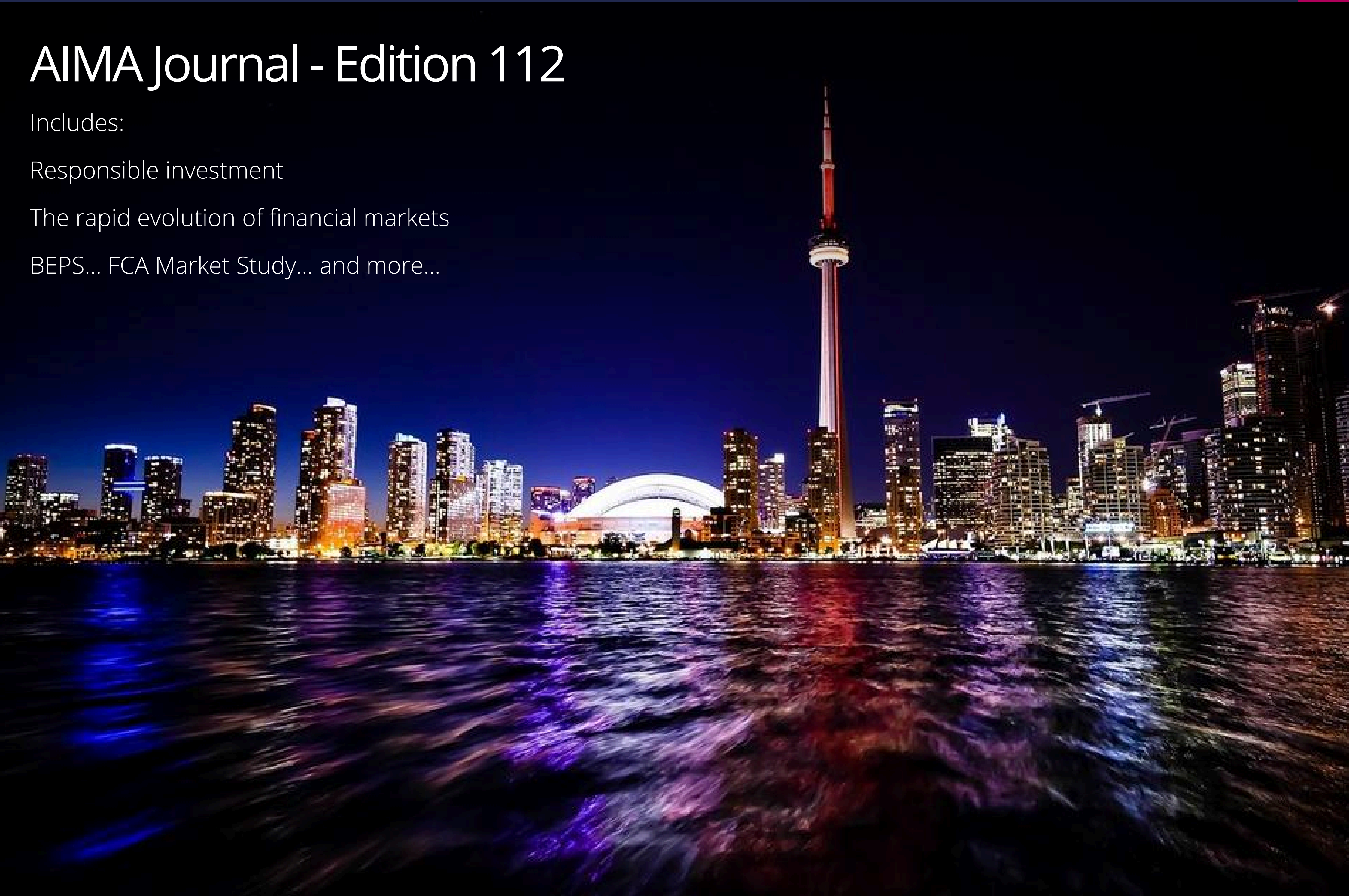
AIMA Journal - Edition 112

Includes:

Responsible investment

The rapid evolution of financial markets

BEPS... FCA Market Study... and more...



October notes

By Jack Inglis, CEO AIMA

Jack Inglis

At an enjoyable dinner with a group of members in early October, it was asked that I highlight more often some of the key areas of interest in our work to help narrow down the large volume of information coming out from AIMA. I'll be penning these every month - they will appear on the AIMA Blog page - and I welcome any input on the type of information you would like them to contain.

I've just read a news headline stating, "Hedge funds edge closer to 'perfect' 2017". It is in sharp contrast to much of the media coverage in 2016 which was predicting a gloomy future for the industry. While perfection is perhaps an elusive state, the point being made is that every month this year has seen **positive gains for hedge funds on average** and you have to go back to 2003 since we last saw that. Investor flows and intentions are positive so we have good reason for optimism as we head towards the end of the year.

Mind you it's not as though managers don't have other concerns on their hands. It is less than three months to go for firms to be **compliant for MiFID II**. AIMA has done a huge amount of work in helping people prepare for this. A lot of this is available via the MiFID section of our website (here). You can look at our checklist to verify what you have been implementing within your firms.

More than that though, our team here is beginning to resemble a call centre as it deals with individual queries. I can promise that you don't get the annoying voice recording of multiple options before you get to speak to someone who can help - so do give it a try.

We expect to be busy over the next few months helping members get to grips with our new modular Due Diligence Questionnaire for Investment Managers. It is 20 years since we first created it and this completely new version allows for considerable flexibility and ease of completion which we firmly believe will strengthen the exchange of information between manager and investor. Do get in touch with us if you require any help in adoption.

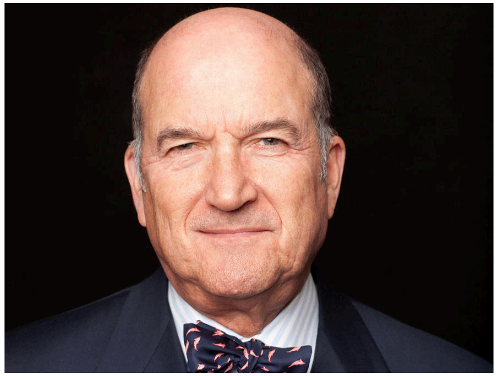
Over the past month we've hosted large conferences in Australia and Canada. What's notable about these is the significant **participation by institutional investors** at these events. With around a third of attendees being allocators, these were good opportunities to hear from and meet them. It is no coincidence that we are seeing increased visitors to these forums from members not actually based in those countries. They are open to all and you should expect to see more such focused events from us in the future.

One of the most common questions we get at AIMA is “how are other people dealing with this?”, whether it be a new piece of regulation, a jurisdictional marketing opportunity or one of the many other issues where nobody wants to be an outlier. At this time of year we often get asked if we can shed any light on **compensation practices** at managers. While we have not run our own research on this we are happy to alert our members to opportunities when we see them. Currently on our website is a link to an independent survey which grants you a free copy of the results if you complete it.

Finally, I always want to hear from members about what more we can do for you. Our governance process with the AIMA Council drives our strategy and how we channel our resources but is always enhanced by direction given by the wider membership. We will look to do a full membership survey in 2018 but in the meantime I welcome your **feedback and suggestions**. We want to be as good as you need us to be. Contact me at jinglis@aima.org.

Five key issues facing the global industry

By Simon M. Lorne, Chair, AIMA



Simon Lorne

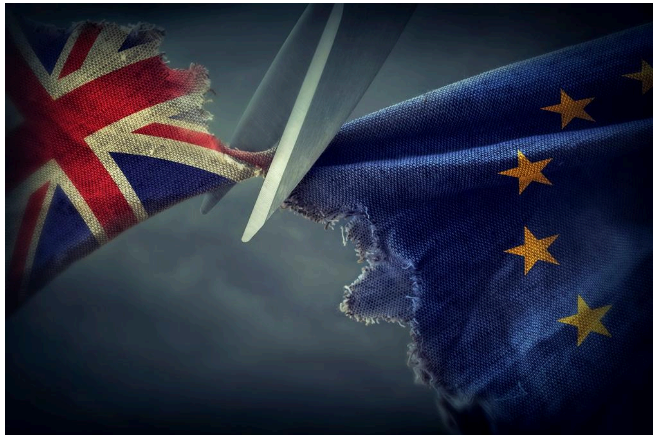
AIMA and the global industry it represents continue to thrive and grow. But there are always challenges, and I'd like to use this, my first press article as AIMA chair, to identify some of the key challenges I see and very briefly to set out how the Association is working to address them.

