. This is consistent with the broader industry move towards greater alignment of interests. It reinforces the message that competitive fee structures are crucial to attracting investors for emerging hedge funds.

Emerging manager fees have been stable at these competitive levels for many years, with management fees averaging at 1.37% and performance fees at 16.36%. Furthermore, Managed Accounts, with their own fee terms, are becoming increasingly popular. Emerging managers can be more nimble and amenable to bespoke opportunities, meaning they potentially stand to benefit from this trend more than their larger counterparts.

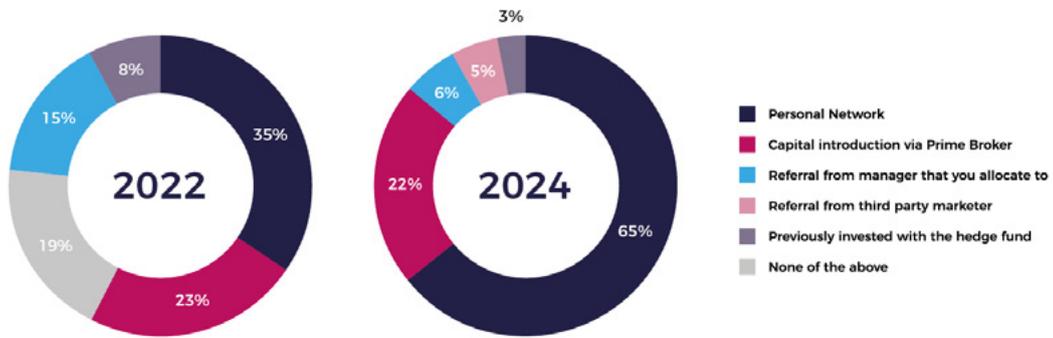
Emerging funds attract investor interest

Despite higher global costs and persistent pressure on fees, emerging funds continue to stand strong, attract investors and adeptly manage expenses to stay ahead. According to the research findings, there are a number of reasons why fund managers should be optimistic about investor interest.

- **Investor behaviour:** Investors continue to show interest in funds with a track record of one year or less, with 48% selecting this option, in line with previous reports. More than 75% of investors rely on their personal networks or prime broker capital introduction teams to source new hedge fund managers.
- **Strong interest in smaller funds:** Two-thirds of investors surveyed are still open to allocating to emerging managers with less than US\$100 million in assets under management (AUM), a welcome counterpoint to the industry's bifurcation trend.
- **Track record requirements:** Half of the investors surveyed said they would consider allocating to an emerging manager with a track record of less than a year.

RAISING CAPITAL

Source of most recent allocation



Source: Standing Strong: Emerging Manager Survey 2024

It is worth noting that investors also expect more from their managers regarding transparency and communications before making an allocation. The average time to close on new investments has increased from six to eight months since 2022, with investors taking a more sophisticated approach to due diligence, making emerging managers work harder to secure new tickets.

RAISING CAPITAL

Factors causing longer closing time



Source: Standing Strong: Emerging Manager Survey 2024

Meaningful insight

The research has been conducted to help both fund managers and investors make informed decisions and adapt to the evolving market. The time series analysis reveals long-term trends, while cross-sectional analysis provides detailed insights into variations across fund types, sizes and regions.

The report provides a nuanced understanding of the resilience and adaptability of emerging hedge fund managers. It is very encouraging to see how emerging managers are standing strong and attracting investor interest amid the fiercest of fee environments and increasing costs.

About 'Standing Strong: Emerging Manager Survey 2024'

The research findings are derived from two surveys: one of managers running funds of up to US\$500 million AUM (171 respondents) and the other from investors that allocate to this segment, (60 respondents, with an estimated aggregate AUM of US\$400 billion). Data has been gathered on hedge funds running between US\$500m-US\$1bn AUM, which is presented for comparison purposes to act as a roadmap to scaling.

Hedge fund manager survey respondents in this year's survey had an estimated aggregate AUM of US\$18.3bn and an average AUM per manager of US\$107m. This research amongst fund managers and investors was carried out in H1 2024.

Similar to prior reports, the data has been broken down by region and investment strategy in some areas to provide a more granular analysis of how trends differ within the pool of survey respondents.

To download a copy of the report, please visit [this link](#).

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2024 Presidential election and tax policy: What's at stake for the asset management industry

The 2024 election is likely to profoundly impact tax policy and legislation. Once the dust settles on the results, the incoming president and Congress will have a tall task in 2025, as the expiration of several 2017 Tax Cuts and Jobs Act (TCJA) provisions will loom large and many other tax policy proposals will be on the table. All of the moving parts have inspired pundits to refer to 2025 as a year we will see the 'Super Bowl of Tax'.

This article highlights some of the important tax provisions in play for the asset management industry and related considerations.

Key provisions of the TCJA set to expire at the end of 2025

Without legislative action extending the provisions, several changes enacted under the TCJA will expire at the end of 2025, including:

- Individual tax rates will revert back to pre-2018 levels, so the highest rate will increase from 37% to 39.6% for ordinary income.
- The US\$10,000 limit on state and local tax (SALT) deductions will be eliminated, obviating the need, in some cases, for pass-through entity tax (PTET) elections.
- The Qualified Business Income deduction under Section 199A, which benefits partners and owners of certain pass-through businesses, will be eliminated; this would impact choice of entity considerations for private equity and venture capital portfolio companies.
- Deductions for management fees and other portfolio expenses, currently disallowed under Section 212 for partners in investor funds, will once again be deductible, albeit with limitations.
- The estate tax lifetime exclusion amount will revert back to roughly US\$7 million, significantly less than the current exclusion amount, which is US\$13.6 million; there may be significant planning and gifting activity involving fund interests in 2025 if this change appears imminent.

President-elect Trump has expressed support for extending the TCJA, but is open to repealing the SALT cap. Vice President Harris would be in favour of extending certain provisions, such as the reduced individual tax rates, for taxpayers with less than US\$400,000 of taxable income. She would, however, seek to increase tax rates for both ordinary and capital gain income for taxpayers with income more than US\$400,000 and US\$1 million, respectively.

Other relevant provisions at stake in 2025

Depending on the election outcome, there are other provisions that may be a part of legislative negotiations between Congress and the White House next year. Several of those provisions would impact funds, general partners, and portfolio companies.



Joe Pacello
Managing Director
BDO USA, P.C

These include:

- **Corporate tax rates:** Vice President Harris has proposed raising the corporate tax rate from 21% to 28%, whereas President-elect Trump has proposed lowering it to 15%.
- **Carried interests:** Consistent with the Biden administration's proposals, Harris would propose to tax certain carried interest allocations at ordinary income rates plus self-employment tax, regardless of holding period; Trump has not proposed any changes to current law, which requires a holding period of over three years.
- **Tax on unrealised gains:** Harris supports the Biden administration's proposal to impose a 25% minimum tax on taxable income, inclusive of unrealised gains, for taxpayers with a net worth more than US\$100 million.
- **Excess business loss limitations (Section 461(l)):** Harris would propose to eliminate the favourable loss carryover rules that apply under current law.
- **Limits on business interest expense under Section 163(j):** These rules may be revised to be more favourable, depending on the landscape in Congress next year. There was bipartisan support in the House of Representatives for this in early 2024, but the bill stalled in the Senate. In light of higher interest rates, these limits currently have a significant impact on some hedge fund investors as well as private equity and venture capital portfolio companies.
- **Bonus depreciation rules:** The rules are currently being phased out and are scheduled to expire at the end of 2026. Similar to the Section 163(j) revision noted above, there was bipartisan support in the House in early 2024 to once again allow immediate expensing of certain business assets. That proposal may also resurface in 2025.
- **The Inflation Reduction Act's clean energy tax credits:** The credits – some of which could be bought or sold by funds – are supported by the Biden-Harris administration but could be rolled back in a second Trump term.

The results of the congressional elections will also be a key determinant of what direction tax policy goes in during 2025.

The results of the congressional elections will also be a key determinant of what direction tax policy goes in during 2025.

Considerations for the asset management industry

All of the variables underscore the importance of scenario planning and modelling. For example, if the sunset of the lower individual tax rates is expected, certain reverse tax planning may be in order – such as accelerating income into 2025. Private equity and venture capital funds could consider electing out of the instalment sale rules to accelerate gain into 2025. And hedge funds could plan for this scenario through the careful navigation of timing issues such as the constructive sale rules.

Fund managers should be proactive about discussing potential tax changes with their advisors and having a game plan in place for different scenarios.

New non-financial misconduct rules are coming – It is time to get prepared

The conduct of firms and their personnel is integral to a well-functioning, healthy financial services system. Non-financial misconduct (NFM) has long been on the FCA's radar but more recently with the FCA's Diversity and Inclusion Consultation Paper (CP),¹ its Notice to Provide Information regarding NFM prevalence² and its contribution to and statement published³ alongside the Treasury Committee's "Sexism in the City" Report⁴ it is clear that not only does the FCA view NFM to be within its regulatory remit, but it now is very much a focus on its agenda.

Below we look at what NFM the FCA considers to be within the regulatory perimeter and provide some practical tips, including how fund managers can be prepared in this developing space and how to approach potential investigations.

What is the current state of play?

The FCA has consistently regarded NFM to be within its remit and it achieves its regulatory oversight of conduct via a number of tools, including via its supervision of firm culture generally but also more specifically through Fitness and Propriety assessments and the Conduct Rules set out in the Senior Managers and Certification Regime.

Firms must be satisfied on an ongoing basis that individuals performing Senior Management or Certification Functions are 'fit and proper' to carry out their roles. Guidance on relevant considerations are set out in FIT⁵ of the FCA Handbook. Existing guidance includes misconduct both within and outside the workplace but focusses on financial business such as fraud and there are no express examples of NFM.

In contrast to FIT guidance, all examples of inappropriate conduct set out in COCON⁶ focus on conduct within the workplace and in relation to the firm, for example, misleading a firm or the FCA in relation to an investigation; or failing to inform the firm under its personal account dealing rules.

Overall, there is a current lack of examples of NFM of a personal nature within the current FCA Rules. Also, if we look to historic FCA enforcement action for guidance, conclusions are somewhat contradictory. In August 2021, the Upper Tribunal stated during the Frensham⁷ decision that *"Provisions requiring professional persons to act with integrity or to be of sufficient repute may reach into private life only when conduct that is part of a person's private life realistically touches on their practice of the profession"*

- 1 CP23/20 published in September 2023
- 2 Sent in February 2024 Letter: [Notice to provide information - non-financial misconduct \(fca.org.uk\)](https://www.fca.org.uk/notice-to-provide-information-non-financial-misconduct)
- 3 Published in March 2024 [House of Commons Treasury Committee's 'Sexism in the City' report | FCA](https://www.parliament.uk/houseofcommons/2024/march/sexism-in-the-city-report-fca)
- 4 Published in March 2024 [Sexism in the City - Treasury Committee \(parliament.uk\)](https://www.parliament.uk/houseofcommons/2024/march/sexism-in-the-city-treasury-committee)
- 5 The FCA's Fit and Proper test for Employees and Senior Personnel sourcebook (FIT)
- 6 The FCA's Code of Conduct (COCON)
- 7 [Final Notice 2021: Jon Frensham \(fca.org.uk\) in September 2021](https://www.fca.org.uk/news/2021/210921-final-notice-2021-jon-frensham)



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concerned". However, subsequent to this, in the Zahedian case,⁸ the FCA stated that *"Given the nature and circumstances of Mr Zahedian's violent offences, this demonstrates a clear and serious lack of integrity... he does not have the requisite reputation to perform functions in relation to regulated activities and is likely to damage the reputation of any regulated firm."*

This has left firms unsure as to the types of NFM which are relevant and whether conduct outside of the workplace should be considered.

How is this space developing?

The FCA has taken steps to clarify what NFM is within its supervisory remit, with the regulator publishing the CP containing proposals aimed at *"clarifying and strengthening its expectations around non-financial misconduct"*.

The proposals explicitly include NFM within the Conduct Rules, the Fit and Proper Assessments and the suitability guidance on the Threshold Conditions with the aim of giving firms the reassurance needed to take decisive and appropriate action against employees for instances of NFM.

The proposed new COCON rules articulate the types of behaviours towards fellow members of the workforce that would breach COCON including sexual harassment, intimidating or violent conduct, malicious or insulting conduct and oppressive conduct. The FCA has clarified that NFM **outside of the workplace** in a person's personal or private life is **not in scope of COCON** and reiterated that, except with respect to banks, the Conduct Rules are restricted to regulated activities.

Further, the FCA propose to amend the FIT Handbook to explain in more detail how NFM forms part of the Fit and Proper test for employees and senior personnel. It clarifies that bullying and similar misconduct within the workplace is relevant to FIT assessments and in contrast to the proposed COCON rules, confirms that **similar serious behaviour in a person's personal or private life are also relevant for the purposes of FIT**. The proposed new guidance states that *"misconduct in a person's private or personal life or in their working life outside the regulatory system ... may show that the person lacks moral soundness, rectitude and steady adherence to an ethical code. That in turn raises doubts as to whether they will follow the requirements of the regulatory system."* The resulting policy statement, updated rules and related guidance can be expected in the next couple months before the end of 2024.

Following publication of the CP, in February of this year the FCA sent a Notice to Provide Information to a number of market participants. Whilst this did not include members of the alternative investment community, it provides a further insight into the behaviour, including bullying, sexual harassment and discrimination, whether inside or outside the workplace, that the FCA considers being under the umbrella of NFM and within its remit.

Further highlighting the FCA's commitment to tackling NFM in the workplace, is its contribution to the Treasury Committee's "Sexism in the City" Report which was published in March 2024. In conjunction with the report's publication, the FCA released a statement confirming that it will prioritise proposals that tighten expectations on firms to tackle misconduct such as bullying and sexual harassment.

How can firms get prepared?

It is clear that there is a revived, concerted effort to give firms the necessary impetus to confront NFM head on. In light of this and the proposed rule changes in the pipeline, firms need to put NFM at the forefront of their agendas and ensure they have appropriate systems and controls in place to address any incidences of NFM that should arise. Below are some tips on what this could look like.

8 [Final Notice 2022: Ashkan Zahedian](#)

Internal culture review: Firms may wish to undertake an internal review to understand how its current culture measures against the expected proposals.

Policies: Tailored policies can set out expectations and guidance for employees regarding inappropriate conduct. Guidance should clearly identify and categorise behaviours and cover both the obvious and also less clear cut scenarios to aid employees in understanding where the balance lies.

Procedures: Firms might also benefit from procedures documenting how to manage a NFM allegation promptly and fairly, including factors to be considered regarding whether a formal investigation needs to be undertaken. Issues can be resolved quickly and efficiently if they follow a well thought through path that ensures that all relevant matters, including regulatory and employment issues, have been considered.

Speak up culture: Beyond formal whistleblowing policies, fostering a firm culture of transparency and accountability from the top down not only promotes ethical behaviour and builds employee trust but also enables the identification of issues. Staff should not only be made aware of the firm's internal whistleblowing policy but also the FCA's whistleblowing procedures.

Training: It is essential for firms to train their staff on NFM to foster a healthy and respectful workplace, with training calibrated to different roles. Training helps employees recognise inappropriate behaviour and speak up allowing the firm to detect and address issues at the earliest opportunity.

What to do if an alleged NFM scenario arises

From the outset of a potential concern firms should consider whether there is a need to investigate. Factors to be taken into consideration include whether there is a need to notify the regulator; whether the complaint could be indicative of a wider issue representing systems and controls failings; whether there might be a Code of Conduct breach; and the extent to which senior management may be involved, either directly or indirectly.

Failing to properly investigate, or the perception of failing to investigate, can exacerbate issues or create further problems for the firm, which in some cases can be a conduct issue in itself. Where a firm takes the decision not to investigate, the rationale behind this decision should be properly documented so it can be revisited at a later date if needed.

Undertaking a robust investigation

The internal policy should be followed closely when undertaking an investigation. It is usually advisable for conflicts management and legal privilege reasons to set up a working group for this purpose.

When undertaking investigations staff wellbeing should be taken into account. Investigations can be an incredibly stressful and consideration of mental health should be at the forefront of a firm's strategy.

Lastly, once the investigation has been completed, a follow up discussion should take place to capture any lessons learned and any process enhancements which can be fed into the firm's policies and procedures going forward.

If you would like any assistance in preparing for the new rules or help with an investigation please contact us.

Further considerations when launching a fund on a third-party UCITS or AIFMD compliant platform

The use of established third-party fund platforms by asset managers wishing to launch a European fund product for global distribution in the form of a sub-fund on an existing umbrella vehicle is now well established. This applies to both Undertakings for the Collective Investment in Transferable Securities (UCITS) and alternative investment funds (AIFs) under the EU's Alternative Investment Fund Managers Directive (AIFMD). In fact, an article which I wrote highlighting key considerations when negotiating to on-board onto an existing third-party platform was published in the AIMA Journal over ten years ago.