1. Globally consistent regulation

Differences in clearing requirements, the relationship between broking commissions and compensation for research, and potential limitations on global transactions are just three of the areas in which different national regulators have been taking potentially inconsistent approaches. These differences clash with the global nature of markets and our industry and inevitably impact the global economy and local economies in untoward ways.

Regulators can handle this—ultimately, their interests are parallel, if not identical - but they need to be talking to each other more effectively. AIMA is expending considerable effort toward facilitating those communications and understandings. I worry that as some countries move toward potentially protectionist measures, and as the UK separates from the European Union, there is increased risk of balkanisation of regulatory structures, where what the world and the investment community really call for is a more uniform global regulatory structure.

To take one small example, it's unreasonably burdensome to be filing a variety of short-selling reports with different regulators, many of them computed according to different and inconsistent standards, when the various regulators' interests in the subject are substantially identical. AIMA, as a truly global hedge fund body, continues to engage closely with regulators worldwide in seeking solutions to these ongoing challenges.



The best regulators appreciate the desirability of global consistency for an industry that is truly borderless and see AIMA as we see ourselves - as a partner in a cooperative undertaking rather than as an adversary.

2. Passive versus active

Even though there have been significant investment flows into an expanding number of index-tracking funds, actively managed funds still comprise the very significant majority of the asset management industry.

According to Morningstar, roughly 22% of total fund assets were in passive vehicles, or $6.7 trillion, at the end of 2016, versus 78% ($23.9 trillion) in actively managed funds, although the gap has closed in recent years. Challenging the contrary misconception, while stressing the benefits that hedge funds and private debt funds bring to investor portfolios, has been a priority for AIMA.

What hedge funds are about, of course, is performing well relative to the risk undertaken. Go back to the meaning of hedging—if we are reducing the degree of risk in the equation, our investors should expect to do a little less well on the upside, but have a meaningfully greater degree of downside protection. Historically, the downside protection has more than compensated for the upside sacrifice. Several years of an uninterrupted bull market, sustained in significant measure by artificially maintained record-low (sometimes even negative) interest rates, can obscure that relationship. AIMA continues to keep it visible.

3. "Consolidation"

Predictions of the sector's imminent demise or very substantial contraction are as old as the sector itself—and are yet to materialize. It's reminiscent of the old quip about some countries that they are the country of the future—and always will be.

AIMA continues to stress, with evidence, an industry growth story on all key metrics: assets under management, investors, allocations, funds and fund management firms, and jobs, all of which are at record levels. This matters, since it speaks to a successful, expanding sector, rather than a contracting one.

I am quite confident that the future will see a continuing, even increasing, need for AIMA's presence to provide a global voice for all the disparate members of our industry. A meaningful part of that effort is trying to clarify the values that our industry provides for institutions, endowments and retirement schemes for a public that is often less financially literate than would be desirable.

4. Pressure on fees

Investors are rightly paying more attention to fee structures and to alignment of interests. If funds can align their incentives more closely with returns to investors, the industry is better off and the investors are better off. AIMA has increasingly addressed the issue of fee pressure, while framing it in the context of enhanced alignment of interests. This was a key narrative of AIMA's 2016 research paper titled "In Concert," for example. The association supports greater transparency and increased alignment of interests—indeed we think these have been key factors in the net inflows seen in 2017 to date.

At the same time, we would not ever suggest that one size fits all; there are rightfully a variety of ways in which funds seek to demonstrate alignment of their interests with those of their investors, and we encourage that process.

5. Rising costs

There is no doubt that barriers to entry have risen since the financial crisis, as regulatory burdens have grown and investors have favored increased operational infrastructure and greater levels of transparency. (As an association, we take no position on the creation of such barriers to entry—certainly some of our members welcome them. We leave it to others to decide whether the broader social costs are justified by the benefits.)

One of AIMA's main roles, which I think we discharge admirably, is producing compliance guidance, good practice guides and due diligence tools in order to enable fund managers to keep costs down in the face of these pressures.

Conclusion

There is much to be positive about as we look forward. The industry is expanding, and sophisticated investors are cognisant of the very meaningful benefits that hedge funds and private debt funds provide for their portfolios. There continues to be a need for efforts to move toward greater regulatory consistency, and our manager members face continued cost and fee pressures, with no end in sight on either front. But AIMA will continue to address these issues in its ongoing support of a vibrant, expanding and sustainable global industry.

**Simon Lorne is the Vice Chairman and Chief Legal Officer of Millennium Management LLC. This article first appeared in September in Absolute Return*

AIMA

Six Ways the Alternative Investment Industry Benefits the Economy

#alternativeviews


Supporting retirees
Over half of all pension funds **entrust** some of their clients' savings with hedge funds
#alternativeviews
Source: Preqin
AIMA


Backing education
More than **four in five** endowments, including those of many universities, invest in hedge funds
#alternativeviews
Source: Preqin
AIMA


Supporting businesses
Alternative investment firms are **providing loans** to small firms and other businesses, filling a gap in the market
#alternativeviews
Source: AIMA/Alternative Credit Council
AIMA


Funding good causes
Two in three charitable foundations grow their assets with hedge funds
#alternativeviews
Source: Preqin
AIMA


Funding infrastructure
Alternative investment firms are financing infrastructure projects, from wind farms to homes
#alternativeviews
Source: AIMA/Alternative Credit Council
AIMA

Providing security
One in three insurance companies invests in hedge funds
#alternativeviews
Source: Preqin
AIMA

Systematic strategies as a force for good in responsible investment

By Steven Desmyter, Head of Responsible Investment and Chair of Responsible Investment Committee and Jason Mitchell, Sustainability Strategist at Man Group

Steven Desmyter

Jason Mitchell

In recent years, the concept of responsible investment (RI) has gained significant traction across the hedge fund industry. As global asset owners become increasingly attuned to the importance of environmental, social and governance (ESG) factors in their portfolios, managers are starting to integrate RI into their investment processes.

Indeed, we at Man Group are part of a growing list of signatories to the UN-supported Principles for Responsible Investing (PRI), which is making positive headway in the hedge fund space.

As the broad hedge fund universe begins to get on board with RI, we believe it's worth paying particular attention to the role of quantitative strategies. Indeed, at first glance, systematic approaches – where decisions are taken by algorithms and machines, rather than humans capable of normative judgement – may not seem likely to be natural leaders in embedding ESG-related principles.

But this relatively small group of strategies within the hedge fund universe has a specific role to play, and this article sets out some of the ways that quant strategies seek to be positioned to develop repeatable and consistent RI frameworks.

Some quant strategies are already embedding RI without fanfare

For investors considering the best ways to express their worldviews, we believe it is often important to look behind the explicit label of a strategy. Cynicism about the motivation of hedge funds is understandable – where some investment managers may be tempted simply to monetise the buzzword of 'responsibility', building marketing brands around explicit 'ESG' strategies, but really only paying lip-service to the more serious effort of RI: making investors more accountable, transparent and informed of non-financial factors. Of course, this backfired a decade ago, when the advent of renewable energy technologies inspired a number of 'cleantech' funds, several of which soon closed down due to poor and volatile returns.

However, in recent years, we have begun to see quantitative investment strategies embedding RI practices without marketing their products with overt 'ESG' labels. Unlike discretionary approaches, quant strategies face inherent limitations in terms of active engagement with company management, but many of them seek to practice RI in other ways.

For example, many have adopted explicit policies around ESG, enhanced stewardship via proxy voting, or established formal RI committees. This is an important development – since we believe real improvement in industry-wide responsibility is about improving investment practices across the board, rather than confining progress to a narrow set of specialist 'ESG' or 'RI' labelled products.

ESG scores are in the eye of the beholder – but quant strategies provide a consistent lens for data

It's no secret that the range of composite ESG scores available to investors today pose challenges for investors. Many active managers rely on these scores, compiled by specialist ESG research agencies, to inform decisions about what constitutes a responsible company. However, these scores are subjective, and the analysis of companies can vary substantially between ratings providers, given the lack of standardised definitions: academic research continues to point to the significant divergence between them[1]. Instead of relying on these scores, quantitative strategies can use their extensive capabilities to dig

further into the raw data – allowing them to develop their own 'scoring' systems to understand and compare companies. Over time, we believe quantitative analysis has the potential to help develop a more rigorous and consistent framework for comparing companies' ESG credentials.

Identifying patterns in ESG data and company performance

Taking their data research capabilities a step further, quantitative investment approaches also have the potential to identify relationships between ESG data and company performance.

Using the same tools they use to analyse other aspects of company information, systematic approaches can help derive statistically significant correlations to understand how these factors might impact performance over time. They can also analyse patterns in existing ESG scores (those subjective measures we highlighted before) – for example, studying the change in scores, beyond the scores themselves, can potentially be a useful indicator of performance[2].

We believe that ESG-related signals, like other factors, exist – but are rarely persistent. In other words, they modulate over time. Consider how volatility in the carbon price has modulated the environmental signal for investors over the past decade, for example. Or how corporate governance reform efforts in South Korea and in Japan have made this governance signal more important regionally.

In this context, quantitative investment approaches have the potential to draw important observations about the role of ESG factors in investment – which qualitative analysis alone cannot achieve.

What does this mean for discretionary managers?

Of course, while we believe that quantitative strategies have a role to play in RI – and we expect this to expand over the coming years – they also have the potential to support discretionary managers in their adoption of RI processes. As with so many areas of investment, we believe that the line between quantitative and discretionary approaches is thinner than ever, and we could see discretionary managers making use of quant capabilities over the coming years. More broadly, research into ESG factors – as they modulate over time and influence company performance – could help managers identify regimes and rotations which impact portfolios.

In the shorter term, however, we believe quantitative strategies may be at an advantage when it comes to turning raw ESG data into the potential for portfolio outperformance. As the investment industry continues to make progress towards ingraining RI principles across the board, we believe that quant approaches are likely to matter more than ever.

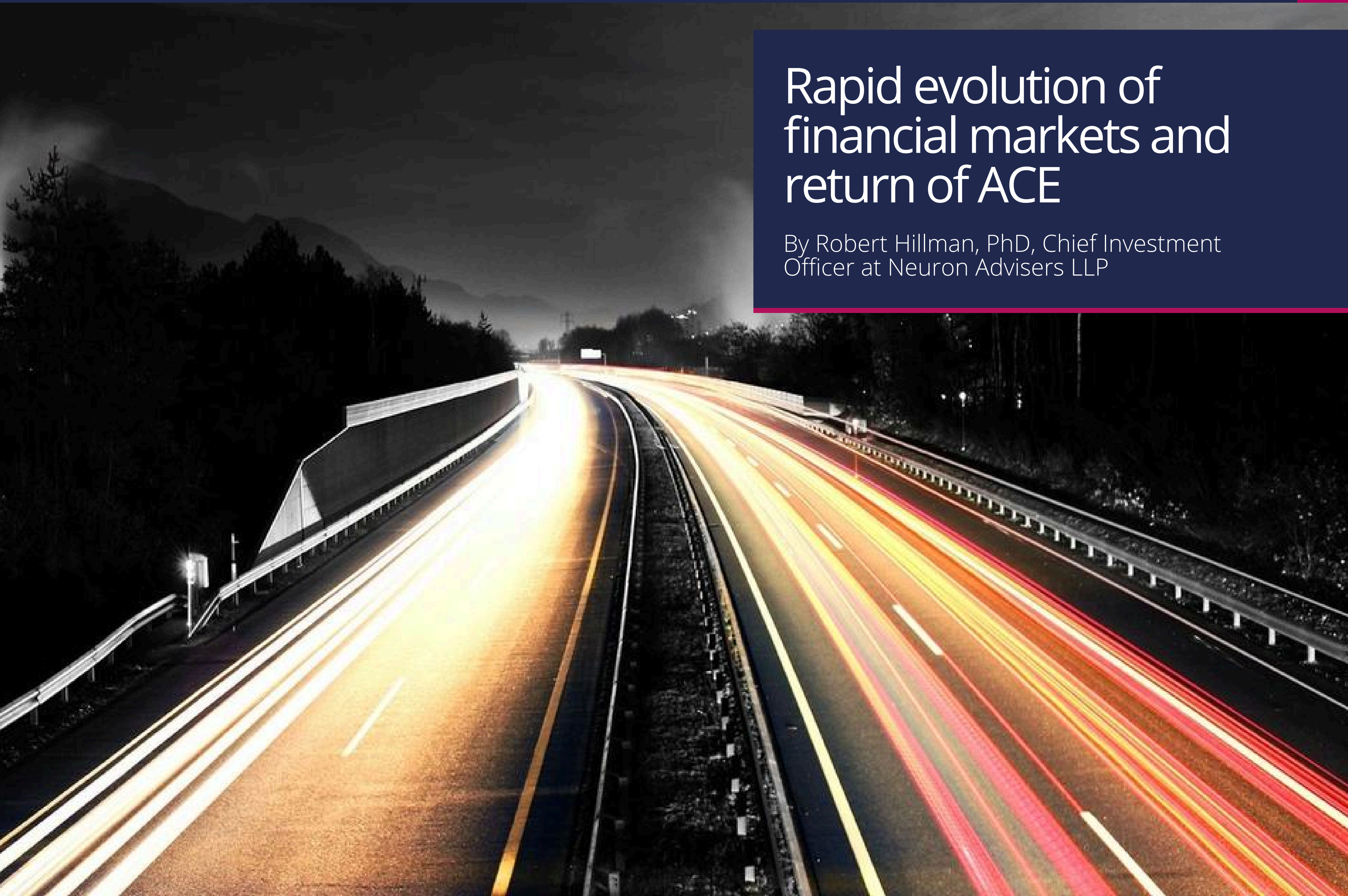
Find out more about Responsible Investment at Man Group: man.com/ responsible-investment

Footnotes:

1. Source: Chatterji, A., Durand, R., Levine, D., Touboul, S. 'Do Ratings of Firms Converge? Implications for Managers, Investors and Strategy Researchers'. HEC Paris Research Paper, Nov 2014. Available here.

2. Source: Joint study by European Centre for Corporate Engagement (ECCE) at Maastricht University and Dutch firm, NN Investment Partners, 2016.

Important information



Rapid evolution of financial markets and return of ACE

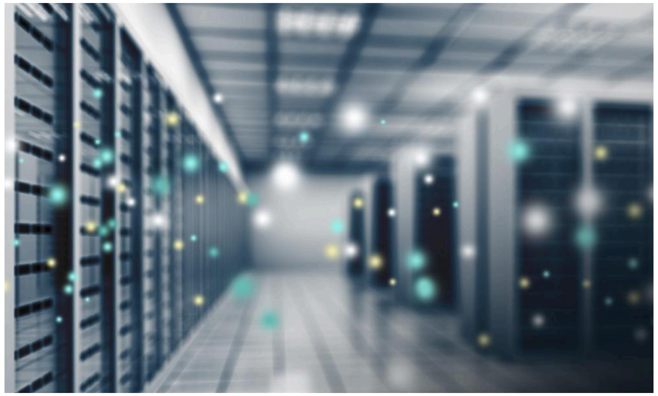
By Robert Hillman, PhD, Chief Investment Officer at Neuron Advisers LLP

Robert Hillman, PhD

The rapid growth of algorithms in the world of finance is giving regulators, economists and investment professionals plenty to think about. They may need to look toward approaches more in common with Minecraft than with traditional methods of economic analysis.

In the seven years since the May 2010 'flash crash', multiple theories have been proposed as to the source of that and subsequent crashes.[1] No simple explanations are readily available because conventional research methodologies are not well suited to analysing these events. Economists typically take a two-pronged approach to analysis, collecting and analysing historical data, and building toy models of the situation at hand. But while there is no shortage of data in terms of sheer volume of information (because the events take place at such high-frequency that there are often millions of records per minute), there are very few distinct events to study and from which to generalise. In terms of building models, economists are well versed in modelling human decision making, but few have until recently considered the implications of trading that takes place so fast that European regulators have had to recently propose a synchronisation of clocks to within a millionth of a second to reduce ambiguity about the order and sequence of trading orders.[2]

With conventional methodology falling short, some economists are looking towards alternative methods including an approach developed in the late 1980s and 1990s in an effort to build an alternative way to study financial markets via the simulation of people (often called 'agents') with computer programs. Often labelled 'agent-based computational economics' or ACE, it built on 1950s work by pioneers like Herbert Simon who studied human behaviour as computational processes and vice versa. These models offered new explanations for concerning phenomena like bubbles and crashes, but they had little impact on economics or investment management professions at the time.



ACE techniques are ideal for simulating today's technologically-driven automated markets. Within artificial markets, researchers can explore what types of algorithms, external shocks and exchange rules might be prone to generate flash crash type behaviour. Exchanges can explore the effects of defensive mechanisms such as circuit breakers for example, and on the other side of the fence, investors can explore what the effect of circuit breakers might be on their operations. For these experiments, computer simulation is not merely conveniently aligned to the reality of modern trading technology, it is vital. Two lessons from the earlier period of ACE were that the interaction of simple algorithms can lead to complex dynamics, and that macro level behaviour can be impossible to predict from analysis of the components in isolation – the whole being greater than the sum of the parts.