However, while the points made in that article ([which is available here](#)) remain valid, the market has evolved considerably since then as new commercial and regulatory impacts have brought new considerations to bear. This article explores some of these new factors which managers would be advised to include in their due diligence exercise when assessing potential platforms.

Market developments

The number of potential providers has grown considerably in recent years, and this affords those seeking a European host platform with a wealth of choice. In the Irish context this has been driven in part by the CP86 reform initiative. This essentially shut down the previously dominant model of self-managed investment companies, or SMICs, by requiring additional substance in management companies including full time employees. For smaller managers, it will rarely be worthwhile capitalising a management company as well as employing local staff. Third party management companies can meet this need by acting as the delegate to a fund board and then sub-delegating portfolio management activity to an external overseas asset manager. In many cases they will also offer a host fund vehicle where a new sub-fund can be launched for new underlying portfolio managers. This applies both under UCITS and AIFMD, with individual management companies being capable of being authorised to manage both categories of vehicle (so called 'supermanco's'). However, it's vital to conduct extensive due diligence to find the right partner vehicle.

Even if a third-party management company is used, it is not necessary (at least from a regulatory perspective) to use an existing platform vehicle so consideration should initially be given to establishing a new separate fund entity. This will afford choice of service providers and ensure flexibility in case of replacement. Seeking to move a fund from a third-party platform will generally be considerably more onerous than replacing a management company.



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Regulatory impacts other considerations

The European Securities and Markets Authority (ESMA), the lead supervisory authority across the European Union, has been increasingly focussed on the role of the management company under UCITS and AIFMD. It constitutes the 'responsible person' under the terms of much of the applicable legislation – also in terms of liability. The fact that ESMA's related guidelines highlight the need for consistency in the treatment of related issues mean that the existing approach by a management company regarding their platform is highly important as this should be applied to any new funds. Different treatment for other funds on a platform could only normally be justified if an objective basis for this can be identified. I have included details below of some specific relevant points to consider when assessing the suitability of a platform.

Valuation policy

In January 2022 ESMA announced the launch of a common supervisory action (CSA) with national competent authorities (NCAs) across Europe addressing valuation provisions under UCITS and AIFMD. It focussed in particular on the valuation of less-liquid assets held by UCITS and open-ended AIFs including unlisted equities, unrated bonds, corporate debt, real estate, high yield bonds, listed equities not actively traded and bank loans. A Final Report from ESMA issued in May 2023 included analysis of adherence to valuation principles and methodologies with a view to reflecting a true and fair view of their financial positions in line with applicable rules.

The Central Bank of Ireland (the CBI) issued a "Dear CEO" letter on the topic in December 2023 clarifying that all firms should have documented, comprehensive and entity specific asset valuation policies and procedures clearly outlining the operational roles and responsibilities for all parties involved in the asset valuation process.

Asset managers should assess the extent to which these existing valuation policies and procedures are compatible with their own approach. This issue will be particularly relevant where they wish their European fund to be held out as an equivalent to an existing vehicle under a 'side by side' distribution strategy - since different valuation policies may result in markedly diverse results.

Errors policy

In addition to the above, the CBI letter of December 2023 clarified that all relevant firms should have a formalised and comprehensive errors procedure in place to ensure remedial action is implemented when valuation errors or incorrect calculations of the net asset value (NAV) occur. Similarly, asset managers should check that the standard approach of the management company as applied on their fund platform does not diverge from their own approach to minimise the potential for unpleasant surprises.

Costs and charges policy

Another set of policies that has been the subject of a CSA by ESMA and subsequent guidance by the NCAs including the CBI relates to costs and charges. Again, I have previously had a detailed article on this topic published in the AIMA Journal ([this article is available here](#)), however in summary this interprets the relevant legislation prohibiting the charging of undue costs to mean that fund costs charged should: (a) be consistent with the investment objective of a fund and not prevent it from achieving this objective, and (b) be clearly identifiable and quantifiable. Management companies are expected to develop and periodically review a structured pricing process addressing key elements including disclosure, consistency, sustainability, equal treatment, proportionality and necessity of costs. Such policies should be reviewed and discussed to ensure that they are aligned with the expectations of asset managers intending on launching on a relevant platform.

Policies generally

Some specific examples of relevant issues based on recent communications from both ESMA, and the CBI have been included above. It is evident from these that a general analysis of the policies of the management company to a proposed third-party fund platform would be appropriate prior to onboarding onto a platform they manage to minimise the potential for conflicts with the policies of the asset manager.

Risk framework

ESMA also launched a CSA to investigate UCITS liquidity risk management in early 2020 following highly publicised issues relating to the Woodford Equity Income Fund. In Ireland the CBI released a “Dear Chair” letter highlighting 9 specific areas of concern and indicating its related expectations for Irish UCITS Management companies in May 2021.

Asset managers should review the underlying liquidity risk management framework (the LRM Framework) including both the Risk Management Policy and Risk Management Process pertaining to any relevant fund platform for potential compliance issues.

ESG

In the European funds context, the Environmental, Social and Governance or ESG policy of entities has been an area of increased focus due to legislation such as the Sustainable Finance Disclosures Regulation (SFDR). Under the SFDR funds must categorise themselves under one of three headings, with Article 9 funds being focused on related issues. Asset managers seeking to pursue an ESG aligned objective, and especially those under Article 9, should consider the appropriateness of launching on the same platform as funds with an unaligned view on ESG issues.

Pricing

While costs are one of the drivers towards the third-party model and indeed specific providers within that model, attention should be paid to both the platform cost structure and its constituent elements, as well as any term limits or restrictions on fee raises or new charges. While the market is highly competitive, with additional regulatory pressure coming to bear, as well as their own potential investor demands, management companies are inevitably trying to find ways to increase revenue. Although direct fee raises are generally rare to date, other ways of increasing revenue may include, adjustments of minimum fees, additional fees for any services deemed to be additional or ancillary and a stricter defining of the service offering, expiration of teaser introductory rates etc. The ownership structure of the platform may be a factor to bear in mind when assessing the likelihood of such hard or soft fee raises.

Service providers

An existing fund platform has incumbent service providers which will typically be non-negotiable. While the incoming asset manager may be satisfied with these, care should be taken that any additional service providers that it wishes to use specifically for its fund, such as prime brokers, distributors etc. will be willing to work with the existing service providers (and vice versa). Ideally examples of existing sub-funds that have appointed them should be apparent or related assurances be sought.

Summary

The market for third-party fund platforms has grown exponentially in recent years. However, while the basic key considerations when assessing such options, such as costs, service providers, directors etc. remain unchanged, regulatory and market factors have caused an evolution and expansion in the range of issues to be assessed when conducting prior due diligence to ensure a good fit.



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UK EMIR reporting changes are live: What you need to know

2024 has been an important year for EMIR reporting.

In April, the EU EMIR REFIT reporting changes took effect, followed, on 30 September, by changes to the UK EMIR reporting regime.

This article takes a high-level look at the changes made to the UK regime, the differences between the EU and UK regimes and what in-scope entities need to know.

Key takeaways

- All derivatives users directly in scope of UK EMIR are affected.
- Whilst very similar, the UK and EU regimes are separate, and there are differences.
- Changes are significant and new processes and procedures may be required.
- The FCA has published an accompanying set of Q&A.

Who is affected?

All derivatives users directly in scope of UK EMIR reporting. This is not a new requirement: all derivative contracts¹ have been subject to a reporting requirement under EMIR since February 2014. However, it is a significant overhaul of those existing rules.

What are the requirements since 30 September 2024?

- **Form of reports.** All derivative transactions entered into on or after 30 September 2024 must be reported in accordance with the new standards.² There is a 180-day transition period, ending on 31 March 2025, for existing transactions to be upgraded to the new standards. A modification (which includes a lifecycle event) or correction to an existing transaction report before then prompts an earlier upgrade.
- **Reconciliation and verification – new processes and requirements.** New trade repository (TR) verification and reconciliation processes have taken effect. Counterparties, the entity responsible for reporting (ERR) and the report submitting entity, as applicable, must have put in place arrangements to ensure that feedback on reconciliation failures provided by TRs pursuant to the new rules³ is taken into account and where that feedback identifies reconciliation failures, they are resolved where possible, as soon as practicably possible.

1 Both over-the-counter (OTC) derivatives (including cleared derivatives) and exchange traded derivatives.

2 The February 2023 joint FCA/Bank of England Policy Statement (PS 23/2) is available [here](#) (the **Policy Statement**). Accompanying schemas and validation rules are available [here](#).

3 EMIRR 2.3.5R of the FCA Handbook.



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The FCA's expectation was day one compliance. The same is true for updates to historic transactions. For the latter, the Q&A refer to ERRs proactively engaging with the FCA ahead of the 31 March 2025 deadline, with an explanation, if there is a risk that outstanding reports will not be updated in time.

- **New notification requirement.** The ERR must notify the relevant regulator of any material errors or omissions in its reporting, as soon as it becomes aware of them. There is no prescriptive definition of ‘material error or omission’ but the new FCA Q&A (see below) provide steer and focus on proportionality. Specific reference is made to the assessment of materiality being based on the size, nature and complexity of the business in question. The form to notify the FCA of any such errors or omissions is unchanged.
- **FCA Q&A.** Following consultation, the FCA published a set of questions and answers on the new UK reporting requirements (the **Q&A**), which have also applied since 30 September 2024.⁴ The Q&A, which cover 11 areas, including the key topics of reconciliations and errors and omissions, must be read alongside the Policy Statement and other supporting documentation listed on the FCA’s EMIR reporting obligation webpage, including the latest (updated) validation rules. The FCA also consulted on further Q&A⁵ specifically to support TRs in the implementation of the updated UK EMIR reporting requirements (**Draft Q&A**). The consultation closed on 25 September 2024 and final guidance will be published via the FCA Trade Repositories webpage.⁶

Why do I need to know?

- **Compliance timeline.** The FCA’s expectation was day one compliance. The same is true for updates to historic transactions. For the latter, the Q&A refer to ERRs proactively engaging with the FCA ahead of the 31 March 2025 deadline, with an explanation, if there is a risk that outstanding reports will not be updated in time.
- **Minimum expectations.** For errors and omissions, the Q&A state that, at a minimum, ERRs are expected to have systems and controls in place to ensure timely and complete reporting in accordance with UK EMIR. ERRs should also have in place: (i) effective governance to oversee their UK EMIR reporting; (ii) effective systems and controls to identify and remediate errors and omissions; and (iii) arrangements with counterparties to address reconciliation breaks. The Q&A refer to ERRs using the information provided by the TRs in the Warnings Feedback messages to monitor the accuracy of their reporting by investigating the potential issues. In turn this can inform any remediation, and whether any material errors and omissions notification is required.
- **Reconciliation breaks.** The new requirement to have arrangements in place to ensure the remediation of reconciliation breaks as soon as practically possible highlights a focus on reconciliation. The expectation is that ERRs have arrangements to remediate reconciliation breaks that are appropriate to the nature, scale, and complexity of their business. The Q&A confirm that the FCA does not intend to provide prescriptive guidance as to when and how counterparties should remediate breaks because the nature and severity of reconciliation breaks varies.

4 Q&A are [here](#).

5 Draft TR Q&A are [here](#).

6 FCA Trade Repositories webpage is [here](#).

How do the EU and UK rules differ?

- **Legal framework.** The UK framework is principally set out across the Policy Statement, the Q&A, validation rules and XML schema. The EU rules are housed in six implementing and delegated regulations supported by the ESMA “Guidelines for reporting under EMIR” (the **ESMA Guidelines**).⁷ The ESMA EMIR reporting landing page⁸ includes comprehensive detail on other resources, including the validation rules.
- **Reporting fields and other technical aspects.** Only the UK rules include the (optional) execution agent field. There are other differences across the more technical aspects, including between trade state reports and XML schema. The Q&A is explicit that the Warnings Feedback messages (which identify missing data and potential outlier values even though the reports have not been rejected) should be used to help identify and remediate possible errors and omissions.
- **Notification requirement.** The EU regime includes a three-limb notification requirement to the relevant national competent authority.⁹ This must be read alongside the ESMA Guidelines which, for the purposes of determining ‘significance’, set out a quantitative and a qualitative test. In comparison, as mentioned above, the UK regime includes a requirement to notify the FCA of any material errors or omissions in reporting.

Ensure you can access and process information on reports and reconciliation issues.

Tips and traps

- **Resources and support are plentiful** – the FCA EMIR landing page includes comprehensive detail on UK EMIR reporting and related resources.¹⁰
- **Delegated reporting** – users of delegated reporting services should already have engaged with delegates to understand how to address the changes for both new and legacy transactions. This should be an ongoing dialogue, particularly where issues arise.
- **ERR** – this is a new field for OTC derivatives only, for both EU and UK reporting. It refers to the legal entity responsible for reporting as set out in EMIR. EU and UK EMIR are consistent in this respect. Under the UK EMIR regime, for alternative investment funds, this means the UK alternative investment fund manager, and for UK UCITS, the UK UCITS management company.
- **Reconciliation** – ensure you can access and process information on reports and reconciliation issues.
- **Policies and procedures** – consider new or revised policies, arrangements and procedures to afford the necessary oversight to ensure compliance with the new requirements.

⁷ ESMA Guidelines are [here](#).

⁸ ESMA EMIR Reporting Landing Page, [click here](#).

⁹ Per Article 9(1) of Commission Implementing Regulation (EU) 2022/1860, [click here](#).

¹⁰ See [here](#). The FCA’s EMIR Reporting webpage, [click here](#).

Post 30 September 2024

At the time of writing, an on-going issue with the UK regime is the absence of an execution agent field on margin and collateral reports, which may impact the ability of TRs to share details of affected reports with executing entities. The FCA has formally acknowledged the issue by way of the Draft Q&A, stating that it expects affected parties to consider any reasonable steps that could be taken to ensure the accuracy of their reporting whilst this issue persists.

In the EU, the most recent milestone was the 26 October 2024 deadline for conforming historic trades to the revised requirements.

Work of industry associations in the area continues. Recently a list of key EMIR reporting contacts was published.¹¹

More changes to EMIR are coming

For those market participants affected by EU EMIR, more change, in the form of EMIR 3.0, is to come. EMIR 3.0, which is expected to be published in the Official Journal of the EU before year end, will bring changes across various aspects of EU EMIR. Certain of those new requirements will take effect straight-away.

11 See [here](#) “Central Database of Reporting Entity Contact Details for EU and UK EMIR” as published on 17 October 2024.

CSRD: A practical guide

Introduction

The [Corporate Sustainability Reporting Directive \(CSRD\)](#) is looming large for investors and corporates alike. It's extensive in scope and content, requiring a preliminary double materiality assessment and a huge number of disclosures for each material ESG topic.

Many companies will need to start collecting sustainability data and beginning their double materiality assessment in fewer than 100 days.

So, what should companies do to prepare for CSRD?

This short guide outlines the key elements of the framework and practical steps companies need to take to prepare for CSRD reporting.

Scoping

CSRD will bring 50,000 companies into scope, expanding far beyond the original 11,000 affected by the previous corporate sustainability reporting, the Non-Financial Reporting Directive (NFRD).

CSRD will apply to EU companies as well as to international companies generating revenue from within the EU. Its scope includes public and private companies.

Introduction will be phased as follows:

- **2025:** the first companies i.e. those already in scope for NFRD will need to publish their reports based on 2024 sustainability information.
- **2026:** all other large EU companies (public and private) and other non-EU large companies listed on an EU regulated market will need to report using 2025 sustainability information.
- **2027:** SMEs listed on an EU regulated market and EU small and non-complex credit institutions and captive insurance companies will need to report using 2026 sustainability information.
- **2029:** Non-EU companies which generate €150m net turnover in the EU and meet certain other conditions will need to report using 2028 sustainability information.

Analysis to assess whether a company is in scope, and the level at which it will be required to report, can be complex. Its therefore important companies get advice and confirmation from their legal counsel.

Large organisations need to check whether they're in scope as soon as possible so they can start to put in place processes to collect and report data by 2026.



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2026 may seem quite far away but there's a lot to do for companies in this cohort, especially if they are starting to collect sustainability data for the first time. Companies are strongly advised to make sure they allow enough time and start as soon as possible.

From our analysis, there are two groups in the asset management world that should pay attention here: 1) EU portfolio companies of private equity managers who are likely to be in scope in wave 2; and 2) certain investment managers who are structured with EU-based management company entities. Note that Funds themselves are not caught here (as they're addressed by SFDR).

Double materiality assessment (DMA)

The double materiality assessment is at the heart of the CSRD. This approach combines two sustainability reporting concepts: financial materiality, sometimes known as the 'outside-in' approach, and impact materiality aka the 'inside-out' method.