Simulation of artificial markets can also generate unlimited quantities of data and suggest behaviour not previously recorded in the real world. Interesting parallels can be drawn here between innovative simulation-based approaches now being used in weather forecasting and the modelling of extreme and ‘unseen’ weather events by the Met Office in the UK[3] and how similar techniques are being used in finance.[4] During periods of rapid structural and technological change, artificial simulation can complement the limited historical data available. For example, risk and technology managers might find ACE techniques helpful in suggesting stress scenarios that might lead to market or operational risks, and in doing so take steps to future-proof their business.

New uses for ACE are not likely to be limited to high-frequency contexts. The last few years have seen the spread of algorithms right across the investment management landscape. Many fund managers may nowadays best be described as designers and guardians of rules-based strategies.

The proliferation of exchange traded products alongside the commoditization of dynamic portfolio management techniques like risk parity and smart beta are only accelerating this trend. The original ACE approach approximated human investor

behaviour by modelling agents as simple algorithms, and one reason ACE failed to disrupt mainstream economics was because economists viewed the approach as ad hoc and lacking logical foundations. But twenty years of actual evolutionary processes at work have brought us to a situation where today, real markets closely resemble the algorithmic markets of ACE. Science fiction has become fact.

There is some urgency around these issues. The August 2015 market crash prompted questions about the role of lower frequency algorithms, specifically risk-parity strategies and ETFs, in contributing to market volatility and disrupting the relative pricing of cash and derivative instruments. ACE models offer one means of studying these issues as part of a wider simulation or 'virtual markets'-based approach and financial regulators have been developing similar techniques, operationalising agent-based models and other network approaches to study the effect of increased connectedness of the propagation of risks throughout systems and networks.[5] If economists are reluctant to embrace the power of virtual environments, there is a new generation of Minecraft players who may be more at ease with the concepts.

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Disclaimer

Unless clearly indicated otherwise, this article represents the opinions of the author based on his research experience.

Footnotes

[1] See for example 'Findings Regarding the Market Events of May 6, 2010' Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues. September 2010. https://www.sec.gov/news/studies/2010/ma...

[2] Under Article 50 of MiFID II, see for example https://www.thetradenews.com/Regulation/...

[3] For more on this see the Met Office website, in particular https://www.metoffice.gov.uk/news/releas...

[4] See Hillman (2017), 'Extreme Weather and Extreme Markets – Computer Simulation Meets Machine Learning' on http://www.neuronadvisers.com/

[5] For example, see Braun-Munzinger, K, Liu, Z and Turrell, A (2016), 'An agent-based model of dynamics in corporate bond trading', Bank of England Staff Working Paper No 592, available at http://www.bankofengland.co.uk/research/...

The FCA's Asset Management Market Study Final Report

By Neil Simmonds, Partner and Robert Turner, Partner at Simmons & Simmons

Neil Simmonds

Robert Turner

On 28 June 2017 the Financial Conduct Authority (FCA) published its Final Report in relation to the Asset Management Market Study launched in November 2015 to assess whether competition is working effectively in the asset management sector and investors are getting value for money.

The FCA also published a consultation paper (CP 17/18) in respect of some key remedies having concluded both that competition is not working effectively and that investors are not getting value for money. The deadline for responses was 28 September 2017.

The Final Report includes findings of weak price competition particularly for retail active asset management services and that investor awareness and focus on charges is mixed and often poor. The package of remedies proposed targets protections for investors the FCA has concluded are not well placed to find better value for money.

Within the package the headline remedy is perhaps the "strengthened duty on asset managers to act in the best interests of investors" and the package also includes governance requirements introducing independent scrutiny of that strengthened duty. This note provides a commentary on the concept of a "strengthened duty" and what that means.

Stage 1 - The Interim Report

A key conclusion in the FCA's Interim Market Study was that investors are not driving the asset management industry to deliver value for money and that external help is required to help achieve that result for investors. The question was what form that external help should take. One option was "placing a duty on asset managers to demonstrate how their funds deliver value for money to investors"[1] . At the same time, however, the FCA recognised that there was no "explicit and well defined obligation to seek value for money" for investors. So the Interim Report appeared to recognise a tension in placing a duty on asset managers to demonstrate how their funds delivered "value for money" when it was not explicit that they, in fact, had that underlying obligation in the first place.

So when the FCA concluded that authorised fund managers (AFMs) generally do not robustly consider value for money for investors, it seemed to be recognised that one reason for that was that it was not appreciated that AFMs had an obligation to do so in the first place.

Stage 2 - The Final Report

The FCA's preferred route is not to impose an "explicit and well defined obligation to seek value for money" for investors, but to take existing regulatory duties that are more broadly expressed and clarify that those duties require AFM's to provide value for money for investors.

The existing obligations the FCA has in mind appear to be those in the Collective Investment Schemes sourcebook (COLL) 6.6A (Duties of AFM in relation to UCITS schemes and EEA UCITS schemes) and Conduct of Business sourcebook (COBS) 2.1.1 (The client's best interests rule). COLL 6.6A, includes a duty to act in the best interests of Unitholders (COLL 6.6A.2(4)(a)), a duty to ensure unitholders are treated fairly (COLL 6.6A.2(1)), a duty to "act in such a way as to prevent undue costs being charged to any scheme it manages and its Unitholders" (COLL 6.6A.2(5)) and duties in carrying out its functions to act "solely in the interests of the UCITS scheme and its Unitholders" (COLL 6.6A.2(6)). COLL 6.6 does not contain the same general duties, although there are, even here, specific issues where regard is required to be had to the "best interests of investors"[2].

The client's best interest rule in COBS 2.1.1 is derived from MiFID and the UCITS Directive and provides "a firm must act honestly, fairly and professionally in accordance with the best interests of its client." For a UCITS management company (such as an AFM of a UK UCITS or EEA UCITS) the "client" in the context is the UCITS itself, not the investors in the UCITS. COBS 2.1.4 recognises that and goes on to provide that a full scope UK Alternative Investment Fund Managers (AIFM) must, for all Alternative Investment Funds (AIFs) it manages "act in the best interests of the AIF, it manages or the investors of the AIF it manages and the integrity of market".

As the FCA recognises in its Interim Report, there is no express reference in COLL or COBS to providing "value for money" for investors. The examples given of "undue costs" in COLL 6.6A.3 are unreasonable charges and excessive trading. Even so the FCA Final Report (paragraph 11.1) makes clear that the starting premise for the proposal that AFM boards be required to demonstrate value for money is an FCA clarification of its expectation that an AFM providing value for money for investors is a sub-set of the AFM's existing obligation to act in the best interests of investors and to prevent undue charges[3]. At one level that makes perfect sense.

As a matter of common parlance "Is it in the best interests of investors that they get value for money?" - answer "Of course". As a matter of the intent of the UCITS Directive (underlying COLL 6.6A), was it envisaged that the directive would regulate and harmonize across the EU an AFM's approach to pricing - that is far less obvious. Indeed if COLL 6.6A did govern the function of determining client pricing, then the obligation in

COLL 6.6A(6) "to act solely in the interests of the UCITS scheme and its Unitholders" would seem to wholly undermine any commercial profit-making incentive.

The Final Report explains the FCA's rationale for preferring not to recommend that the Government introduce a fiduciary duty on AFM's by statute, but to deal with the issue through regulatory reform. In doing so it refers back to the FCA's April 2017 Feedback Statement (FS 17-01) "Our Mission 2017", which, in rejecting the idea of introducing a general duty noted that for some regulated activities (specifically referencing UCITS and some AIF business) it already had "client's best interest" rules which "have a similar effect to that of a fiduciary duty".

The FCA also concluded a statutory duty would take longer to come into effect and would not provide the necessary clarity around the FCA's expectations. Of course there is a middle ground between a statutory duty and clarifying existing regulations to give them new meaning; a new regulatory rule. At the level of underlying duty, that is not proposed either.

Stage 3 - Consultation

The "strengthened duty to act in the best interests of investors" will not on the FCA's analysis involve any re-statement of the existing duties in COLL 6.6A or COLL 2.1. The "strengthening" component comes not in the duty itself, but in the FCA clarifying how it understands the existing client's best interests rules - to implicitly include a duty to provide value for money for investors as a sub-set of the duty to act in their best interests - and in governance changes which are the subject of current consultation. So while there is a lot of granular detail in Consultation Paper 17/18 about what AFMs should be doing in terms of governance to assess a duty to provide value for money to investors - there is close to nothing about the extent of the underlying duty.

The Consultation Paper asks 10 questions under Chapter 3 dealing with providing value for money - all are about governance to assess compliance with a duty - none are about the underlying duty itself or the ambit of that duty. The Consultation Paper proposes "a new value for money rule" requiring the AFM to assess whether value for money has been provided to fund investors (proposed New COLL 6.6.20). Notable, is the presumption of an existing underlying duty on the AFM to provide value for money. What is being consulted upon is the imposition of a new duty to assess, not the ambit of the underlying duty.

Also subject to consultation are the minimum requirements for the assessment. That is of interest as the presumption must be that the minimum requirements for the assessment must delineate the FCA's view as to the minimum ambit of the AFM's underlying duty. The questions - "Do you agree the underlying duty exists?" and "Do you agree with its ambit as set out in this Consultation Paper?" - are not asked.

To illustrate how delineating an assessment requirement risks backfilling the underlying duty, the proposed requirements on AFMs in terms of assessment are summarised below:

<u>Economies of scale</u>

- identify economies of scale in direct and indirect costs of operating funds

- consider the introduction of break points
- consider whether savings and benefits should be shared with investors
- explain the decision if savings not passed on,

Fees and charges

- are charges reasonable in relation to the costs incurred?
- assess appropriateness of charges relative to quality of service, comparable rates and ancillary services,

Share charges

- consider whether different share classes offer value for money
- assess and explain why some investors are in more expensive classes,

Quality of service

- assess the quality of services received
- explain criteria used
- explain conclusions.

The FCA also proposes further governance changes "strengthening" the existing duty to act in the best interests of investors. These include:

- a new specific Prescribed Responsibility under SM&CR allocated to the chair of the AFM Board: responsibility for an AFM's value for money assessments, independent direct representation and acting in investors' best interests, and
- requiring a minimum two and at least 25% independent directors to the AFM board.

Take-away points

When the FCA talks about a "strengthened" duty to act in the best interests of investors, the underlying duty or duties in the FCA Handbook are not going to be amended or changed. Nothing new is proposed in terms of the underlying duty itself. What is changing is the FCA getting specific about what it understands "best interests" of investors to mean and to extend to - and that is not something on which the FCA has invited consultation.

The clarification that the clients' best interest rules in COLL 6.6A and COBS 2.1 impose duties going to granular aspects of providing value for money is, however, both questionable, and a legitimate target for consultation responses even if not invited. However, if the point is taken that COLL 6.6A and COBS 2.1 (and the EU directives from which they flow) in fact fall short of imposing the duty the FCA now says they impose, then that invites explicit and well defined regulation.

If the ambit of clients' best interests rules in COLL 6.6A and COBS 2.1 is going to be clarified in the way proposed for AFMs, what might that mean for the interpretation of COBS 2.1.1 in its broader context?

Whatever is, following consultation, provided in New COLL 6.6 by way of minimum requirements for AFM board assessment will, from an FCA perspective, then be regarded as defining the underlying duty of the AFM (as well as the assessment duty).

COLL 6.6 and 6.6A are capable of a direct right of action under s.138D Financial Services and Markets Act (FSMA) by a private person, so if, following consultation, the FCA's proposals with respect to value for money are accepted, then a private person who has suffered a loss as a result of a breach of COLL 6.6A (or New COLL 6.6) will have a direct right of action against the firm. That would presumably be for the amount that private person (or group of private persons in a collective action) has been charged over what might be regarded as "value for money".

Observation

As the FCA gets to grips with its new competition powers and responsibilities there may be a temptation to re-interpret rules and regulations drafted and consulted upon before that agenda existed, and imbue them with meaning convenient to the competition agenda when, in fact, that was not intended at the time. Pragmatism from the regulator in that respect may well be reflected by a degree of pragmatic acceptance by the regulated. Even so, there are tensions involved which might usefully be explored in this consultation process. While it may be commendable to minimise the extent of redrafting of the Handbook, there is something unsatisfactory about a detailed regime of assessment and governance to deal with an aspect of a duty which nowhere features in the underlying rules.

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Footnotes:

1. Interim Report paragraph 10.9
2. COLL 6.6.5A as regards resolution of conflict of laws issues undermining limited recourse principles for umbrella schemes.
3. This is reflected in proposed New COLL 6.6.24. The FCA also places emphasis on Principle 6 and the duty to treat customers fairly.

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Current BEPS action items for asset managers

By Anna Burchner, Partner at CMS

Anna Burchner

For asset managers including managers of Alternative Investment Funds (AIFs) the Base Erosion and Profit Shifting project (BEPS) is a particular issue. Many outcomes will likely affect this industry, but those regarding permanent establishments (PE), tax treaty shopping and transfer pricing deserve immediate attention.

Why now?

The Multilateral Instrument (MLI), designed to affect many of the tax treaty based BEPS changes, was adopted on 24 November 2016 and signed by representatives of approximately 70 governments in June 2017. The operation of the MLI is rather complex, due to two key factors: it is to achieve its objective by forming a layer over existing bilateral tax treaties; and allows broad optionality for governments. Upon signature of the MLI, each signatory government was requested to submit its 'MLI Positions' inter alia listing Covered Tax Agreements (existing bilateral tax treaties to be modified by the MLI), choices of options and reservations. These MLI Positions may be changed during the ratification processes. Once the MLI takes effect, the interpretation of bilateral tax treaties will become an elaborate exercise. MLI Positions, options and reservations taken by respective treaty partners will have to be analysed to assess how the MLI modifies, or not, a single bilateral tax treaty. For example, the MLI will only apply to modify a bilateral tax treaty if both treaty partners have listed that specific tax treaty in their respective MLI Positions document. A relevant MLI provision will not apply if either of those two partners has made a respective reservation. It is expected HMRC will publish consolidated versions of UK bilateral tax treaties, as modified by the MLI, while other countries (eg Australia) are not proposing to do this. The first modifications by the MLI are expected to become operative in the course of 2018. The timeline is dependent on the ratification processes of the signatory governments.

The 2017 update of the OECD model tax treaty, along with updated commentary, was released in July 2017. This will bring to life the balance of tax treaty based BEPS changes.

Key issues arising for asset managers

Permanent establishment

PE is the threshold for the chargeability of a business to tax overseas. To avoid overseas PEs and tax exposure arising from overseas business activities, management staff of AIFs and asset managers have long relied on what is termed the dependent agent exemption. Under this exemption no overseas PE arose unless an agent was concluding contracts in an overseas jurisdiction for the home enterprise. The new threshold is an agent who, while overseas, 'habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification'. This ‘agent’ could be a fund manager working on finding, negotiating or closing an overseas deal, or the client relationship manager of a bank visiting clients and developing overseas business. Various examples given by the OECD materials explain that mere active promotion is not harmful, but active overseas business development where new clients subsequently agree to standard or pre-agreed contracts or pricing with head office will result in an overseas PE.

Importantly, many European and other tax regimes do not distinguish between revenue and capital (trading and investing). Therefore, an overseas PE can arise even if overseas activities are related to investment, rather than trading, by an AIF.

Required action

Asset managers will need to consider making changes to how they employ staff and agents overseas. The relevant action items are:

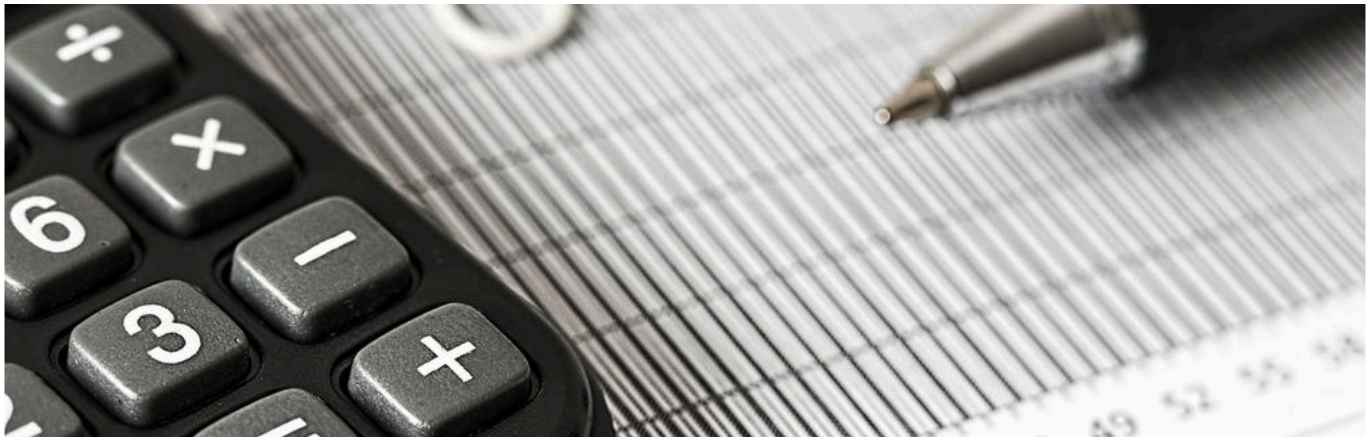
• In light of new PE risks, review existing operations and protocols and consider how those now require modification. Particular focus is required for guidelines regarding overseas negotiation and authorisation of contracts, and decision-making protocols and their implementation by operating staff;

• Review and map out existing overseas marketing, fund raising, deal sourcing activities and related staff to identify new PE risks.