A DMA means thinking about both how people and the environment impact a business AND how a business impacts people and the environment.

So, for example, under financial materiality, a company might consider how more stringent sustainability regulations like mandatory transition planning might impact on its profitability or they might think about the financial implications of having facilities in certain areas of the world that could be damaged or disrupted by flooding or other climate-related issues, both now and in the future.

Meanwhile under impact materiality, a company might assess how their manufacturing processes are contributing to air pollution or how suppliers in their value chain might be violating human rights by underpaying staff and employing children.

Unlike other sustainability regulations and standards (e.g. TCFD, ISSB) which only require a financial materiality assessment, CSRD requires assessment of both financial and impact materiality. If a topic is either financially material or meets the impact materiality threshold (or if it meets both), the company will be required to report on that topic under CSRD.

It's also worth emphasising that companies need to consider not just their direct operations but all elements of their up-and-downstream operations including the suppliers in their value chain.

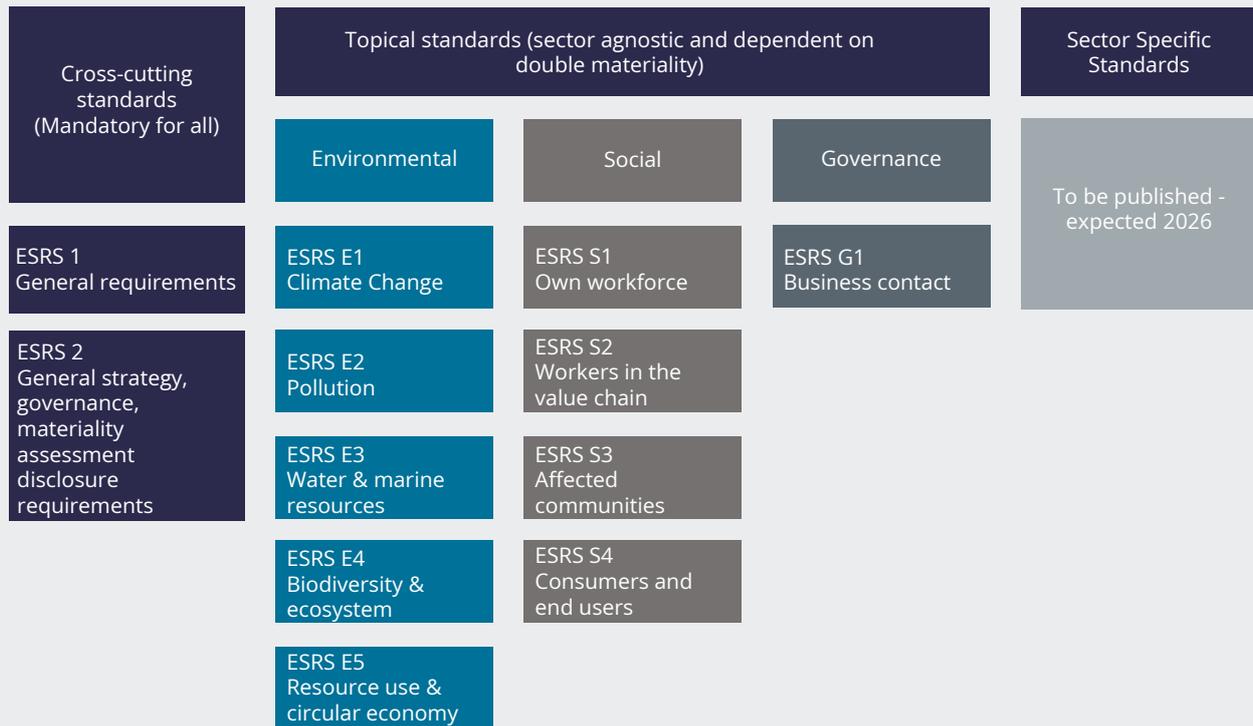
The CSRD does not mandate how a company should conduct its materiality assessment, but we expect some organisations will choose to use existing frameworks such as SASB or the Global Reporting Initiative (GRI).

The DMA itself requires the assessment of impacts, risks and opportunities (IROs) to a company, which in turn will require them to engage their suppliers and stakeholders via surveys, reviews of existing data and analysis of other inputs such as media, peer analysis and third-party research.

This element of CSRD is likely to be challenging and time consuming for many companies, which is why getting started as soon as possible is advised.

ESRS reporting standards

The CSRD utilises the [European Sustainability Reporting Standards](#), a set of mandatory sustainability topics using a standardised format and prescribed content.



All in scope companies must follow guidance provided in ESRS and report on ESRS 2 which contains disclosures on general requirements as well as strategy, governance and the outcomes of the materiality assessment.

The double materiality assessment is used to determine which of the 10 E, S & G topical standards a company must report against. Each topic contains numerous sub-disclosures.

For example, under the Environmental pillar, ESRS E1 (Climate Change) includes disclosures on transition plans, climate change policies, actions and resources, adaptation and mitigation targets, energy consumption, greenhouse gas emissions, GHG removals and mitigation, internal carbon pricing, and the financial impacts of climate impacts, risks and opportunities. This is just one of the topics covered by the ESRSs.

Sector specific standards are also coming and will be applicable to specific business sectors. These are expected to be published in 2026. They will be mandatory for any company within that sector and not subject to a materiality assessment.

Data collection and gap analysis

Collecting data is another essential element of preparing for CSRD reporting.

Once a company has completed its double materiality assessment, they will then need to begin gathering the data to complete the required disclosures under the ESRS.

Each ESRS has a range of associated reporting elements, with their own required disclosures. There may be thousands of data points required.

Alongside this, companies will need to start identifying any gaps in the data and thinking about how they will fill them prior to reporting.

Whilst collecting the data, companies will need to think about the data's validity, relevance, accuracy and reliability.

Furthermore, the data collection process must be fully documented for assurance purposes later in the process.

Tagging and reporting

A company's CSRD report must be included as a dedicated section in their annual management report.

This 'sustainability statement' comprises four parts including a general section, and information on the three ESG areas: Environmental, Social and Governance.

Within the statement, companies will need to report on their sustainability impacts, risks and opportunities, as well as the metrics and targets they are using, and any sector or entity specific information relevant to the ESRS standards.

The statement also needs to be both human and machine-readable; tagged using the XBRL Taxonomy – a digital categorisation system aligned with the ESRS.

Assurance

To comply with the CSRD, companies will need to get their sustainability information assured by an independent external auditor (e.g. PwC, Deloitte etc.).

In the first year of CSRD disclosure, companies will need to provide 'limited' assurance over the reliability and accuracy of their information. Potentially this could shift towards 'reasonable' assurance over time and under certain conditions.

As assurance needs to be done externally and by an accredited provider i.e. a statutory or financial auditor, companies should allow additional time (and budget) to complete the process. The resulting assurance report also needs to be publicly disclosed alongside the company's annual financial report.

Summary

As you can see there is a lot to do to comply with CSRD.

Many large companies will need to report on their 2025 sustainability data, meaning they'll need to complete the DMA process and establish processes to collect data as soon as possible.

For those with processes already in place, they'll need to ensure the information they collect aligns with CSRD before conducting their DMA.

All this means there is a significant resource burden on companies needing to comply with CSRD.

So where should you begin?

Our advice is don't delay! Find out if you or your portfolio companies are in scope, start to look at the requirements and get a plan in place for the next 1-2 years.

If you'd like to find out more about CSRD and how Danesmead ESG can help, please get in touch at enquiries@danesmeadesg.com or visit danesmeadesg.com/csrd.

Integrating ESG risks into the corporate valuation process



Ioannis Michopoulos
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Environmental, social, and governance (ESG) factors have emerged as critical risk drivers influencing companies' financial performance and long-term viability. ESG considerations are no longer just ethical imperatives; they are essential components of comprehensive risk assessment and corporate valuation. Firms with strong ESG practices tend to enjoy a lower cost of capital, reduced financial risks, and enhanced investor confidence.

Ignoring ESG risks during the valuation process can lead to significant financial repercussions, including higher financing costs and potential reputational damage. Therefore, integrating ESG risks into the corporate valuation process is essential for making informed investment decisions, achieving accurate valuations, and ensuring sustainable business practices.

In this article, we present a robust framework for incorporating ESG premia into the valuation of corporate assets and discuss the financial implications of ESG risk for contingent-claims analysis and cost of capital assessment. The following discussion is based on the findings of our recently published paper "Measuring ESG Risk Premia with Contingent Claims" in *The European Journal of Finance*.

How do ESG factors affect the valuation of corporate assets?

ESG risks impact the valuation of corporate assets by influencing both the expected cash flows and the expected return on investment. Companies with poor ESG practices may face higher operating costs, regulatory fines, and reputational damage, which can significantly reduce the present value of future cash flows.

It is widely recognised in both the academic and industry communities that ESG risk is associated with higher levels of idiosyncratic and systemic risk.¹ As a result, investors require higher discount rates to offset the additional risk that they bear.

1 Chava et al., 2014; Barth et al. 2022; Cao et al., 2022.

Is ESG risk an economically significant pricing factor of asset returns?

To address this question, we examined the implied valuations of market participants in the equity and credit derivatives markets for the universe of S&P 500 companies from 2018 to 2023. By analysing publicly available data on stocks, credit default swaps (CDS), and physical default probabilities, we inferred the asset value dynamics, including long-term expected risk and return. Our findings indicate that greater exposure to ESG risk is priced into the market, resulting in a higher cost of capital and increased firm asset volatility.

How can we bifurcate the impact of ESG risk on the valuation of equity and debt securities?

To address this problem, we relied on the Black-Scholes-Merton option pricing model,² which is the most widely used and accepted method for valuing equity securities in multi-share capital structures for financial and tax reporting purposes. Specifically, we developed a novel approach for estimating the ESG premium embedded in equity and debt values by incorporating various firm-specific and industry-specific variables into a tractable econometric model.

This approach allows us to statistically assess the impact of ESG risk on the cost of equity and cost of debt, and it is consistent with the company's assumed capital structure and the economic rights and privileges of its securities upon the consummation of a liquidity event. The proposed bifurcation method relies on the foundations of contingent-claims analysis and is consistent with the observed market data.

What is the magnitude of equity and debt ESG premia for a representative firm?

We calculated the ESG premia using the option pricing method, assessing various levels of indebtedness and ESG risk exposure. As outlined in the accompanying exhibit, we evaluated the equity and debt ESG premia by considering a representative industrial firm with a leverage ratio ranging from 10% to 90%, and an ESG score spanning from the first decile (ESG laggard) to the ninth decile (ESG leader) of the empirical ESG score distribution.

Our analysis suggests that equity ESG risk premia range from 0 to 310 basis points, while debt ESG risk premia vary between 0 and 59 basis points. Specifically, for a medium-leveraged firm positioned in the fifth decile of the ESG score distribution, the equity and debt ESG risk premia are 132 and 20 basis points, respectively. ESG risk premia increase with leverage and when firm's ESG profile declines.



Greater exposure to ESG risk is priced into the market, resulting in a higher cost of capital and increased firm asset volatility.

² Black and Scholes, 1973; Merton, 1974

Figure 1: Equity ESG Premia (in basis points)

Leverage Ratio	10%	161	131	115	102	96	89	70	48	30
	20%	175	142	126	111	104	97	77	52	33
	30%	189	154	136	121	113	105	83	57	36
	40%	204	167	147	130	122	113	90	61	39
	50%	221	180	159	141	132	122	97	66	42
	60%	239	195	173	153	144	133	106	72	46
	70%	260	213	188	167	157	145	116	79	50
	80%	284	232	206	183	172	159	127	86	55
	90%	310	254	225	200	188	174	139	95	60
			1	2	3	4	5	6	7	8
		ESG Score Decile								

Figure 2: Debt ESG Premia (in basis points)

Leverage Ratio	10%	4	3	3	2	2	2	2	1	1
	20%	13	10	9	8	7	7	5	4	2
	30%	21	17	15	13	12	11	9	6	4
	40%	28	23	20	17	16	15	12	8	5
	50%	35	28	25	22	20	19	15	10	6
	60%	41	33	29	26	24	22	17	12	7
	70%	47	38	33	29	28	25	20	14	9
	80%	53	43	38	33	31	29	23	16	10
	90%	59	48	43	38	35	33	26	18	11
			1	2	3	4	5	6	7	8
		ESG Score Decile								

How should the cost of capital build-up be adjusted in the presence of ESG risk?

Our framework provides a transparent mechanism for adjusting the cost of capital for companies with any given capital structure and exposure to ESG risk. To illustrate this, we calculated the blended cost of capital for a hypothetical industrial firm with a leverage ratio of 40%.

For this exercise, we considered a firm positioned in the second decile of the ESG score distribution and calibrated all other inputs to match the market data applicable as of September 2024.

In the left panel, which shows the cost of capital build-up in the absence of ESG risk, we observe that the cost of equity and debt is 13.20% and 4.80%, respectively. The blended cost of capital is 9.84%. In the right panel, which shows the cost of capital build-up in the presence of ESG risk, we observe that the cost of equity and debt is 14.87% and 4.96%, respectively. The blended cost of capital is 10.90%. Overall, we observe that ESG risk has a significant impact on the concluded cost of capital calculation, leading to a combined difference of approximately 106 basis points. This analysis underscores the importance of incorporating ESG considerations into financial models of corporate securities valuation.

Figure 3

No adjustment for ESG risk			Adjusting for ESG risk		
Risk-free rate		4.20%	Risk-free rate		4.20%
Equity risk premium	6.00%		Equity risk premium	6.00%	
Firm equity beta	1.50	9.00%	Firm equity beta	1.50	9.00%
ESG risk premium		0.00%	ESG risk premium		1.67%
Cost of Equity		13.20%	Cost of Equity		14.87%
Risk-free rate		4.20%	Risk-free rate		4.20%
Default risk premium		2.65%	Default risk premium		2.65%
ESG risk premium		0.00%	ESG risk premium		0.23%
Less: Income tax rate	30%	-2.06%	Less: Income tax rate	30%	-2.12%
Cost of Debt		4.80%	Cost of Debt		4.96%
Weightage of Equity	60%	7.92%	Weightage of Equity	60%	8.92%
Weightage of Debt	40%	1.92%	Weightage of Debt	40%	1.98%
Weighted Average Cost of Capital		9.84%	Weighted Average Cost of Capital		10.90%

Alexandros Bougias also contributed to this article.

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Beyond the siloed tech stack

How applied AI will dramatically alter fund administrator selection for fund managers

Things are about to shift in the fund industry as the role of applied AI (i.e., generative AI applied to real world use-cases) has become increasingly pivotal. Traditionally, fund managers have faced significant challenges when selecting a fund administrator, primarily due to the siloed nature of technology stacks within these organisations. This fragmentation often results in inefficiencies and a lack of integration, which can hinder the overall performance and responsiveness of fund administrators. However, the advent of AI and applied AI is set to transform this paradigm, offering a more holistic approach to data management and operational efficiency.



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The traditional challenges

Historically, fund managers have grappled with the limitations imposed by the disparate systems used by fund administrators. These siloed technology platforms often lead to a lack of integration, making it difficult for fund managers to access and analyse data seamlessly. This fragmentation not only slows down processes but also impacts the quality of client service, as fund administrators struggle to deliver timely and accurate information.

Moreover, the manual processes inherent in these traditional systems have been a constant source of frustration for fund managers. The need for manual interventions and the slow responsiveness of fund administrators have long been pain points in the industry. As a result, fund managers have often found themselves outgrowing their fund administrators, necessitating a switch to more capable service providers as their needs evolve.

The AI revolution

Enter AI and applied AI, which are poised to revolutionise the way fund administrators operate. By applying AI holistically across their technology platforms, fund administrators can unify their data, breaking down the silos that have traditionally hindered their performance. This integration allows for more efficient data management, enabling fund managers to access the information they need in real-time, regardless of its format or origin.

AI's ability to parse through structured and unstructured data, such as PDFs, documents, and spreadsheets, means that fund administrators can now offer a level of service that was previously unattainable. This capability not only enhances the client service experience but also allows fund administrators to scale their operations more effectively, taking on more clients without compromising on quality.

Empowering fund managers with future-proof choices

Given these advancements, it is imperative for fund managers to approach vendor due diligence with a new perspective. The focus should now be on identifying fund administrators who have embraced AI as a core component of their operations. An AI-first fund administrator is not just a service provider; they are a strategic partner capable of growing alongside the fund manager, adapting to their evolving needs without the risk of being outgrown.

By selecting a fund administrator who has integrated AI into their processes, fund managers can ensure a more seamless and efficient service. The ability to deliver bespoke reporting, faster turnaround times, and enhanced data analytics are just a few of the benefits that an AI-driven fund administrator can offer. This empowers fund managers to make future-proof choices, ensuring that their service provider can scale with them as their needs grow.