• If a new PE risk materialises, appropriate profit allocation to that new PE is required along updated transfer pricing principles, inter alia to avoid any potential double taxation. Several countries, such as the UK, have decided not to implement this new PE standard by way of including a reservation in their MLI Positions document. Therefore, the MLI Positions and local rules of various overseas jurisdictions will have to be carefully considered as part of the above PE risk assessment exercise.

Access to treaty benefits

Access to tax treaty benefits for investment structures is now more difficult. Benefits will only be available if relevant new treaty tests are satisfied by a taxpayer: the principal purpose test (PPT) and/or limitation on benefits test (LOB). The relevant test for most of Europe is the PPT. Treaty benefits (for example exemption from, or reduction of, withholding tax) will not be available if the obtaining



of that benefit was one of the principal purposes of a structure or arrangement.

The OECD materials offer various options to governments to address treaty entitlement of regulated (non-alternative) fund structures, ranging from listing in bilateral tax treaties those fund forms that should have treaty eligibility to requiring funds to due diligence their investor base quarterly.

For the alternative fund sector, the above PPT rules apply, and three examples are given. The theme emerging from the various examples appears to be that taking into account the existence of a favourable tax treaty when creating a structure is not harmful, as long as there are other non-tax drivers for choosing a location - such as legal and regulatory framework, skilled workforce, investor familiarity, substantive activities at a regional platform etc. A new way of thinking will be required when drawing up structures.

The last of the three examples reflects a classic real estate fund structure involving a fund, master holding platform and individual investment holding companies. Helpfully the commentary suggests these structures may be able to pass the newly elevated treaty access hurdle, but the devil will be in the detail.

Required action

Asset managers must now:

• Review the substance of any entities in their existing structures availing themselves of tax treaty benefits, to assess whether any additional substance is required for continued benefit from tax treaties. Reviewing existing financing arrangements (at fund investor and asset level) will be part of this work, as many countries have now introduced rules along the BEPS interest relief restriction and hybrid mismatch recommendations;

• Consider, in light of the new guidance and examples given, if any previously employed structures can be recycled or sufficiently improved for new investments;

• Review alternative options when devising new investment structures. For example, consider whether reliance on domestic, rather than tax treaty based, exemptions is an option or whether there are any structures available with government-blessed preferential tax treatment, such as securitisation vehicles or REITs;

• A cost benefit analysis will be mandatory in each case.

Transfer pricing

Mounting pressure for transparency is the relevant theme arising from transfer pricing BEPS initiatives for the asset management sector.

Management companies and in some cases funds will be required to provide detailed information enabling tax authorities to conduct transfer pricing risk assessments and enquiries. The threshold for this sort of country-by-country (CbC) reporting and filing requirement is annual consolidated group revenue of €750m or more. The UK rules on CbC reporting capture multinational groups whose ultimate parent entities are partnerships governed under laws in the UK, including LLPs. The regulations will require the reporting partner of such partnerships to ensure compliance.

Separately from CbC requirements, the format of required transfer pricing documentation is also changing. The filing of a 'local' and a 'master' file is now required for taxpayers with cross-border controlled transactions in each jurisdiction where a multinational operates. This is likely to be required for most AIFs. The local file will look similar to current transfer pricing documentation, although some new and more detailed information will be required, such as expanded financial information. The master file will require an overview approach and detailed description of global operations. For example, the master file will require detail on group structure, mapping of group intangible property (including items such as customer lists and internally developed software), intercompany financial transactions, the group's financial and tax positions and certain tax rulings.

Actions

Impacted asset managers will have to:

• Identify, for disclosure purposes, intangibles and key value drivers. Review what could be classed as intangibles;

• Put systems in place that can track data in respect of revenue, pre-tax profit and taxes paid in each country where they operate;

• Review the data collated and consider if there are any particular transfer pricing risks within the wider group;

• The first CbC reports in respect of years ending 31 December 2016 are due by 31 December 2017. Asset managers will have to be mindful of local requirements as these will vary from country to country.

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Adapting for growth in alternatives

By George Sullivan, Executive Vice President,
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George Sullivan

In The Origin of Species, Charles Darwin told us, “a grain in the balance will determine which individual shall live and which shall die - which variety or species shall increase in number, and which shall decrease – or finally become extinct.”

The principles of evolution are highly relevant to the alternative asset management industry, where we’ve seen growth surge over the last two decades. New research from State Street[1] finds that more than 58 percent of alternative asset managers surveyed are confident in meeting their growth objectives over the next year. That optimism jumps to 78 percent over the five-year horizon. But future growth is far from guaranteed. With performance challenges, and mounting pressures from both investors and regulators, there’s no time for complacency.

An influx of capital from institutional investors puts new demands on alternative managers as global competition for high-quality assets heats up. Increasingly sophisticated clients are keenly focused on how fees are assessed, how investments are run and how risk-adjusted performance is reported. And sadly, the days of light-touch regulation are a thing of the past. For the alternative asset managers in our study, regulation governing liquidity risk and regulatory focus on investment fees are the two biggest perceived external threats to their growth prospects over the next five years.

Adapting to thrive

More than half (52 percent) of the alternative asset managers we surveyed say they’ll need to overcome significant operational inefficiencies to sustain growth for their firms. And 69 percent recognize that if they don’t improve operational agility, their competitors will be better placed to capture growth opportunities.

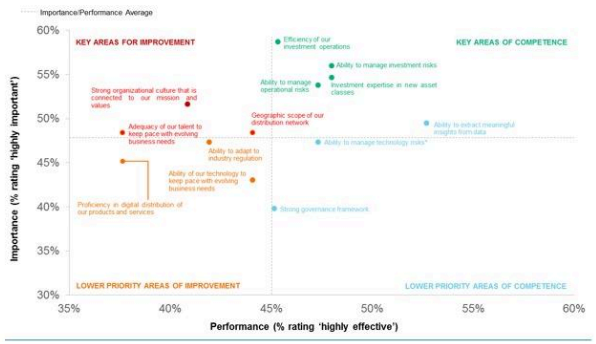
To better understand what’s keeping alternative asset managers up at night, we looked at what respondents in our survey rate as most important for enabling long-term growth versus their relative strengths and weaknesses today (Figure 1).

The results are telling. Across the alternatives sector, there are three areas that respondents deem to be critically important for their long-term growth, but also are relative weaknesses today.

1. Strong organizational culture that is connected to mission and values
2. Adequacy of talent to keep pace with evolving business needs
3. Geographic scope of distribution network

As the environment becomes more tightly regulated – and institutional investors demand closer control over their assets – alternative managers know that stronger governance will also be necessary. This means established processes and controls at both the fund and firm levels, and clearly separated responsibilities between front-, middle- and back-office personnel.

Figure 1: Mind the gap



Source: State Street 2017 Growth Readiness Study

New rules of engagement

The appetite for alternative strategies is growing, but managers must deliver tailored outcomes, transparent reporting and a differentiated offering. Our research identified some important misalignments between the areas that alternative managers believe they need to prioritise, and the areas that investors would like them to address (Figure 2). For alternative asset managers to win investor trust, they'll need to anticipate shifting needs. And equally important, they'll need to make sure they have the right resources in place to service investors' expectations.

Figure 2: Realigning expectations

What are the most important changes that asset managers will need to make over the next five years to remain attractive to investors?

Source: State Street 2017 Growth Readiness Study

Evolve to compete

With growth models under profound pressure, the needs of institutional investors are evolving. One of the biggest misalignments our research uncovered between investors and their alternative manager is related to fees. Thirty-nine percent of investors say managers should have more transparent costs. Yet only 12 percent of managers say the same. The alternative managers in our study do agree they'll need to bring fees down, but such a dramatically different response from investors suggests that clearer fee structures will be more important in the long term. Especially as alternative managers work to regain investor trust.

Another item that's further up on the agenda for investors than it is for managers? Bespoke solutions that align with investors' interests. According to our research, 44 percent of asset owners and insurers are planning to consolidate their use of external asset managers over the next five years. That means they'll be placing larger mandates with fewer providers. Managers that can deliver tailored solutions to meet investor objectives — whether it's through portfolio growth, liability matching or downside protection — will be best positioned to compete for new business.