Competitive advantage and operational efficiency

AI enables fund administrators to automate repetitive manual tasks such as data entry, reconciliation, and report generation. This reduces the need for human intervention to more of a review process, allowing firms to process higher volumes of work at lower costs, while still keeping the human in the loop. As a result, fund administrators can handle more clients and products with the same resources, leading to increased capacity, better scalability, and higher profitability.

Moreover, AI-driven analytics provide deeper insights into fund performance and market conditions, enabling fund administrators to offer personalised services that cater to specific GP/LP fund client needs. In addition, fund administrators are constantly looking in the rear-view mirror and often on a quarter or more lag, when forecasting or analysing their internal business or existing client base. The ability to monitor their business in near real time, allows the fund administrator to make decisions faster, monitor service level agreements (SLA's) and do real-time fund client and competitor due diligence at scale. This opens up new revenue streams and enhances client satisfaction and retention.



The ability to deliver bespoke reporting, faster turnaround times, and enhanced data analytics are just a few of the benefits that an AI-driven fund administrator can offer. This empowers fund managers to make future-proof choices, ensuring that their service provider can scale with them as their needs grow.

Conclusion

In conclusion, the integration of AI into fund administration is not just a technological upgrade; it is a fundamental shift in how these services are delivered. By selecting a fund administrator who has embraced AI, fund managers can ensure that they are partnering with an organisation that is equipped to meet their needs both now and in the future. The days of siloed technology stacks and manual processes are numbered, and the future of fund administration is undoubtedly AI-driven. As fund managers embark on their due diligence journey, the choice is clear: select an AI fund administrator and unlock the full potential of your operations, ensuring a partnership that will not be outgrown.

Evaluation Criteria	Traditional Fund Administrator	AI-Enabled Fund Administrator
Expertise and track record	Focus on historical success, client satisfaction, and regulatory knowledge.	Similar focus, but with added emphasis on AI-driven insights and adaptability.
Technology infrastructure	Robust, scalable systems with integration capabilities.	Advanced AI platforms offering real-time data processing and dynamic adaptability.
Service quality and scope	Manual processes with potential delays in responsiveness.	Automated, faster response times with AI-driven client support tools.
Operational efficiency	Manual transaction processing and NAV calculations. Still manipulating excel spreadsheets.	Real-time fund valuation and automated reconciliation processes.
Compliance and risk management	Manual AML/KYC procedures	Automated compliance processes with AI-enhanced onboarding and KYC.
Investor experience	Standard investor reporting and communication tools.	Personalised investor services with AI-powered analytics and reporting.
Scalability and growth support	Limited by manual processes and system integration challenges.	Enhanced scalability with AI-driven automation and data handling capabilities.

Note: This comparison highlights the growing importance of AI in enhancing operational efficiency and client service in fund administration.

2024

The State of Applied AI in Fund Administration: An In-Depth Industry Survey

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Driving operational excellence for fund managers with digital treasury technology

Why operational excellence starts with treasury for fund managers

Whether you're managing listed securities or alternative assets, optimising cash flows and mitigating risks are critical to achieving financial success for asset management firms. The complexities of managing diverse portfolios require highly automated and seamlessly connected treasury operations.

By modernising existing processes with integrated, automated workflows, asset managers are in a stronger position to increase interest revenue, reduce middle-office costs and minimise operational risk, all while ensuring next-level cybersecurity and compliance.

Operational excellence is vital for sustainable success. But why is end-to-end automation so important in the treasury function? And how can you best achieve it?

The benefits of automating treasury functions

Technology significantly enhances efficiency and productivity for all firms, while reducing the risks of human error. When you integrate purpose-built, industry certified workflows with an ecosystem of banking, accounting and investment platforms, you eliminate the need for manual data entry and reconciliation, allowing operational staff to shift their focus towards high-value tasks.

Utilising ISO certified platforms also helps to counteract more nefarious risks such as fraud or hackers, who seek to interfere with day-to-day processes. Automation empowers asset managers to complete the entire treasury management workflow with optimal efficiency to increase returns, lower costs and remove both operational and cybersecurity risks.

The industry agrees. At a recent roundtable in Melbourne, Australia, hosted by FIS, leading buy-side firms listed the positive impacts of adopting modern treasury technology solutions, including:

- Automated bank reconciliations, cash forecasting and investment processes;
- Enhanced payment workflows controls and efficiencies;
- Better collateral forecasting and management;
- Accurate entity mapping and integration with general ledger and accounting systems;
- Better collateral forecasting and management;
- Accurate entity mapping and integration with general ledger and accounting systems;



James Land
Director
FIS Capital Markets



Alex Newman
Director
FIS Capital Markets

- Tighter credit facility monitoring and management of rates-affected instruments;
- Real-time risk management and portfolio simulations.

The future of treasury is digital. But given current market volatility, elevated interest rates, increasing operational costs and ongoing cybersecurity attacks, the time to modernise is right now.

How to modernise your treasury operations

Industry feedback from leading asset managers in APAC identified a six-step route to operational excellence for the treasury.

1. Cash management: Automate cash forecasting and investment.

Automation tools allow users to effortlessly monitor multiple bank accounts, view transactions and sweep cash balances. By integrating invoicing/ERP systems and investment and accounting platforms, automation not only saves time, but also improves visibility – reducing the risk of making poor cash management decisions.

By automating cash positioning and forecasting, you're empowered to make informed, data-driven choices, resulting in improved cash management and increased interest revenue on cash of more than 200 basis points.

2. Payments: Streamline payment processing, remove unsecure emails.

Automated payment workflows and controls transform businesses by replacing labour-intensive manual entry with seamless, electronic processes.

Now you can efficiently establish recurring payments, batch-process invoices for all currencies and use the New Payments Platform to improve visibility and management of incoming and outgoing payments.

Structured payment processes with embedded, auditable approval controls (instead of emails or other manual, unsecure processes) also reduce the risk of payment errors, fraud and cyberattacks.

3. Risk management: Analyse and execute hedging transactions in real time.

With a single integrated treasury management solution, fund managers can easily model investments and debt, integrate with market data and risk management platforms, and consume external investment information.

In turn, that enables you to continuously monitor interest rates, exchange rates, equity markets and credit risks. Plus, you can reduce decision-making time and costs when executing transactions, while ensuring compliance with risk limits and investment strategies.

4. Reporting: Gain accurate and timely financial insights.

In the digital age, accurate and timely reporting is fundamental for managers to serve increasingly sophisticated investors.

A modern treasury management system simplifies the reporting process by consolidating data from multiple sources, removing the need for manual data entry and becoming the single source of truth.

5. Accounting: Increase the speed and accuracy of journal entries.

Complex entity structures with diverse tax treatments often make accounting tasks cumbersome and expensive for fund managers. But a modern treasury management solution will model all entities and generate the journal entries to feed an organisation's accounting system.

So, as well as significantly reducing the time and expense of these tasks, you can improve the accuracy of the accounting entries by avoiding errors and inconsistencies.

6. Managed IT services: Improve stability and security by leveraging existing expertise.

For resilience to cybersecurity attacks, managers need the latest solutions and services to help them improve data security, privacy and system stability.

As technologies continually advance and cyberattacks become more sophisticated, there's a growing reliance on technology providers that continually enhance their infrastructure and controls while complying with global information technology standards.

Global technology providers, such as FIS, are best placed to stay ahead of cybercriminals due to their deep domain expertise and extensive resources available to fund ongoing development.

For more information visit www.fisglobal.com.

RegTech for the investment manager: Patchwork or single provider

The last five years has seen a significant increase in the volume of governance, and compliance. While there is a consensus that RegTech (Regulatory Technology) plays a critical role in helping investment managers navigate today's regulatory environment, firms are often undecided as to whether they should adopt a single Enterprise-level GRC tool or adopt a patchwork of tools who are each strong in their chosen niche. Below are some of the considerations when choosing the appropriate strategy for your firm.



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Partnering with a single Regtech provider

The advantages of using a single provider includes more streamlined support, a consistent user experience, or if there are economies of scale, potential cost savings from buying a bundle of solutions from a single provider. The downside to using a single enterprise platform is that a provider may not excel in all areas of compliance or governance or there may be a lack of depth in specialised areas. There may also be scalability concerns with a single provider, in that the system may not have the flexibility to be modified or customised with ease.

Partnering with multiple RegTech providers

The upside to using two or more providers, is that a firm may choose specialized providers for each regulatory requirement ensuring you get the best solution for each GRC area. This specialisation may be in the technology or subject matter expertise brought by the provider. For example, a single provider may have a deep knowledge of international accountability regimes such as SMCR or IAF/SEAR. Their monoline approach allows them, to align the evolution of their software specifically to that niche. The downside to using multiple providers include potential high-costs and increased training required on the different platforms.

Considerations for your decision

Is the Regtech provider a consulting or technology-led organisation?

The consulting-led provider is primarily focused upon providing advisory services, which is then supported by their technology offering. Consulting-

led providers tend to have a deep industry-specific knowledge and can offer strategic advice tailored to the organisation. Consulting services tend to be more expensive and it may create a dependence or reliance on the consultant rather than developing the organisation in-house skills and knowledge. Consulting-led platform may not scale as easily as technology-driven solutions as the evolution of a software requires teams of engineers and support staff. The technology-led Regtech provider is focused on the software and may more rely on the client to have a certain amount of in-house regulatory expertise.

How simple or complex are your GRC programmes?

If your organisation has complex regulatory needs and a distinction between Governance Risk, and Compliance functions (GRC), then a multiple provider approach may be more appropriate. As an example, an investment manager with distinct operational risk and regulatory compliance functions may opt for two providers, one to track compliance obligations and one to track operational risk taxonomies. Alternatively, organisations with simple GRC programmes may be better suited to a simplified, one-stop solution.

What resources can your firm commit to implementation?

Due to their complexity, some enterprise-level systems can take years to implement. They may involve substantial organisational change and a dedicated team for implementation and ongoing management. Smaller niche providers take less time to implement and may be adopted without requiring client resources. There is essentially less friction for the organisation.

What is the history or future roadmap of the software?

There has been a series of acquisitions or consolidation of GRC providers over recent years. While consolidation can bring benefits such as additional resources and improved integration with other products, it may also result in a shift of focus. The acquiring company may shift the priorities of the software to align with a broader strategy or alternatively the product may be de-prioritised in terms of development roadmap.

Conclusions

Regardless as to whether you opt for a single GRC platform or multiple providers there are some 'must-haves' from any GRC software

Interconnectivity. Regardless of whether you opt for a single enterprise GRC solution or multiple vendors, interconnectivity between components within a software platform is essential. Taking the example of an operational risk solution, the system should be able to connect a risk to specific controls, KRIs or incidents related to that risk. This interconnectivity provides the risk owner with a 360-degree of their risk before making an assessment.

If your organisation has complex regulatory needs and a distinction between Governance Risk, and Compliance functions (GRC), then a multiple provider approach may be more appropriate.

Reporting Options. Regardless as to whether the organisation opts for a single GRC platform or the multiple provider option, the availability of reporting and API / data-exchange options is essential. A single platform will provide the advantage of presenting an overview of all GRC programmes on one dashboard whereas the use of multiple platforms will require the user to access each platforms reporting dashboard individually. More often than not management and Board packs are derived from a number of different sources.

Configurability and Flexibility. It is essential that a GRC software, be it at enterprise-level or stand-alone, must be highly intuitive and allow workflows to be modified or added without friction. Every organisation has unique needs according to their GRC maturity. Any system should allow the client to create a compliance workflow or risk assessment autonomously.

Client Support. Although not a technical differentiator, the level of post-implementation support provided by a GRC provider is key. Dedicated relationship management and ongoing training support are a minimum when choosing any GRC provider be they at enterprise or niche provider level.

Same same, but different: Navigating the US vs the UK regulatory landscapes

RQC Group's Allison Gill (New York), and Matt Raver and Camilla Cater (London) demystify the differences between the SEC and FCA regulatory frameworks and consider some of the compliance challenges.

The US and UK buy side sectors are the two largest in the world, and the differences between the respective regulatory frameworks are often emphasised over the similarities. In our view, this notion should be challenged, starting with an appraisal of high-level regulatory objectives and desired outcomes.

The UK Financial Conduct Authority (FCA) has a strategic objective to make sure relevant markets function well. It also has secondary objectives including protecting the integrity of the financial system. However, from an asset management perspective much emphasis, including many prescriptive rules, emanate from a singular concept - investor protection. The U.S. Securities and Exchange Commission (SEC) is similar – after the stock market crash of 1929, the SEC was established to protect investors, maintain fair, orderly and efficient markets and to facilitate capital formation. So, at a high level, the regulatory philosophies and priorities are aligned.

There's often a perception that these regulators are at odds with each other, and therefore operating in the two jurisdictions, or establishing an integrated compliance program, is fraught with difficulties. Although there are practical examples of divergence, in our view they are more comparative than they are dissimilar. Also, whilst the regulators operate differently, there is a lot of cooperative effort taking place behind the scenes.

From the perspective of UK firms, there's often some trepidation when it comes to becoming SEC registered. However, a firm that is FCA authorised will already be doing many of the things needed to be compliant with SEC regulation. For example, the SEC concept of having a fiduciary responsibility to clients is also a feature of various FCA requirements, including having policies that focus on putting clients' best interests first and implementing an effective conflicts of interest framework. Conversely, a US firm seeking to establish a UK regulated entity will encounter new regulatory frameworks such as the prudential regime and the Senior Managers and Certification Regime. However, boiled down to essentials these themes already exist for SEC regulated firms. For example, the fiduciary responsibility to clients can be compromised if a firm's financial position is weakened or staff don't act competently or with ethical integrity.



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Continuing with holistic themes, the FCA is sometimes called a principles-based regulator as it has 12 principles for business that act as a code of conduct for regulated firms. Whilst this monicker has not typically been used to describe the SEC, the US securities regulator has the antifraud provisions, which support the same aims as the FCA principles insofar as a high-level ethical code is required to be established.

The antifraud provisions speak to investment advisers not doing anything that the SEC could see as being fraudulent, deceptive or manipulative conduct. It's a broad concept that overlays a number of different elements of an investment adviser's compliance and operational infrastructure, such as policies and procedures related to portfolio investing and marketing, as well as how information is disclosed on the Form ADV. It's common for an enforcement action to cite a violation of the antifraud provisions.

The FCA is similar in that much enforcement activity relates to a breach of one or more of the FCA principles. Both regulators make it very clear that these overarching concepts are pervasive and this shouldn't be underestimated.

A firm seeking to establish an integrated compliance programme can leverage these similarities as a starting point. The firm can then use its understanding of its risks, conflicts of interest and compliance risk profile, to ensure policies and procedures address these risks while referencing the specific requirements of each regulator.

Both regulators have been transparent in their expectations that once a compliance programme is put in place, it cannot be left alone. Changes to the programme are a product of both business and regulatory developments. Regarding the latter, the SEC has been in a "rule-making mindset" over the last few years. An example of a rule change that required policy and procedural revisions was the adoption by the SEC of the Marketing Rule which was a significant exercise in modernising and codifying marketing requirements for firms.

Meanwhile, the UK continues to adjust its regulatory framework post-Brexit via initiatives such as the "Edinburgh Reforms". This currently manifests as piecemeal changes to the FCA Handbook, as opposed to a wholesale regulatory change such as MiFID II.

SEC examinations cause much consternation for all, but we see additional apprehension in some UK-based managers. The UK has the largest cohort of SEC registered firms outside of the U.S. The SEC is adept at remote examinations but continues to visit the UK to perform in-person inspections.

Both regulators have been transparent in their expectations that once a compliance programme is put in place, it cannot be left alone. Changes to the programme are a product of both business and regulatory developments.

There are various ways in which a firm can prepare for an SEC examination, including:

1. Engage a provider for a large-scale compliance review or what is often termed a “mock audit”. This allows an independent set of eyes to determine if current policies and controls adequately address risk and conflict areas and match internal day to day procedures. If there are not resources to bring in an outside party for assistance, a similar exercise could be performed internally.
2. Prepare for the different stages of the examination itself. This may be the first examination experience for many members of staff, and it’s important for key individuals to practice, for example, how quickly they can pull together the documentation requested, as well as how to explain their role and responsibilities, including supervisory responsibilities, compliance risk and the firm’s activities.
3. Consider focus areas identified in the SEC’s annual examination priorities, risk alerts and recent enforcement cases. We have seen reoccurring focus areas for examination priorities over the last few years, such as conflicts of interest, disclosures to clients, custody, valuation and calculation and allocation of fees and expenses.
4. Get into the mindset of responding to an examination collegially and do not just leave it to the Chief Compliance Officer. Key players should understand how an examination is conducted and the “perspectives” of the examiners. It should be recognised that an examiner could request to interview any member of staff. It’s extremely important to get buy-in from senior management – noting that an appropriate “tone from the top” is an integral element of a firm’s compliance framework.
5. Many examinations result in a deficiency letter since the SEC reports back on all detected violations, even minor ones, and individuals should be mentally prepared for this. If the deficiencies are minor and can be easily rectified then this may not present a significant business risk. However, multiple breaches, even of a more administrative nature, will likely be seen as an issue. This reinforces the need for an effective compliance programme, ensuring that staff are well trained and there are escalation processes in place for even basic breaches.

The FCA doesn’t follow the same approach to supervision as the SEC. However, as is the case for the SEC, when engaging with the regulator the importance of being upfront and honest at all times and not attempting to conceal, should not be underestimated. SEC enforcement action is perhaps higher profile, however much FCA supervisory action, including action that poses an existential threat to a firm’s ability to conduct investment activities, is not in the public domain. Firms shouldn’t be complacent in respect of either regulator.

SEC enforcement action is perhaps higher profile, however much FCA supervisory action, including action that poses an existential threat to a firm’s ability to conduct investment activities, is not in the public domain.

Firms shouldn’t be complacent in respect of either regulator.

Aside from the SEC examination focus areas noted above, recent SEC enforcement action has focussed on insider trading cases, recordkeeping (electronic communications) and marketing.

In the UK, the FCA is very engaged with investor protection in the guise of “consumer outcomes” as seen in initiatives such as the Consumer Duty. Again, this builds upon existing themes and should not diminish or undermine duties to non-retail clients and investors. Other areas of focus revolve around the dual topics of financial innovation, and resilience, which encapsulates various items such as financial soundness, outsourcing arrangements and cyber security. Financial crime is a habitual hot topic.

To conclude, firms should consider an integrated compliance programme mainly in terms not of challenges, but of opportunities. Whilst there is potentially enhanced regulatory risk due to being regulated in multiple jurisdictions, various tools and techniques can be deployed to ensure that the integrated programme runs smoothly. Whilst the SEC and FCA regulatory frameworks differ, there are common high-level philosophies that underpin them.



Rules are not necessarily sacred, principles are.

Franklin D. Roosevelt



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The evolving scope and application of 'Disqualified Lender' lists

Most syndicated loan documents allow the borrower to designate certain entities as 'Disqualified Lenders' that are prohibited from acquiring the debt in the secondary market. Historically these provisions received little attention from syndicated lenders, as they were designed and utilized primarily to prevent competitors of the borrower, or other entities with competing business interests (such as owners of competitors), from acquiring the debt and then using that position to obtain access to the borrower's confidential and proprietary information—or worse, exploiting the ownership of debt to behave in a manner harmful to the borrower. To prevent this, the borrower would, at or before the time of the closing of the loan, generate a list of Disqualified Lenders (a DQ list) that would be shared with the agent and that would be fixed for the duration of the loan. Typically, the loan documents provide that any assignment or transfer of a loan to an entity identified as a Disqualified Lender is void *ab initio*, as a means to ensure that lenders do not slip through the cracks of the DQ list.

Over time, borrowers in the syndicated loan markets have expanded the scope of DQ lists to include entities other than competitors (and their owners). Now, such lists also regularly include distressed investors who are perceived to be overly aggressive in their dealings with borrowers and their sponsors. This expansion takes the form of including in the definition of 'Disqualified Lender' catch-all language that attempts to classify *"any person whose primary activity is the trading or acquisition of distressed debt"* as a Disqualified Lender. Or it may include a DQ list with hundreds of names included.

In addition to expanding the scope of entities included in DQ lists, borrowers and their sponsors now regularly negotiate for the right to amend and supplement the list of Disqualified Lenders *after* the closing date. While these post-closing updates to the DQ lists may not apply retroactively to disqualify existing holdings of lenders in the syndicate, they may apply to future acquisitions by such lenders. The added flexibility of being able to update the DQ list offers borrowers and their sponsors additional control and influence over the roster of potential investors in the borrower's debt.

It is understandable why borrowers and their sponsors would want to exclude, as holders of debt, entities with interests perceived to be contrary to theirs. That said, the trend to expand the scope and application of DQ lists has various consequences for the syndicated loan market and its participants. One example is the impact on liquidity of such loans in the secondary market by eliminating a large swath of potential purchasers. It is not clear that lenders who purchase the debt when issued are pricing in the risk of reduced liquidity and the corresponding effect on their ability to unload the debt if it later becomes distressed.



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Another potential consequence of widespread adoption of expansive DQ lists and provisions is to discourage a distressed investor from engaging in overly aggressive behaviour in an isolated situation, knowing that such conduct might lead to blacklisting of that investor in future issuances of debt. Obviously, the overall size and importance in the market of the sponsor or debt investors will impact whether the threat of blacklisting is meaningful, but it nonetheless provides a mechanism to deter what may be perceived in the market to be uncommercial behaviour by investors.

The evolving use of DQ lists has also resulted in controversy as borrowers and sponsors utilise DQ lists and provisions in ways that debt investors' view is unfair and impermissible.

The evolving use of DQ lists has also resulted in controversy as borrowers and sponsors utilise DQ lists and provisions in ways that debt investors' view is unfair and impermissible. Litigation has already occurred in multiple cases such as *Byju's* and *Serta*. *Byju's*¹, a matter pending in New York state court, involved the company asserting that Redwood Investments LLC was a Disqualified Lender due to its "*primary activity [being] the trading or acquisition of distressed debt.*" In *Serta*, which involved a dispute between the company and an affiliate of Apollo, the parties ultimately entered into a settlement pursuant to which 50% of the US\$186 million of loans allegedly assigned to a Disqualified Lender were cleared (i.e. such assignment was permitted), while the attempted assignment of the other 50% were "*deemed null and void.*"² These early cases, which arose from disputes over the scope of assignment limitations in the relevant credit agreements, shine a light on the controversies that can arise in this evolving area of syndicated loans, and highlight the importance of well drafted loan documents that clearly outline what is and is not permitted.

The expansion of DQ lists raise other questions, such as whether administrative agents - who are often responsible for maintaining a borrower's DQ list, and confirming with potential investors that they are not included on such lists - should have any liability in connection with such DQ lists if they, for whatever reason, assure a potential investor that they are not included on the list, if such assurance is later proven to be untrue. Typically, administrative agents have the benefit of provisions in the credit agreement that hold harmless or indemnify them from liability for their missteps, absent especially egregious circumstances. The absence of liability on the part of the administrative agent, coupled with provisions in the loan documents that strip Disqualified Lenders who have nonetheless become a holder of a loan with certain rights and remedies (such as reduced information rights, exclusion from indemnification rights provided to other holders, and the exclusion of such a holders loans in calculation 'Required Lenders'), can have the result of leaving good faith purchasers holding loans they would not have otherwise purchased and no remedy for their unfortunate investment.

1 See *Byju's PTE. LTD. et al v. Glas Trust Company LLC et al.*, No. 652717/2023 (Sup. Ct. N.Y. Cnty. Jun. 5, 2023).

2 See *Serta Simmons Bedding, LLC, et al., v. AG Centre Strreet Partnership L.P., et al.*, Adv. No. 23-09001-ADV (Bankr. S.D. Tex. Feb. 14, 2023).

Market participants may consider adopting provisions to mitigate the harsh outcome that might result if an entity who is unknowingly on a borrower's DQ list purchases the borrower's loan. As an alternative to deeming such transfers and assignments void *ab initio*, drafters may consider providing the borrower other less exacting remedies, such as redeeming the loan at the price paid by the purchaser (plus accrued interest) or providing the borrower the right to force such purchaser to sell the loan in the market to an eligible assignee. Such provisions could soften the blow for the unknowing purchaser while preserving, for the borrower and its sponsors, the benefit of its DQ list.

Other questions, such as whether aggressive uses of DQ lists can lead to claims related to the duty of good faith and fair dealing, or whether antitrust laws can limit the enforceability of certain assignment restrictions, are bound to arise if the trend of borrowers and their sponsors using DQ lists more strategically and aggressively continues on its current trajectory. Potential investors - especially those investors who could arguably be captured by the definition of Disqualified Lender without being specifically included on the list of such parties (i.e., captured by catch-all language in such definitions that attempts to include "*all persons whose primary activity is the trading or acquisition of distressed debt*") - should be cognisant of such risks prior to investing in a loan that includes such a broad definition. Borrowers and sponsors, on the other hand, should be cautious about utilising DQ lists too aggressively in order to minimise the risk of potential litigation that can be both costly and distracting.

Credit funds: Considerations of a credit fund as a borrower under subscription-secured facilities and NAV lines

Relevant nuances of a credit fund's structure

When structuring any fund, the same questions need to be asked. For instance: What is the strategy? Who are the likely investors? Does the fund sponsor and/or the key investors have a preferred fund domicile? In what jurisdictions are the investors, assets and manager/adviser likely to be? What is the liquidity of the underlying portfolio (and to what extent should the liquidity terms offered to investors reflect it)? Is carried interest structuring required?

For private credit funds, extra time and attention needs to be given to the questions relating to the liquidity of the underlying loans and the liquidity provided to investors (open-ended, closed-ended or somewhere in-between); upstream structuring (such as blocker vehicles above the fund); and downstream structuring (such as securitisation vehicles and/or SPVs beneath the fund vehicle).

1. *Open-ended, closed-ended or 'hybrid'?*

Open-ended funds allow new investors to come into the fund on a regular basis and investors can redeem/withdraw on request (subject to the fund's terms). The classic hedge fund structure is open-ended. Closed-ended funds permit new investors to come into the fund at the beginning of the fund's life (via one or more closings) and investors generally have no redemption rights. These funds generally have a fixed life. The classic private equity fund structure is closed-ended.

Private credit funds are much more likely to be hybrids. They either start with the open-ended fund structure and add closed-ended fund features or liquidity management tools (e.g., side pockets and gates) or they start with the closed-ended fund structure and add open-ended features or liquidity options (e.g., tranches). Hybrid private credit funds that permit new investors to come into the fund on a regular basis are sometimes referred to as "evergreen" funds.

In our experience, investors are quite markedly split between those who prefer private credit funds to be closed-ended and those who prefer hybrid private credit funds.



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2. Upstream and downstream structuring

Both upstream and downstream structures are largely driven by tax issues. For example, upstream structuring can be used to mitigate the exposure of non-US investors to Effectively Connected Income (ECI) relating to US originated loans.

Downstream structuring can get complicated. One goal will be to reduce the rates of withholding tax on interest payments (e.g., by accessing treaty benefits) but downstream structuring can also be used to (i) shift tax filing responsibilities away from the fund vehicle and its investors, (ii) facilitate leverage and its related security, (iii) ring-fence liabilities, (iv) facilitate re-investment, and (v) reinforce and support the liquidity offered to investors.

A key consideration for structuring a credit fund relates to the fact that lending (and often acquiring existing loans) could be regulated in the borrower's jurisdiction, requiring strategic consideration to determine which entity in the structure is permitted to be the lending entity.

Credit funds as borrowers under subscription-secured facilities

As with any subscription-secured facility (a **Subline**), a lender's recourse will be against investor uncalled commitments, rather than the fund's assets. The lender will be looking up the fund structure rather than down for its collateral, the asset class of the fund is not relevant to the collateral package. However, the structure of the fund is dependent upon the asset class and the fund's structure with respect to the type of fund vehicle used, its jurisdiction, and whether it is open or closed-ended is relevant to the structuring of a Subline.

A Subline is structured around the mechanics of a fund structure so as not to disrupt the operation of the fund. Lender's counsel will identify at due diligence stage whether the fund is closed-ended, open-ended or a hybrid. The limit on the amount that can be borrowed under a Subline is calculated by applying advance rates against different designations of investors dependent upon the creditworthiness of such investors. This 'borrowing base' will fluctuate to account for new investor closes, as well as any events that could negatively impact an investor's creditworthiness or lead to the investor exiting the fund. If an event were to occur that negatively (and materially) impacts the investor's creditworthiness, the investor defaults in its payment obligations to the fund, or the investor transfers, redeems or otherwise disposes of part or all of its ownership interest, the uncalled commitment of the investor relating to the interest affected will be excluded from the borrowing base calculation (**Exclusion Events**).

An investor's request to be redeemed in an open-ended or hybrid fund structure would be classified as an Exclusion Event. Due diligence will also reveal if there is a 'queue' system in place in relation to calling on investor commitments, i.e., the fund can start calling on investors that came in through a later close only once investors in prior closes have fully funded. If calling on newer investors is contingent on first close investors having fully funded, there can be an impediment to including the uncalled commitments of newer investors in the borrowing base unless specific wording disapplying this queue system in relation to calls made by creditors is included in the fund's constitutional documents.

A Subline is structured around the mechanics of a fund structure so as not to disrupt the operation of the fund. Lender's counsel will identify at due diligence stage whether the fund is closed-ended, open-ended or a hybrid.

Redemptions impact the borrowing base, so representations should be provided by an open-ended or hybrid credit fund borrower under a Subline regarding redemption requests received to date, as well as undertakings to provide copies of redemption requests to the lender. If satisfying a redemption request would cause a borrowing base breach, a mandatory prepayment will be triggered. Where a fund borrower is structured to allow redemptions, an event of default will often be triggered in the Subline if a number of investors representing over a certain percentage of aggregate commitments request redemptions within a certain timeframe.

The above-mentioned protections are relevant to any borrower structured as an open-ended, or semi open-ended, fund which allows redemptions (which may include credit funds), rather than specific to credit funds as an asset class.

Credit funds as borrowers under net asset value (NAV) facilities

In contrast to subscription-secured facilities collateralised by uncalled commitments, in NAV lending, a lender instead looks to the assets of the fund and the cash flows, distributions and other amounts received in connection with the fund's assets as the main collateral for the loan.

NAV financing to credit funds (also called back-leverage or loan-on-loan financing) is typically utilised alongside other tools and products available to such funds as a long-term leverage approach to optimise its liquidity position and allow the fund to originate a higher number of generative assets.

Security structures are bespoke but typically consist of one, or a combination, of (a) security over shares or other ownership interests of a holding company between the fund and the underlying assets that will often be the borrower of the NAV facility, and (b) security over the accounts into which distributions from portfolio companies are paid, thereby capturing the value to the fund of both the portfolio as a whole, and the cashflows up from the portfolio.

NAV lenders must diligence the portfolio assets and fund documentation and carefully review the distribution flows (with a goal of taking account security as close as possible to the source of the distributions). Recourse on NAV facilities to credit funds is to the portfolio of loans owned by such funds. The value of portfolio assets that the lender deems valuable and stable enough to underwrite operates as a borrowing base to determine the size of the NAV loan available. Whether a lender includes such loans in its borrowing base will depend on whether such loans meet certain eligibility criteria, including: whether the loan is performing, the loan currency, how often interest is payable, that it's a term loan rather than a revolver, that it does not contain any restrictive confidentiality wording etc. Where the portfolio is highly diversified, concentration limits may also apply in order to prevent the lender from being overly exposed to a particular type of asset.

Lenders will usually require liquidity tests, portfolio interest coverage ratios and other financial tests depending on the portfolio/strategy of the fund. Diversity measures may govern the advance rate and a number of collateral quality metrics (e.g., the minimum weighted average spread of the portfolio). In some facilities, cash sweeps and loan-to-value tests are included with the intent of bringing stakeholders to the table when early warning signs appear, to avoid default. These early pre-default triggers could result in amortisation payments or initiation of a plan to cure specific breaches.

As with any NAV facility, a NAV financing provided to a credit fund is a bespoke product with no 'market standard'. Points to consider when providing a NAV facility to a credit fund include (i) which entity is the originator of the underlying loans? Is this the same entity as the borrower, and if so, does that entity hold the loan for the entirety of its term or sell down to another entity? and (ii) is there a separate 'servicer' entity that would be responsible for enforcing the provisions of the underlying loans? These are important points for a lender to consider at due diligence stage when determining which fund entities need to be party to the NAV financing.

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The private credit era

Current landscape and growth projections

Private credit (PC) is experiencing a pivotal moment, marking its strongest position since the global financial crisis (GFC), now accounting for ½ of global financial assets amid the highest interest rates seen in four decades, bank retrenchment, and greater demand for capital than supply. This environment heightened demand for capital, propelling PC to a forecasted US\$2.8tn market by 2028, a leap from the current US\$1.5Ttn. Now the second largest private market strategy PC overtook venture capital and is second only to private equity (PE). There is a growing paradigm shift away from PE to PC. Investor interest remains robust, 92% plan to increase allocations, supported by a notable 2023 internal rate of return (IRR) of 9.2%, not far behind PE 10.5% IRR. Performance was exceptionally strong for floating-rate products.