To deliver on this, alternative managers told us that they have a clear need to improve their access to emerging market investment opportunities and to strengthen their front-office teams. These measures will help them better understand the specific investment needs of individual clients and match them with the right investment opportunities. This will also give managers the opportunity to improve transparency and create the tailored solutions investors are demanding.

Playing by the new rules

The alternative asset manager sector has seen tremendous growth in recent years. With more capital coming into the market, the environment is transforming faster than ever before. And it's testing alternative asset managers to the extreme. Our research finds an industry bullish about growth, but also aware of the significant challenges that lie ahead. Managers will need to more effectively anticipate the needs and expectations of their investors. The leaders of tomorrow will start now by focusing on new investment expertise, sophisticated tools and integral partnerships that can help them fulfill their growth ambitions. As Darwin showed us, only those who adapt will thrive.

[1] State Street commissioned Longitude Research to conduct a global survey of more than 500 investment industry executives, including 93 respondents from the alternative asset management sector, during March and April of 2017. Study participants spanned investment, operations, sales and distribution roles. Alternative asset manager respondents include hedge funds, fund of hedge funds, private equity and real estate funds.

ERISA rule changes – an update on the US Department of Labor Fiduciary rule

By Paul Koppel, Counsel, Clifford Chance

Paul Koppel

Investment managers of all types are currently contending with recent rule changes under the US Employee Retirement Income Security Act of 1974, as amended (ERISA) that alter when investment managers are subject to ERISA's regulation. Many of the changes are already applicable, and others may become applicable in the next 18 to 24 months. Investment managers who have not recently evaluated how their marketing and communications with investors are affected by ERISA should do so now.

ERISA governs and regulates private pension plans in the United States. ERISA imposes fiduciary responsibilities on those who manage ERISA plan assets, including a very high standard of care, restrictions on many forms of compensation for asset managers and a prohibition on self-dealing. ERISA also imposes limits on transactions between plans and parties in interest to plans (including certain service providers and certain of their affiliates) and fiduciaries to plans.

The Fiduciary Rule

On 6 April 2016, the US Department of Labor (DOL) published a new final fiduciary rule under ERISA and Section 4975 of the Internal Revenue Code, as amended (Code) and two new and six amended prohibited transaction class exemptions, which permit certain transactions with ERISA plans and individual retirement accounts that would otherwise be prohibited. The regulatory package is intended to address the conflicts of interest that may arise when persons give investment advice to plans for a fee.

Under the final rule, persons who provide investment advice or recommendations for a fee or other compensation with respect to the assets of an ERISA plan or an individual retirement arrangement (IRA) are fiduciaries. (The new rule also applies to advice given in respect of certain other US tax favoured vehicles that are not specifically intended to be used for retirement savings.)

The final rule has substantially expanded the types of entities and persons who will be ERISA fiduciaries by covering any persons who provide investment recommendations for a fee or other direct or indirect compensation.

Restrictions apply to typical compensation arrangements for an investment manager or fund manager who is an ERISA investment advice fiduciary: unless a prohibited transaction exemption applies, an ERISA investment advice fiduciary cannot receive commissions, sales loads, revenue sharing, incentive fees or other variable compensation or transaction payments from third parties. Any such fees could violate the fiduciary/ self-dealing provisions of ERISA, because a fiduciary may generally not control the amount or timing of the fiduciary's compensation with the investment advice. A violation of the ERISA prohibited transaction rules can lead to excise taxes, and a breach of ERISA fiduciary duties can require disgorgement of profits and a restoration of ERISA investors' losses; the consequences of being an ERISA fiduciary can be significant.

The rule applies to advice, suggestions and recommendations about investments for ERISA plans and IRAs. Although the new fiduciary rule has a much broader reach than the prior formulation, and more types of communications can turn someone into an ERISA investment advice fiduciary, there are specific limits on what constitutes fiduciary investment advice.

The communication must be a recommendation about a course of action to take or to refrain from taking. A "recommendation" has been characterized as a "call to action," which is a communication that a reasonable person would view as recommending that he or she actually buy, hold or sell a particular investment. The content, context and presentation would all need to be taken into account to determine whether a communication is in fact a recommendation, considering how individually tailored the communication is.

An ERISA fiduciary investment advice relationship is generally not created if advice, recommendations or suggestions about investments are not being given or a direct or indirect fee is not received in connection with the advice.

Department of Labor. (Shutterstock)

Even when a communication could otherwise create a fiduciary relationship, there is an exemption in the new fiduciary rule that allows investment fund managers and others who are marketing investments to engage in their typical marketing and other communications to ERISA and IRA investors without becoming a fiduciary. Persons who provide advice with respect to certain arms-length transactions, such as the sale, purchase, loan, exchange or other transaction related to the investment of securities or other investment property, to an ERISA plan or IRA or a fiduciary of either who is financially sophisticated and independent of the person providing the advice, will not be deemed to be an investment advice fiduciary if certain requirements set forth in the new rule are met.

Fund managers who are communicating with sophisticated independent fiduciaries who represent ERISA and IRA investors can obtain representations, including deemed representations, that should allow the fund manager to rely on the exemption described above. However, communications with ERISA and IRA investors who are not so represented will not have the benefit of the exemption. One needs to carefully consider how such communications should be scripted, so as to avoid being an ERISA investment advice fiduciary.

When will the new rules apply?

The new rule has faced a number of hurdles, as is shown in the table below, which have culminated in delays to full implementation.

The Fiduciary Rule – chronology of events

- On 20 April 2015 the US Department of Labor (DOL) published proposed regulations that were intended to expand the circumstances in which a person providing investment advice to an employee benefit plan subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA) (an ERISA Plan) or an Individual Retirement Account (IRA) would be considered a "fiduciary" under ERISA and for purposes of the excise tax provisions of the Internal Revenue Code of 1986, as amended. In 2010 the DOL had proposed an expanded fiduciary definition but withdrew that proposal after it received many adverse comments related to the additional burdens that the proposal created.
- On 6 April 2016 the DOL published a new fiduciary rule, which replaced a 1975 regulatory definition and provided a new regulatory definition of investment advice fiduciary and new and revised prohibited transaction class exemptions under ERISA and Section 4975 of the Internal Revenue Code, as amended (Code).
- The effective date of the new final regulations and class exemptions was 7 June 2016, but compliance had not been required until 10 April 2017, and in some cases full compliance was not required until 1 January 2018.
- On 3 February 2017 the President of the United States directed the DOL to update its

analysis of the likely impact of the new rule on access to retirement information and financial advice.

- On 2 March 2017 the DOL proposed a 60-day delay of the applicability date of the final regulations and the class exemptions.
- On 7 April 2017 the applicability of the new rule was delayed from 10 April 2017 until 9 June 2017.
- Many elements of the new and amended prohibited transaction exemptions are currently not effective until 1 January 2018.
- The 9 June 2017 provisional effective date was announced on 23 May 2017.
- On 29 June 2017 the DOL asked for comments as to whether elements of the new rule or the certain of the new and amended class exemptions should be delayed past 1 January 2018, and whether it should be modified.
- On 30 August 2017 the DOL officially proposed delaying full implementation of the fiduciary rule's key prohibited transaction class exemptions until 1 July 2019.

The DOL has proposed that full implementation of two of the key components of the complete regulatory package be delayed until 1 July 2019 (the full implementation for those two and some other portions is already being delayed until 1 January 2018). Those components are relevant for persons who are intentionally acting as a fiduciary with respect to ERISA and IRA plans, and one of those components, the so-called "Best Interest Contract Exemption," in its current transitional form, provides a framework for giving actual investment advice to ERISA and IRA plans that are not represented by independent sophisticated fiduciaries while retaining traditional forms of compensation. That framework does require that the person giving advice to agree to be an investment advice fiduciary, and while there are limited procedural steps to follow during the transition period, one should discuss with counsel before agreeing to be an ERISA investor's fiduciary, even for a limited purpose.

Will the new rules be changed or rescinded?

The DOL is currently considering whether to revise the entire regulatory package, and while the new fiduciary rule is in effect right now, it may be changed or rescinded. We will provide updates as developments occur.

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The Senior Managers & Certification Regime: The HR perspective

By Hayley Robinson, Partner, Employment and Matthew Ramsey, Professional Support Lawyer, Employment at Macfarlanes LLP

Matthew Ramsey

Hayley Robinson

Introduction

The purpose behind the introduction of the Senior Managers & Certification Regime (SM&CR) back in March 2016 was to create a system that drives individual accountability in firms. The FCA emphasises that it wants "all firms to develop a 'culture of accountability' at all levels and for senior individuals to be fully accountable for defined business activities and material risks". For firms this shift in emphasis has implications, not only from a compliance perspective, but it may well also require a revamp of many of their HR practices. Consultation on how the rules will apply is ongoing and the final rules are expected in early 2018. This will not leave much time before the extended regime comes into force and so some advance planning is recommended.