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Investor sentiment and strategy preferences

Direct lenders contribute more than capital, acting as strategic partners leveraging their operational/re-structuring expertise. Direct lending stands out as the preferred strategy, capturing 70% LP interest and surpassing US\$590bn, a steep rise from US\$70.8bn a decade ago. Although the direct lending growth rate has begun to taper going from half of fundraising in 2021 to just 31.8% 2023, it still constituted 88% of the US\$50.4bn raised Q2-2023. Mezzanine and infrastructure gained traction and special credit situations saw elevated fundraising. Pure distress strategies are tailing off as workouts pre-empt opportunities. In emerging strategies, 58% of LPs prefer asset-backed lending; 37% secondaries.

PC earned a place in institutional portfolios with almost one-third invested, two-thirds having 5%+ allocations targeting 8-14%. Global flows exceeded US\$200bn for the fourth consecutive year. Better downside protection, higher returns and lower credit losses than fixed income is driving pensions and insurers into the asset class. Performance met or exceeded expectations of 89% of investors. Performance is expected to remain strong over the next year by 63% while 30% expect even better performance.

Canada's largest pensions, managing US\$1.3tn, have a strong foothold in PC globally with plans to increase exposures. Notable allocations range from a 25% year-over-year increase to plans to double allocations over five years, with some ramping up internal asset-based lending teams. However, Canadian institutions remain relatively under-invested creating opportunities for PC expansion.

Untapped opportunities in the retail segment will accelerate growth. Retail investors must have access to PC, especially in Canada where a significant proportion of the population lacks pension coverage. In the new normal, balanced portfolios warrant allocations of 5-20%. PC is often associated with higher inherent risk even though it spans the capital structure and has varying risk profiles. To de-bunk this myth and expand democratisation through broader distribution, dealers must embrace robust risk assessment for a clear picture of investment processes, liquidity terms, and effects of stressed conditions.

Market dynamics

Post-GFC there was an evolutionary shift to private lenders who stepped in to fill the widening void left by banks. In Canada, banks still dominate the lending landscape with ~80% market share. Less than 3% of loans are made by alternative lenders and US managers only invest 2-3% of their deals in Canada. Change may be on the horizon, Q4-2023 only 60% of US\$1.43tn issued came from banks.

Canadian banks extended amortisation/covenants for businesses tackling a challenging inflationary environment but are now adopting a more cautious approach by increasing loan loss provisions and maintaining large capital buffers, resulting in loan growth rate slowdown of 4%. Q1-2024 loan losses were 20% higher than pre-pandemic, but credit loss provisions are expected to peak this year. This conservatism is a hallmark of stability of the Canadian economy, but contagion of investor fear related to global bank sector stress and wholesale market disruptions could have an impact.

Credit and insolvency trends

Banks are retrenching in the face of greater regulatory scrutiny, cost structures, and liquidity constraints. Business lending indicators show significant tightening close to peak pandemic levels. Financial authorities are universally enhancing supervision of risk exposures and increasing capital requirements when capital is already at a premium. US Banks need to free up regulatory capital to comply with tougher rules in the wake of regional bank crises and Basel III, while Canadian banks ready themselves for the first major reforms in recent times raising stability buffers.

Bank contraction due to financial conditions reminiscent of recessions and reluctance to lend to non-PE sponsored complex businesses is resulting in a corollary increase in non-bank credit. While banks face regulatory and operational constraints, PC is a testament to the innovative spirit of alternative lending supporting businesses to survive and thrive. PC fosters a dynamic financing ecosystem by diversifying borrower options and reducing systemic risk of over-reliance on banks, thereby offering resiliency through banking crises/regulatory shifts.

Capital supply growth is contracting as macro weakness put pressure on the credit environment and floating-rate loans added ~500 bps of interest expense (20% earnings before interest, taxes, depreciation, and amortisation (EBITDA) degradation). Inflation and more expensive debt

Q1-2024 loan losses were 20% higher than pre-pandemic, but credit loss provisions are expected to peak this year. This conservatism is a hallmark of stability of the Canadian economy, but contagion of investor fear related to global bank sector stress and wholesale market disruptions could have an impact.

coupled with enduring pandemic issues squeezed margins. Corporate distress is on the rise as companies became highly levered post-2009. Stress impacts of higher rates, slower economic activity, and catch-up effect of phasing out government intervention elevated insolvency rates. US Chapter.11 filings are 39% higher than 2023 and 46% higher than the past decade. Canadian insolvencies surged at record rates not seen in over two decades, increasing sharply since mid-2023 to double the pre-pandemic average. Insolvencies were expected to rebound to pre-pandemic levels but surpassed those levels by a large margin. Insolvencies are heavily concentrated among small businesses, and while broad-based across industries, sectors more vulnerable to economic disruptions (retail, hospitality, energy) were harder hit.

Economic uncertainty persists but the higher-for-longer thesis is fading along with default risk. The question is whether rate reductions can stabilise and eventually improve deteriorating credit conditions – keeping defaults low.

Correlation anomalies

Default rates, a leading indicator of recessions, tend to mirror insolvency trends. Based on characteristics informing credit cycles the market is in the 'average' stage whereas insolvency data and interest rates point to a 'stressed' phase. Surprisingly, default rates are unusually low, below the 10-year average, despite skyrocketing debt-servicing costs and insolvencies figures, due to forbearance and exacerbated by a rise in debt restructurings preventing default and extending maturities. This anomaly stems from delayed impact of broader economic conditions as effects of rising rates/downturns lag initial triggers. Full impacts could manifest in coming quarters.

Economic uncertainty persists but the higher-for-longer thesis is fading along with default risk. The question is whether rate reductions can stabilise and eventually improve deteriorating credit conditions – keeping defaults low. The massive, delayed default cycle predicted post-pandemic has not materialised, large scale defaults were staved off as the peak of stress has been hit. PC proved its resilience, strong underwriting capabilities, and benefits of cooperation with borrowers which is evidenced by low defaults and good performance.

High credit spreads and distress debt ratios are approaching pre-2008 levels. Indicators of financial stress were below historical averages through the pandemic but have been normalising. There is a mismatch in supply and demand and capital raised for direct lending. Earlier this year when corporate defaults were rising there was still very little pricing at distressed levels. Distress scenarios today look very different than pre-2020, even when S&P distress definitions are met businesses can be operationally sound and have sufficient liquidity, but refinancing could be challenging. Secondary markets which typically inform distress debt ratios can no longer be relied upon. Traditional metrics no longer make sense in today's fast-evolving landscape.

Unprecedented levels of liquidity support and central bank intervention created cheap liquidity for fundamentally sound businesses causing overleveraged balance sheets, delaying impacts of underlying financial pressures. Correlation between defaults and the distress debt ratio broke down because of the infusion of trillions of dollars of surplus capital since the pandemic. This marked disconnect is forcing nuanced examination of key fundamental metrics (maturities, leverage, cashflow) for a true

picture of a borrowers' ability to navigate credit markets and survive margin pressures. Restructurings, amends, and extends can be a red flag.

Financial system resilience

Despite inflationary pressures, record high rates, and geopolitical concerns, US GDP grew at a steady pace of 1.4% and Canada's financial system proved its resilience. Middle market companies are experiencing positive year-over-year growth in sales and profits. While inflation impacted bottom-line profitability, small and medium enterprises (SMEs), especially in essential/resilient sectors, maintained stable cash flows and met debt obligations. Businesses remained financially healthy due to diversified and long-term financing, reduction of credit demands, and higher levels of illiquid assets built up during the pandemic. Debt-to-asset ratios rose due to lower asset valuations but remain below pre-pandemic levels. While liquidity positions deteriorated, levels are still strong by historical standards. Interest costs as a share of earnings remain below pre-pandemic levels but will keep rising if existing debt is refinanced at higher interest rates. Liquidity management came into sharp focus as businesses adapted to challenges.

Anticipation of declining policy rates is driving renewed appetite for risk, raising asset prices and driving down risk premium and credit spreads. The end of tightening is coming but will be unlikely this year as recent data signals economic slowdown and risk of liquidity pressures in the financial system. Uncertainty remains given that inflationary pressures and geopolitical concerns could persist. Recent forecasts of US recession increased by 10%, but with declining inflation risks of a major recession lessened. Debt serviceability and asset valuations are key risks to financial stability. Valuations of some financial assets are stretched, increasing risks of a sharp correction generating system-wide stress. Recent rises in leverage in the non-bank financial intermediation sector could amplify the effects of such a correction. The interconnectedness of the financial system could result in stress in one sector having a contagion effect.

Outlook

The outlook for PC is promising. Persistent inflationary pressures driving a high-rate environment, tightening bank conditions, liquidity constraints in the syndicated market, and evolving lending trends have had a favourable impact. Higher rates raised borrowing costs, removing excess liquidity across the economy. These dynamics allowed lenders to command enhanced deal terms, including lower leverage ratios, and better debt-coverage metrics. Direct senior credit maintained solid covenants with at least two financial. While rate cuts will affect floating-rate loan yields, PC will gain ground and perform as banks retreat.

Market uncertainty and tighter capital conditions drove M&A slowdown (-35%) to pre-pandemic levels impacting exits/turnarounds and causing pent-up demand for deals. A rebound is imminent as economic uncertainty lessens and rate cuts materialise. PC sponsors are ramping up asset-backed financing, a US\$5-20tn market historically dominated by banks. Hybrid/ junior capital will be in play as fundamentally sound businesses facing higher debt-service levels maximised senior debt. Opportunities abound to finance high quality growth companies as PE investors cycle away from growth to stable/profitable companies. In the lucrative world of private markets, direct lending has potential for dramatic expansion into the PE footprint as bank lending declines and regulatory constraints rise.

The next growth phase will capitalise on macro themes of de-globalisation, data/security, distress, digitisation, and de-carbonisation and specialised industry-specific, thematic, or situational credit solution funds. The burgeoning PC sector will need to get in front of heightened policymaker/financial stability body scrutiny.

Navigating preferred equity in private funds: What to expect and key considerations

1. What is preferred equity in private funds?

Preferred equity sits between traditional debt and common equity in a private fund's capital stack, which is a hierarchical depiction of the priority of distribution on the fund's assets and investment proceeds. Preferred equity is so named because it provides an investor with priority to a certain amount of the distribution payments (often calculated by reference to an enhanced rate of return) over common equity. This typically makes it a more secure investment than common equity but with no security and/or guarantee protection (as in debt) and often no sharing of increased investment value as in common equity. Private funds may issue preferred equity to raise additional capital (for example, if third party debt is unavailable and/or investors require incentivising), diversify their funding sources, or provide liquidity to existing investors.

Subject to tax and regulatory considerations,¹ preferred equity may be issued by an existing fund or, alternatively, by an aggregator fund or special purpose vehicle newly formed by the existing fund and (sometimes) its related funds managed by the same sponsor² (the **New Vehicle**). The existing and related funds may contribute all or part of their portfolio investments to the New Vehicle, as a consideration for common equity, and the New Vehicle will issue preferred equity to new investors. This New Vehicle structure is used by sponsors because it is structurally cleaner, requires minimal changes to the fund documents of the existing fund and related funds, and does not affect the existing debt at the existing fund and related funds.³



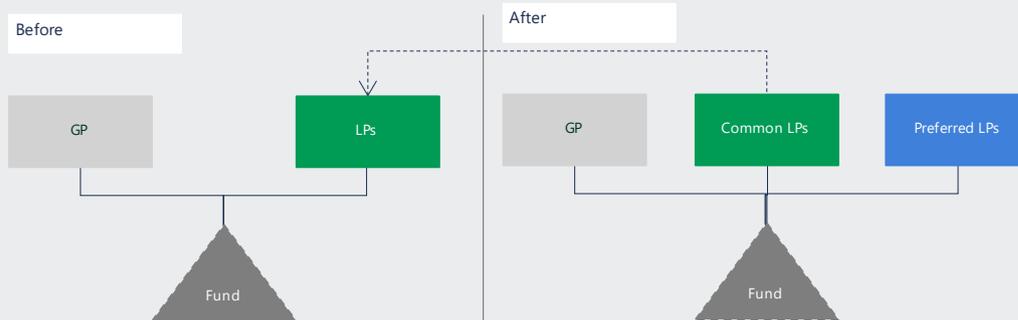
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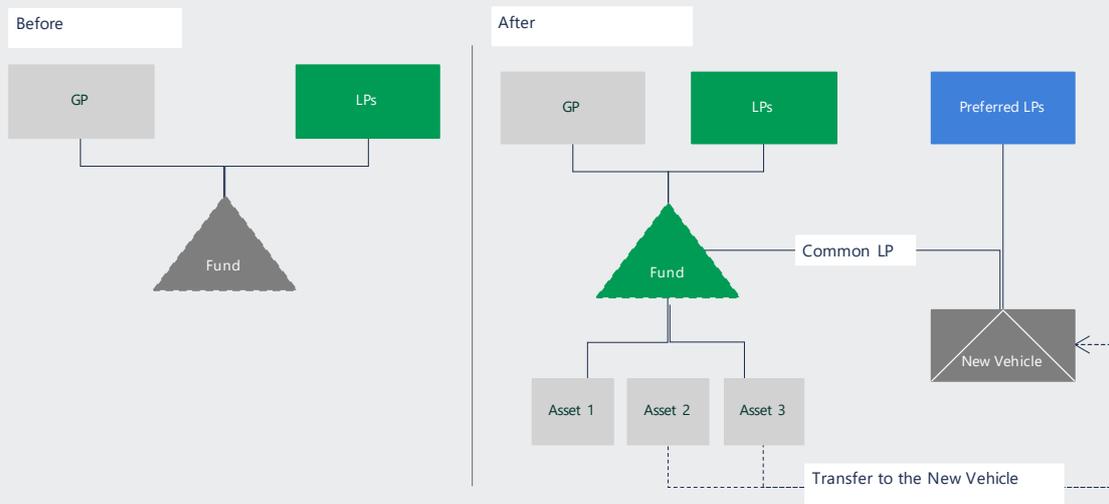
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- 1 For example, from a regulatory perspective, the sponsor should assess whether the EU securitisation regulations would be applicable due to the creation of different tranches.
- 2 The existing fund is the fund that intends to issue preferred equity, while the related funds are other funds managed by the same sponsor that may have similar or complementary investment strategies or portfolios. These related funds may contribute their assets to the New Vehicle to create a larger and more diversified pool of assets that can attract preferred equity investors.
- 3 Sponsors should carefully review the existing finance documents to determine whether lender's consent is needed. This is because lenders may sometimes restrict any third party (e.g., preferred investor) from enjoying a more senior ranking over the assets held by the existing fund. Tax and regulatory implications should also be carefully considered to ensure the transfer of relevant assets to a New Vehicle does not trigger adverse consequences.

Option 1: Issuance of preferred equity in the existing fund



Option 2: Issuance of preferred equity via a new vehicle



2. Where is a preferred equity structure relevant?

Preferred equity can be used in various scenarios. For example:

(a) Use of preferred equity to support secondaries

A traditional sale isn't always the best solution for managers if the assets could have long-term value should the fund hold them for a few more years. As an alternative to continuation funds, preferred equity may be quicker to implement and avoid the transaction costs and complexities of a secondary sale, especially if the sponsor and the investors prefer to maintain the existing fund structure.

(b) Use of preferred equity to finance follow-on investments or existing investments

Preferred equity can also be used to finance follow-on investments and existing investments as an alternative to NAV facilities⁴ or where existing and/or new investors require enhanced (and potentially more secure) returns to incentivise the commitment of new capital. Proceeds from preferred equity issuance could, for example, be used to repay existing fund or portfolio company debt (where debt refinancing is not available or does not make commercial sense), or to support a portfolio company's financial needs such as remedying potential debt covenant breaches (resulting from reduced asset values) or meeting increased development or other contractual liabilities. The proceeds of such follow-on investments and existing investments would usually be aggregated and shared by both common equity holders and preferred equity holders.

4 Compared with a NAV facility, the preferred equity structure may provide capital to release liquidity in the portfolio or provide additional investment capacity on less onerous terms and without leveraging and encumbering the portfolio.

3. Managing the relationship with existing investors in the fund

Regardless of whether the fund intends to set up a New Vehicle, one key question it needs to solve is how to manage the relationship with existing investors who will be subordinated as common equity holders should the fund issue preferred equity. This requires proactive and clear communication, alignment of interests, and respect for existing investors' rights and preferences.

(a) The sponsor should explain the rationale, terms, and expected benefits of the preferred equity issuance, such as enhancing the fund's liquidity, protecting the value of the existing investors' investment, diversifying the capital structure, or pursuing attractive follow-on opportunities. Most of the time, the existing investors will be offered the opportunity to subscribe to the preferred equity, even if the fund documentation does not expressly grant them that right.

(b) The sponsor should also address any potential concerns or questions from the common equity holders, such as the impact on their valuation, dividends, voting power, or exit options. The sponsor may seek to align the interests of the preferred and common equity holders by offering them similar or proportional economic and governance rights, or by providing them with incentives or protections, such as fee reduction, participation, conversion, anti-dilution, or liquidation preferences. The fund should also respect the existing rights and preferences of the common equity holders, such as consent, information, or pre-emptive rights, and comply with any contractual or fiduciary obligations.

4. Key terms expected by preferred equity investors

From the perspective of preferred equity investors, to protect their priority payment rights and expected return, they would usually require the following key terms:

(a) Distribution Waterfall: This is a critical term that outlines the order in which distributions are made to the investors and the manager. For preferred equity investors, there is often a preferred hurdle rate (which could be a fixed rate or a floating rate, usually compounded annually) or aggregate return that must be met before any profits are distributed to other subordinated classes of investors or the manager.

(b) Leverage Restrictions: Preferred equity investors would expect limits on the amount of leverage the fund can use to prevent excessive risk-taking and to prevent the fund from incurring additional indebtedness that ranks in priority to or *pari passu* with the preferred equities.

(c) Redemption: The fund document may allow the sponsor to redeem the preferred equity once the fund has sourced cheaper financing or has liquidity from an asset disposal. Accordingly, preferred equity investors usually require a minimum expected return, often facilitated by a lock-up period during which the sponsor cannot carry out any redemption without paying a redemption premium.⁵

5 A redemption premium is an extra amount payable by the sponsor to the preferred equity investors if the sponsor redeems their equities before a certain period. This premium compensates the preferred equity investors for the foregone expected return and for costs associated with negotiating and implementing the preferred equity investment.

(d) Anti-Dilution/Subordination Rights: These rights protect preferred equity investors from dilution in the event that additional interests are issued in the future at a lower valuation. Anti-dilution measures include:

- Full ratchet anti-dilution: if new common or preferred equities are issued at a price lower than the price paid by the existing preferred equity holders, the conversion price of the existing preferred equities is adjusted to the new lower price. This means that the existing preferred equity investors can convert their equities into a greater number of the new equities, maintaining their ownership percentage; and/or
- Pre-emptive rights: existing preferred equity investors have the right to purchase additional interests in future funding rounds/follow-on investment opportunities before they are offered to new investors.
- Anti-subordination rights: preferred equity investors may request a prior approval right if the fund is to issue other preferred equities that rank in priority to or *pari passu* with the existing preferred equities.

(e) Tag-Along and Drag-Along Rights: Tag-along rights allow preferred equity investors to participate in the sale or conversion⁶ of the preferred equities if the manager or other preferred equity investors are selling or converting their stake. Drag-along rights enable a majority of the preferred equity investors to force minority stakeholders to join in the sale or conversion of the preferred equities.

(f) Voting Rights: Preferred equity investors may have enhanced voting rights on certain key decisions affecting their class, such as, changes to the investment strategy or amendments to the fund documents affecting the priority of the preferred equities.

5. Conclusion

For both managers and investors, preferred equity funding presents a useful and potentially attractive alternative in high interest, distressed, or other scenarios where debt or common equity funding is commercially unattractive or unavailable. The commercial terms and structures are often uniquely designed to balance risk and reward between preferred equity investors, common equity investors, and the sponsor. Consequently, the terms applicable to common and preferred equities are subject to careful construction and thorough negotiation to ensure that the interests of all parties are adequately protected and aligned.

6 Conversion is the process of changing the preferred equities into common equities or other classes of equities of the fund, which right may be optional or linked to specific events such as an asset exit.

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Lender on lender violence: The meaning of Uptier Priming Debt

Position enhancing transactions (PETs) are now commonplace as restructuring tools in the US leveraged loan market. In recognition, European CLO offering circulars now permit CLO managers to invest in Uptier Priming Debt.

Uptier Priming Debt describes the super priority debt that results from a PET. A distressed debtor colludes with a sufficient majority of its lenders to exchange their existing holding of first or second lien for new super priority debt, on condition (in the form of an 'exit consent') that they vote to release covenants that protected their original holding but – and here's the twist – the exchange offer isn't made to all holders – only to those invited who commit their votes to achieve the requisite majority.

The 'winning' majority trade some combination of new funding, extended maturity, and a discount on the exchange, against a higher coupon and improved probability of repayment. The 'losing' minority are subordinated down the new order of priority, with the prospect that they will be wiped out if the debtor company becomes insolvent.

Abandoning the pro rata treatment of creditors leaves investors in leveraged debt transactions with many reasons to feel queasy. CLO investors checking to see if their deals allow for Uptier Priming Debt should note that restructured obligations (and similar) have long been a constituent of CLOs. Eligibility criteria commonly require a first priority security interest and at least a 66.6% majority for any change that is averse to lenders' interests, but that does not stop a PET. Following the precedent set in the US by Serta Simmons, PETs can be blocked by "*a few carefully chosen words*" in the debt terms (see box on page 72) but do not violate implied covenants of good faith and fair dealing. Which begs the questions: which bonds and loans in the portfolio have the necessary blockers? If PETs are a risk in documents governed by US laws do PETs also work under English law?



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Not just a US problem?

To the English courts, it has always been axiomatic that powers given to majorities in a company's constitution allowed them to control their own but also others' property and so were liable to abuse. The law should therefore protect the minority from being expropriated. Reconciling this concern with the problem of 'hold outs' blocking restructurings for their own purposes, led English law down two parallel tracks.

Statutory schemes of arrangement (now Part 26A of the Companies Act 2006) were introduced early on to facilitate restructurings; providing a court sanctioned process to compromise the debts of a company on the basis of a 75% majority of each relevant class. The court's role was to ensure the overall fairness of the scheme and the legal certainty of its outcome. Fairness in this context includes testing whether creditors in each relevant class would be treated the same way in whatever the alternative may be to the scheme - usually insolvency - thereby upholding the *pari passu* principle.

Separately, a legal principle (the **abuse principle**) emerged that the powers of majorities to bind minorities must be exercised in good faith, without oppression of the minority, and bona fide for the benefit of the relevant class as a whole - not merely individual members. This test is one of 'rationality'; could no reasonable person honestly conclude that the decision was capable of benefitting the relevant class as a whole?

Assénagon

The force of the precedent set by *Assénagon Asset Management SA v Irish Bank Resolution Corpn Ltd (formerly Anglo Irish Bank Corpn Ltd)* [2012] EWHC 2090 (Ch) (**Assénagon**) justifies explanation here.

Following the 2008 credit crunch, Anglo Irish Bank failed and was nationalised. As part of its restructuring, the bank proposed to issue a senior class of debt with a sovereign guarantee, for which holders of subordinated notes were entitled to exchange their holding in the ratio of €0.2 for every €1 held. As a condition to the exchange, holders were required to approve a resolution allowing the bank to redeem the non-exchanging holders for €0.01 per €1000 of principal. The resolution was approved by a 90% majority. Non-exchanging holders were redeemed at a 100,000th of face value.

Assénagon, an asset manager, sued and overturned the resolution on a technicality, but the judge made plain that their case would also have succeeded because of the coercive threat to the minority and the destruction of the value of the notes being of no conceivable benefit to the noteholders as a whole.

The judgment in Assénagon still leaves English law flexible in relation to PETs. The effects of the exit consent in Assénagon were extreme. Relaxations of negative pledges, non-disposal covenants and the like may facilitate raising new funds and be beneficial to existing lenders. Other cases show that, in a restructuring context, principle can be surrendered to the practicalities of the situation.

A few carefully chosen words.

A "Serta blocker" requires that the consent of all affected creditors is needed for amendments that "subordinate, or have the effect of subordinating, the obligations hereunder to any other indebtedness [or] the liens securing the Obligations to liens securing any other indebtedness."

A "Chewy Blocker" refers to provisions of a credit agreement intended to prevent a subsidiary guarantor from being released from its guaranty obligations because it is no longer wholly owned by the borrower.

A "J. Crew blocker" prohibits the transfer of specified assets (commonly limited to IP that is "material" to the overall business) to unrestricted subsidiaries.

Redwood

10 years before *Assénagon Redwood Master Fund Ltd v TD Bank Europe Ltd* [2002] EWHC 2703 (Ch) (**Redwood**) (see box on this page) is authority that, provided there is no bad faith, “the benefit of the lenders as a whole” does not require equal outcomes between different lenders. If there is a benefit to the lenders as a whole, there can be winners and losers. The loss to one class can be the others’ gain. That fits PETs provided the benefit to the borrower equates to the benefit of the lenders as a whole. Redwood also illustrates the potential disaster that awaits if a court, applying the abuse principle, must then undo a restructuring, with the risk that the debtor will suffer some irreparable harm or be forced into a formal insolvency. This was scarcely a factor in *Assénagon*. Anglo Irish Bank was already insolvent, and a bespoke legislative solution was always the alternative. The consequences of reversing the “exit consent” did not weigh in the court’s reasoning when applying the abuse principle.

So, what is the future for PETs in English law?

The availability of schemes of arrangement will continue to pose a threshold challenge to the usefulness of PETs. If “a few carefully chosen words” prohibit a PET, a scheme may be the only option. Schemes, once agreed and sanctioned by the court, ensure legal certainty. For anyone subscribing a new money issue in a PET, the prospect that a challenge by an excluded minority may invalidate the transaction after the money has gone in makes the advantage of a court-sanctioned scheme obvious. Schemes may also apply to non-UK companies with English law debts. However, the jurisdiction of the UK courts is limited. Schemes are public processes and there may be practical limitations that rule a scheme out. A 66 2/3 % majority to change a loan is materially less than the 75% needed for a scheme. Nonetheless, a court may question why a PET should succeed if it would fail the test of fairness as a scheme.

The growth of the PE industry, funded on a highly levered basis by specialist lenders and CLOs, changes something in the reality from where English law’s principled pro-rata approach has developed. The money borrowed does not go to funding the borrower’s working capital but to paying a purchase price to its former shareholders or a dividend recap. The lenders’ customer is its private equity owners not the company, but, if it all goes wrong, the company alone is on the hook.

The interests of the company, with its real-world customers, trade creditors and employees, are not for nothing. Primarily testing the good faith of the majority in agreeing a restructuring for the benefit of all lenders, grants this hyper-sophisticated community protections beyond what they are apt to negotiate for themselves (see “a few carefully chosen words” above) and creates a dilemma in the law’s priorities. The consequences of violating the abuse principle are binary.

Redwood relates to the restructuring of a distressed company’s debts.

The lenders under a fully drawn B Facility formed the majority authorising the waiver of a condition precedent that permitted the defaulting borrower to drawdown on a smaller A Facility under the same agreement. The drawing was used to repay the B Facility in part.

Switching the drawings between the B and A Facilities, optimised and extended the borrower’s repayment profile.

Some B Facility lenders had sold their A Facility commitment, leaving the A Facility-only lenders as net payers-in, to the benefit of those B Facility lenders whose overall exposure was reduced.

The court upheld the waiver on the basis that there was no evidence of bad faith by the majority and the resulting overall reduction in the Facilities agreed with the borrower was of benefit to all.

If the remedy of the aggrieved minority threatens to force the debtor company into insolvency, absent some egregious facts, a court should pragmatically opt for the lesser of two evils or stretch itself to compensate the injury by some other means.

The burden of proving bad faith will fall on the plaintiff minority. Taking the lead from Redwood, might it be possible to implement a PET that did not raise a question of bad faith by the majority? Consider the following scenario: a company, whose debt is trading at a fraction of face value and needs new funds, offers to 'uptier' the necessary majority, which is selected through a reverse auction of the rate at which a lender will exchange its holding into new senior debt, and approve a new money debt issue. No discretion is used to select the majority. What 'bad faith' is there between the majority and the minority?

Given the current distress in PE world, the English courts may soon be asked the question in relation to a PET. Good faith is not an indivisible absolute, independent of its coordinates. The precedent of US courts upholding PETs illustrates the standard of 'good faith and fair dealing' to which the leveraged debt market now subscribes in restructurings. And here the significance of EU CLOs providing for investments in Uptier Priming Debt will come into play. The expectations of market participants that PETs are both permissible and desirable – regardless of the outcome - will be there in the CLO offering circulars for all to see.

Three emerging regulatory risks and what to do about them



Harry Barnes
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Over the last 18 months, we've seen a significant uptick in Financial Conduct Authority (FCA) communications and enforcement, particularly for firms that have previously gone under the radar. The changing economic and regulatory environment has increased the FCA's concerns in areas that were previously not at the top of the agenda, such as private asset valuations.

Below we summarise the top three areas of regulatory risk we see impacting alternatives managers and advisors as we go into 2025.

Operational resilience and outsourcing

Outsourcing has been an area of concern for the FCA for many years, with continued focus on the degree of oversight that firms are required to maintain over critical outsourced functions. A key element of firms' compliance with the FCA's outsourcing expectations is the way they conduct initial and ongoing vendor due diligence.

The introduction of the Digital Operational Resilience Act (DORA) in the European Economic Area (EEA) has brought vendor due diligence back into the spotlight. Financial services entities operating in the EEA are now required to:

- Assess whether outsourced service providers are critical
- Conduct vendor due diligence, both initially and through ongoing monitoring and oversight
- Maintain an appropriate risk management framework governing critical outsourced service providers
- Embed oversight of critical outsourced functions into governance processes of the firm
- Enhance business continuity planning around critical functions to ensure continuity of operations

Whilst DORA is only applicable to entities operating in the EEA at this time, the UK is also preparing to introduce its own equivalent legislation.

The FCA deems outsourcing as an important risk factor for regulated investment firms, with increased scrutiny on firms' vendor due diligence, governance and risk management arrangements.

This can be particularly applicable in the asset management space, with outsourced advisors, delegated portfolio managers, administrators and depositaries being viewed as critical outsourced functions for fund managers.

To this end, investment firms should be reviewing their vendor due diligence practices against both the FCA's current expectations and the broad themes of DORA to ensure that they are maintaining appropriate systems and controls around outsourcing and operational resilience.

Marketing

The marketing of designated investments has been an area of focus for the FCA recently, with new rules and updated guidance for firms to follow, including:

- The new anti-greenwashing rule and associated guidance
- Social media guidance
- Financial promotions gateway
- Increased scrutiny on the marketing of crypto assets and so-called social media 'fin-fluencers'

In May 2024, the anti-greenwashing rule was implemented, explicitly requiring all sustainability related claims to be:

- Correct and capable of being substantiated
- Clear and presented in a way that can be understood
- Complete – they should not omit or hide important information and should consider the full life cycle of the product
- Comparisons to other products or services should be fair and meaningful

This new rule doesn't change any of the overarching obligations that firms are under when marketing products or services. Instead, it acts to complement the existing marketing rules in COBS 4 with explicit requirements and guidance around ESG, since ESG investing has become much more prominent in recent years.

The introduction of the Consumer Duty updated social media guidance, and the increased scrutiny on the marketing of crypto assets to retail investors, which includes the actions of social media 'fin-fluencers', demonstrates that the FCA is taking a tough line on marketing to retail customers.

We're able to understand that marketing to retail customers is a priority for the FCA in the uptick in their interventions, with 2023 seeing 10,008 financial promotions amended or withdrawn (up 16.6% from 2022), and 5,484 through Q2 2024.

With the recent changes to the rules and guidance and the increased FCA interventions, firms should take this opportunity to review their systems and controls when it comes to the production and approval of financial promotions.

The introduction of the Consumer Duty updated social media guidance, and the increased scrutiny on the marketing of crypto assets to retail investors, which includes the actions of social media 'fin-fluencers', demonstrates that the FCA is taking a tough line on marketing to retail customers.

Valuation practices

The FCA has raised their concerns in the 'Dear CEO letter' sent to alternatives managers issued in March 2024 as to how private assets were being valued. The FCA also confirmed in the same letter that it would be conducting a review into private market valuations. The FCA are not the only body concerned about valuation practices in private markets, with the International Organisation of Securities Commissions (IOSCO) having published a report in September 2023 entitled "Thematic Analysis: Emerging Risks in Private Finance".

The concerns around private asset valuation practices have arisen from worries of poor outcomes for investors, particularly any direct or underlying retail investors, as well as wanting to ensure that there is confidence in the valuation practices of fund managers. Many listed funds and investment trusts investing in private assets are facing steep and widening discounts to net asset value (NAV), suggesting that investors may not possess the same confidence in private asset NAVs and valuations as they do with listed assets.

Currently (under FUND 3.9.7), a manager is allowed to perform valuations internally so long as the process is functionally independent from the portfolio management function and that the remuneration practices of the manager don't create a conflict of interest for the valuation function. For example, a fund manager shouldn't be encouraging the valuation function to inflate valuations through remuneration incentives.

This does create an inherent issue for fund managers as the bonus pools from which the bonuses of the valuations function are drawn are heavily impacted by the valuation of assets (through both management and performance fees), meaning that the potential conflict identified in FUND 3.9.7 isn't easy to mitigate either effectively or entirely.

As such, one potential outcome of the review is that there will be increased scrutiny in respect of this specific conflict on managers which choose to conduct internal valuations.

The valuation of private assets is also quite infrequent, with quarterly valuation periods being the most common. The effect of this is that when public markets are undergoing periods of significant volatility, it can take time for these movements to be reflected in the NAV of a fund. For listed entities and other open-ended structures this may present an opportunity some investors may seek to exploit at the expense of others.

Conclusion

Within a progressively regulated environment, an important aspect firms should note is that we've increasingly seen the FCA link regulatory issues and deficiencies they identify directly to the obligations of senior managers under the senior managers conduct rules. To this end, governance is an important area that firms should be considering. Governance ensures there is adequate oversight of internal or external functions and that governing bodies have been trained with sufficient knowledge to scrutinise the regulatory items they approve.

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The case for Cayman Islands funds

Over the past 30 years, the Cayman Islands has been the pre-eminent jurisdiction for the formation of alternative investment funds, with a strong track record of over 30,000 registered funds with the Cayman Islands Monetary Authority (approximately 13,000 regulated open-ended funds and 17,000 regulated closed-ended funds). This achievement consolidates the Cayman Islands' position as the world's leading funds jurisdiction, with further growth expected in the coming years.

According to Cayman Finance, the current projections indicate the 2024 year-end total will surpass 2023's registrations, building on the steady growth of private funds since the introduction of the Private Funds Act in 2020. Last year saw 16,551 private funds, the previous high for registrations, along with 12,802 as the prior high for mutual funds registrations.

This article will seek to highlight why the Cayman Islands continue to go from strength to strength, while substantiating the reasons why more fund managers across the globe seek to domicile their funds in the Cayman Islands.

Political and economic stability and sound legal system

As a British Overseas Territory, the Cayman Islands enjoy political and economic stability. The jurisdiction's legal system is based on established English common law. Corporate and commercial statutes are continually being revised and improved in response to the demands of international commerce. The courts function effectively and smoothly and employ an investor-friendly and creditor-friendly approach. The final court of appeal is the Privy Council in London. The judiciary is sophisticated and many of the attorneys at Cayman Islands law firms have been sourced from top-tier international law firms. The Grand Court in the Cayman Islands also has a specialist division, the Financial Services Division, which is designed to focus on complex financial services matters and commercial litigation.

Speed of formation

Cayman Islands companies and limited partnerships can generally be formed on a same-day basis and the certificate of registration and other stamped documents will generally be issued by the Cayman Registrar's office that day (if the entity is registered on an express basis).



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Tax neutrality and absence of exchange controls

There are currently no forms of direct taxation in the Cayman Islands (i.e. no income, inheritance, gift, withholding, corporate or capital gains taxes) and no forms of exchange control. In addition, it is possible, but not obligatory, for exempted companies, limited liability companies, limited partnerships and trusts to order a tax exemption certificate, which provides comfort that future changes in the law will not result in that entity being subject to taxation in the Cayman Islands for a period of either 20 years (company) or 50 years (limited partnership, limited liability company or trust). In light of the tax neutrality, some have mistakenly coined the Cayman Islands a “tax haven” when, in fact, it imposes substantive indirect tax in the form of import duties and stamp duty.

Anti-money laundering regime

The Cayman Islands has a strong anti-money laundering regime and is committed to complying with its international obligations. It has signed a large number of tax information exchange agreements with other countries and territories and is on the OECD ‘whitelist’ of compliant jurisdictions. Having been removed from the Financial Action Task Force’s Grey List in October 2023 and the European Union’s Anti-Money Laundering blacklist in February 2024, it is a further recognition of the Cayman Islands’ robust AML/CFT regime and its commitment to adhering to international standards.

Cayman Islands Monetary Authority (CIMA)

CIMA oversees the regulation and supervision of financial services, the monitoring of compliance with money laundering regulations, and has issued regulatory handbooks on policies and procedures, rules and statements of principle and guidance applicable to regulated funds in the Cayman Islands. CIMA adheres to recognised international standards while at the same time ensuring that regulation is both necessary and proportionate. CIMA is a member of the International Organization of Securities Commissions, the principal global standard setting body for the regulation of securities markets. CIMA enjoys a close working relationship with, and regularly consults with, the private sector in developing a bespoke fund legislation over the years which is easy to understand and in line with global standards.

Enforcement of foreign judgments

A judgment obtained in a foreign court will generally be recognised and enforced in the courts of the Cayman Islands at common law, without any re-examination of the merits of the underlying dispute, by an action commenced on the foreign judgment debt in the Grand Court of the Cayman Islands, provided that such judgment:

- Is given by a foreign court of competent jurisdiction;
- Imposes on the judgment debtor a liability to pay a liquidated sum for which the judgment has been given;
- Is final and conclusive as between the parties thereto;
- Is in respect of a fixed sum of money and not for a tax, fine or penalty; and
- Was not obtained by fraud or in proceedings contrary to natural justice and its enforcement is not contrary to the public policy of the Cayman Islands.

There is also direct statutory enforcement of judgment obtained in certain courts in Australia.

Arbitration

The courts of the Cayman Islands will generally recognise and enforce arbitral awards made pursuant to an arbitration agreement in a jurisdiction which is party to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards unless one of the defences set out in section

7 of the Foreign Arbitral Enforcement Act (as revised) of the Cayman Islands can be established. In addition, the Arbitration Act (as revised) of the Cayman Islands (which provides a unitary regime of arbitration largely based on the UNCITRAL Model Law on International Commercial Arbitration) has also established the jurisdiction as a desirable place in which to conduct international arbitrations.

'Onshoring' vs 'Offshoring'

In recent times, market observers in certain jurisdictions like Singapore, Hong Kong and Luxembourg have seen a rise in the uptake of 'onshore' vehicles by fund managers looking closer to home due to the enhancement of anti-financial crime measures globally along with the introduction of new fund structures and incentives to boost the asset management industry in such 'onshore' jurisdictions. Notwithstanding this observation, we nonetheless see a growing popularity and demand for Cayman Islands investment funds utilised throughout Asia. It is indeed not a 'zero-sum' game where managers choose to domicile their funds in only one jurisdiction to the exclusion of others. As fund managers deal with increasingly sophisticated investors from multiple jurisdictions and more complex regulatory environments for foreign investments, we are observing structures in different jurisdictions often used in tandem with each other to achieve different objectives.

From a Singapore and South East Asian perspective, we typically see a wide range of structures being utilised by managers which include Cayman Islands vehicles as either (i) the main fund, (ii) the feeder fund which in turn invests into an 'onshore' master fund vehicle (e.g., a Singapore variable capital company (VCC) or an Australian unit trust), (iii) a parallel fund vehicle which invests alongside an 'onshore' vehicle, or (iv) in a purely Cayman Islands 'master/feeder structure'.

Conclusion

For the above reasons, the Cayman Islands continues to grow and build on its stellar reputation as the world's pre-eminent funds jurisdiction over the last 30 years. That said, fund structuring is a multi-faceted process which should consider a wide range of factors, including but not limited to tax planning, commercial flexibility and investor familiarity. With increasingly complicated regulatory environments and cross-border investment considerations, the flexibility of the Cayman Islands regime ensures it will remain at the forefront of the global funds industry.

Please reach out to your usual Carey Olsen contact, or one of the contacts listed in this article, if you require further guidance in relation to the above.



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“Undoubtedly the “go-to” firm for offshore funds work.”

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The Cayman Islands' beneficial ownership transparency regime: A new era of transparency and accountability

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The Cayman Islands, long known for its robust financial services sector and favourable regulatory environment, has enhanced and improved its existing beneficial ownership regime (the Regime) with the introduction of the Beneficial Ownership Transparency Act (As Revised) (the BOTA).

This legislation, along with its accompanying regulations, marks an evolution in the realm of beneficial ownership. As the global community intensifies its efforts to combat money laundering, tax evasion, and terrorist financing, the Cayman Islands' enhanced Regime stands as a testament to its commitment to international standards and aligns with equivalent regimes in other jurisdictions, such as the US Corporate Transparency Act.

This article delves into the intricacies of the Regime and the BOTA, exploring its implications, challenges, and the broader context within which it operates.

The genesis of the Beneficial Ownership Transparency Act

The BOTA was enacted by the Cayman Islands Legislature on 15 December 2023, and came into force on 31 July 2024. The BOTA builds upon the prior Regime by consolidating and enhancing the existing legislative framework, aligning it with evolving international standards and addressing certain gaps or deficiencies identified in the previous Regime.

The introduction of the BOTA is part of a broader global trend towards greater transparency in beneficial ownership. The Financial Action Task Force (FATF), the global standard-setter for anti-money laundering and counter-terrorist financing, has long advocated for the identification and verification of beneficial owners. The European Union's Fifth Anti-Money Laundering Directive (5AMLD) also mandates the establishment of beneficial ownership registers accessible to competent authorities and certain other persons with a deemed "legitimate interest" due to their role in combating money laundering and terrorist financing. Effective 1 January 2024 the United States also introduced its own Corporate Transparency Act.

The changes made to the Regime are all targeting enhanced transparency and ensuring alignment with evolving international recommendations upon which the Regime was built, emphasising the importance of identifying and verifying true owners and controllers of legal entities and enhancing the Cayman Islands' reputation as a responsible financial centre.

Summary of key changes

The BOTA introduces several key changes to the Regime, including:

1. New in-scope entities

The prior Regime applied only to companies, limited liability companies (LLCs) and limited liability partnerships (LLPs). The BOTA brings new entities into scope and applies to all 'legal persons', which includes companies, LLCs, LLPs, limited partnerships; exempted limited partnerships (ELPs) and foundation companies; and any other legal person that may be prescribed in regulations. Foreign registered entities and certain other categories of legal person are carved out of the new Regime (e.g. certain charities and not-for-profits).

2. New definition of beneficial owner

Under the BOTA, the definition of 'beneficial owner' in relation to a legal person is amended to be more aligned with that under the Cayman Islands Anti-Money Laundering Regulations (As Revised). The BOTA definition refers to an individual (i) who ultimately owns or controls (directly or indirectly) 25% per cent or more of the shares, voting rights or partnership interests in the legal person; (ii) who otherwise exercises ultimate effective control over the management of the legal person; or (iii) who is identified as exercising control of the legal person through other means. The analysis involved looking through all non-Cayman Islands entities up to an individual who meets the test, if any. If another Cayman Islands vehicle is identified as part of the analysis, that Cayman Islands vehicle is recorded on the legal person's beneficial ownership register. Similarly, the trustee is referenced where a trust is identified as a beneficial owner in the analysis.

A person operating solely in the capacity of a 'professional advisor' or 'professional manager' (both terms defined in the BOTA) will not be considered a beneficial owner.

The BOTA also specifically provides for circumstances in which no registrable beneficial owner can be identified under the definition of beneficial owner. In those circumstances, the BOTA provides that a 'senior managing official' should be identified as a contact person.

3. Removal of exemptions and new required particulars

The BOTA removes (or otherwise significantly restricts) the majority of the 'exemptions' which previously applied under the Regime in favour of certain 'alternative routes to compliance', meaning the legal person would not be required to establish a beneficial ownership register or report its beneficial owners on an ongoing basis, but rather report limited 'required particulars'.

Under the BOTA, legal persons able to apply an alternate route to compliance include a legal person that is: (a) listed, or is a subsidiary of a listed entity, on the Cayman Islands Stock Exchange (CSX) or an approved stock exchange; (b) licensed under a regulatory law (note this is limited to certain Cayman Islands regulatory laws); (c) a fund registered with the Cayman Islands Monetary Authority under the Private Funds Act (As Revised) or the Mutual Funds Act (As Revised); or (d) otherwise exempted by Cabinet (none currently).

Relevant to the investment funds industry, legal persons under category (c) (registered Cayman Islands mutual or private funds) are permitted to supply the contact details of a service provider licensed or registered under a regulatory law and located within the Cayman Islands that will provide beneficial ownership information to the competent authority on request within 24 hours (or any other time the competent authority may reasonably request).

Note that only subsidiaries of listed entities are recognised as being able to take advantage of any alternative route to compliance. For example, in an investment fund structure, trading subsidiaries or blocker entities would be in-scope and would need to maintain beneficial ownership registers and identify any beneficial owners or (where relevant) a senior managing official on the basis discussed above. In the context of trading subsidiaries or blocker entities that are owned / controlled by the relevant Cayman Islands investment fund, the Regime requires the entity to report that Cayman Islands investment fund as a “reportable legal entity” but does not require the entity to look through that reportable legal entity in identifying registrable beneficial owners in that chain of control or ownership.

Entities falling outside categories (a) – (d) above (or otherwise opting not to apply an alternative route to compliance) are considered ‘in-scope’ of the requirement to establish and maintain a beneficial ownership register and to report the details of their beneficial owners to the competent authority on an ongoing basis. The required particulars to be reported on the legal person’s beneficial ownership register are largely unchanged from the requirements of the Regime prior to the BOTAs with two notable exceptions, those being that the legal person must also report (1) the nationality of all beneficial owners; and (2) details of the nature in which the individual or ‘reportable legal entity’ owns or exercises control of the legal person.

Transparency and access to information

One of the most notable aspects of the Regime is the centralised electronic platform, maintained by the competent authority, which houses and, in certain circumstances, permits access to beneficial ownership information. This platform can be accessed by various Cayman Islands authorities, including the Royal Cayman Islands Police Service, the Financial Reporting Authority, and the Cayman Islands Monetary Authority, among others. Additionally, licensed financial institutions and designated non-financial businesses and professions can access the platform for a fee, facilitating customer onboarding and ongoing due diligence.

The BOTAs provide that the Cabinet may, subject to resolution in Parliament, make further regulations empowering the competent authority to provide additional organisations access to certain, limited required particulars of registrable beneficial owners. The Cayman Islands Government has indicated that it is currently taking the necessary steps to provide such access to those members of the public who meet a ‘legitimate interest test’. As at the date of this article, draft regulations regarding such access have just been released by the Cayman Islands Government for industry consultation.

Enforcement and penalties

The BOTAs impose administrative penalties and other sanctions for non-compliance, reflecting the seriousness with which the Cayman Islands Government views these obligations. Legal persons that fail to establish or maintain a beneficial ownership register, or that provide false or misleading information, can face fines ranging from CI\$5,000 to CI\$100,000 (US\$6,000 – US\$120,000), as well as imprisonment. Persistent offenders may even be struck off the register, resulting in the dissolution of the entity and directors/managers of such legal persons may also be held liable for breaches in certain situations. Cayman Islands Corporate Services Providers (CSPs) also face significant penalties for failing to fulfil their duties under the BOTAs. These include fines for not verifying the identity of beneficial owners, not updating the register, or not depositing beneficial ownership information with the competent authority. The imposition of such administrative fines and other penalties, which can accumulate over time, underscores the importance of compliance with these obligations.

Challenges and opportunities

While the implementation of the BOTA represents a significant step forward, it also presents several challenges. Legal Persons and CSPs must navigate the complexities of the new requirements, ensuring that they accurately identify and verify registrable beneficial owners. This is particularly relevant for those Cayman Islands legal persons that were previously “exempt” from, or out of scope of, the prior Regime. The need for ongoing updates to the beneficial ownership register adds an administrative burden, particularly for entities with complex ownership structures.

As has been evidenced in other jurisdictions (e.g. Luxembourg and the United States) the potential for broader access rights to beneficial ownership information raises valid concerns about privacy and data security. Striking the right balance between transparency and confidentiality will be crucial to the Regime’s success.

Despite these challenges, the new Regime also presents opportunities. By enhancing transparency, the Cayman Islands strengthens its position as a reputable financial centre, attracting legitimate business and investment. The Regime also provides an enhanced framework for greater cooperation with international partners in the fight against financial crime.

Conclusion

By consolidating and enhancing the beneficial ownership framework, the BOTA aligns the jurisdiction with international standards and demonstrates the Cayman Islands’ commitment to combating money laundering, tax evasion, and terrorist financing in a manner that is equivalent to other significant jurisdictions, including the United States.

Thank you for reading the Edition 140 of the AIMA Journal.

If you would like to contribute to future editions, please email
[Caterina Giordo](#) and [Jorge Palmero](#).

PUBLICATION PLAN 2025

- **Q1 Edition 141**

Deadline for submission 5pm UK time Monday 10 February | Publication Monday 24 March

Please note the deadline for reserving a spot for the Q1 edition of the AIMA Journal is 5pm UK time, Friday 31 January.

- **Q2 Edition 142**

Deadline for submission 5pm UK time Monday 19 May | Publication Monday 23 June

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