The SM&CR has already replaced the Approved Persons Regime for banking firms, and the FCA intends to roll out a modified version of the regime to all regulated firms from 2018. Helpfully, the FCA recognises that it is not appropriate to use an identical model in applying the regime to the wider financial services industry. Instead, the FCA has adapted the tools and principles from the banking SM&CR to be more in line with the different risks, impact and complexity of firms in scope of the extended regime. The consultation paper also highlights the FCA's focus on developing a flexible and proportionate SM&CR, to account for the different governance structures and business models of firms.

Proposed model for asset managers

The FCA proposes a three-tier model for the new SM&CR:

Core Regime

The FCA proposes to apply a standard set of requirements to all firms that it regulates, which are not currently subject to the SM&CR (solo-regulated firms) and which do not fall into either the "Enhanced Regime" or the "Limited Scope Regime" described below. It refers to firms in this regime as "Core Firms". These requirements are further divided into the same three elements as the current SM&CR: (1) the Senior Managers Regime; (2) the Certification Regime; and (3) Conduct Rules.

Under the Senior Managers Regime element, individuals performing FCA-defined "Senior

Management Functions" will need FCA approval before starting their role. These individuals will be "Senior Managers", who must also have a "Statement of Responsibilities" setting out clearly what they are accountable and responsible for. Core Firms must allocate Prescribed Responsibilities to the appropriate Senior Manager. In addition, each Senior Manager will be under a "Duty of Responsibility", meaning they could be held accountable for a regulatory breach within their area of responsibility if they did not take reasonable steps to prevent that breach.

The Certification Regime applies to individuals who are not Senior Managers but who may cause significant harm to the firm or to customers due to the nature of their role. Such individuals do not need prior FCA approval but firms must certify that they are fit and proper to perform their role at least once a year.

The Conduct Rules set high-level standards of behaviour and apply to all employees in a financial services firm, with certain rules only applying to Senior Managers.

Enhanced Regime

For a small number of solo-regulated firms whose size, complexity and potential impact on consumers justify further attention (Enhanced Firms), the FCA plans to impose additional requirements. Enhanced Firms will include those with assets under management of £50 billion or more (at any time over the past three years) and investment firms categorised as "significant IFPRU investment firms" for prudential purposes.

Additional Senior Management Functions will apply to an Enhanced Firm's business, and such firms will have to allocate more Prescribed Responsibilities compared to Core Firms. The FCA also proposes that Enhanced Firms comply with the requirement to have adequate handover procedures, where a person taking over a new role as a Senior Manager must have all the information and material that they could reasonably expect to perform their role.

In addition, the requirement to have a single document setting out management and governance arrangements (a Responsibility Map) will apply to Enhanced Firms. Such firms must also ensure that there is a Senior Manager with overall responsibility for each area of the firm.

Limited Scope Regime

Firms subject to a limited application of the current Approved Persons Regime will only have to comply with a reduced set of requirements (Limited Scope Firms). This includes internally managed AIFs, limited permission consumer credit firms and sole traders.

Apart from the obligation to allocate Prescribed Responsibilities, Limited Scope Firms will have to comply with the same requirements as Core Firms (as summarised above). Fewer Senior Management functions will also apply to Limited Scope Firms.

HR implications

The impact of the new regime requires advance planning from both compliance and HR perspectives. The HR implications of the regime are substantial: recruitment, the drafting of employment contracts, appraisals, performance management, training, employee exits, and the giving of references will all need to be reconsidered in light of the SM&CR.

Recruitment

Senior Managers will need regulatory pre-approval in order to take on Senior Management Responsibilities. Certification Staff will also need to be approved, but firms (not the regulator) will have the regulatory burden of certifying these employees' fitness and propriety. Firms may therefore need to consider building conditional offers and additional pre-employment screening into their existing recruitment processes.

For Certification Staff, firms will also need to consider who in the business will assess fitness and propriety. A Senior Manager will have responsibility for that task, but in some firms the number of candidates may make it impossible in practice for them to be involved in each individual assessment.

Employment contracts

Senior Managers will have a regulatory duty to ensure the new functions and responsibilities imposed on them by the SM&CR are properly performed but it will be desirable from a HR perspective (and for the sake of clarity) to create a separate and additional contractual duty to do this by recording the changes in their employment contracts.

More generally, a firm will want to ensure that it has the flexibility to take the necessary action in order to comply with those of its regulatory obligations which impact upon employment issues, for example, in relation to poor performance and misconduct of employees; long-term absences of employees performing regulated functions; ensuring a smooth transition from Senior Managers to their successors; breaches of the Conduct Rules by employees or failings in fitness and propriety.

Appraisals

The obligation to assess the fitness and propriety of Senior Managers and other Certification Staff not only arises on recruitment. Firms must also assess this on at least an annual basis. This is likely to form a new part of firm's annual appraisal exercises, but firms will also need to consider how often to repeat their various background checks (criminal record checks, credit check etc), how to deal with poor performers, and whether to offer an appeal against an unfavourable decision.

Performance management

SM&CR will not fundamentally change a firm's approach to addressing instances of misconduct and poor performance but some of the core principles will colour the lens through which an individual's conduct is judged and introduce a number of additional considerations for disciplinary or performance procedures.

The interaction of firm's internal procedures and the firm's external relationship with the regulator will be an important consideration for disciplinary investigations, and firms will also need to be alive to the possibility that not all breaches of the Conduct Rules will amount to misconduct allowing dismissal.

Training

SM&CR imposes certain express obligations on firms to train their staff and, by virtue of its impact upon other elements of the employment life cycle, may trigger additional training requirements. Ensuring the firm has adequate training in place is also one of the Prescribed Responsibilities that must be allocated to a Senior Manager. In many cases, it will fall to the HR team to develop appropriate training materials and implement a timetable that ensures training on a sufficiently regular and timely basis.

There are some challenges in implementing the FCA's requirements on Conduct Rules training, particularly as there is a need to: (i) provide tailored role-based training to all employees; and (ii) take reasonable steps to ensure employees understand the Conduct Rules. Banking institutions have therefore dedicated extensive resources to develop appropriate learning content, including computer-based training programmes that incorporate an assessment.

Compulsory training is likely to be the most effective method for demonstrating compliance to the FCA.

Employee exits

Firms must submit a Statement of Responsibility to the FCA whenever there is a significant change in the Senior Manager's responsibility. This will include when one Senior Manager leaves and is replaced. The timeframe for notification and the formal requirements are set out in detail in the FCA Handbook.

Enhanced Firms should also submit an updated Responsibilities Map, and must also establish policies to ensure that Senior Managers taking on new responsibilities have all the appropriate information to perform their responsibilities effectively. In practice, it will often only be the preceding Senior Manager that will have all the necessary information readily available. Whilst the rules stop short of requiring Senior Managers to provide “handover certificates” to their successors, firms will want to ensure that outgoing Senior Managers contribute to the material to be provided to their successor, likely in some form of a handover document.

Some firms may want to consider introducing an express contractual obligation for outgoing Senior Managers to provide handover certificates. An alternative might be to make any exit package conditional on a satisfactory handover certificate, or to require Senior Managers to maintain a rolling

handover document to facilitate a successful handover process.

References

In order to prevent the “recycling of individuals with poor conduct records between firms”, the FCA has implemented a new regime of regulatory references. The requirement to obtain regulatory references came into force for first-wave institutions in March 2017. The extension of SM&CR proposes to extend this requirement to all firms. Balancing the firm’s regulatory obligations, its duties to the outgoing employee/future employer, and the desire for confidential exit settlements will need careful consideration. For instance, the template reference requires disclosure of concluded disciplinary action taken against the individual that relates to regulatory conduct requirements and the test for fitness and propriety. However, it is not uncommon for an individual to leave (whether under an agreed exit or due to resignation) before the employer has concluded a disciplinary process. The rules give guidance on whether to include unconfirmed disciplinary allegations in a reference but it will be for each employer to balance competing obligations. Deciding whether to include uninvestigated or unproven allegations in a reference will be a judgement call depending on the circumstances and the severity of the alleged conduct.

In a regulatory context an agreed reference is typically a key part of a negotiated exit deal. However, a firm may not enter into any arrangements or agreements which limit its ability to give a proper regulatory reference. While it is still possible for an employer to agree the wording of a regulatory reference with an employee, that agreement may not restrict the firm providing more information to a prospective employer or the regulator if required or amending or updating the reference if new information comes to light. Therefore, settlement may now be harder to reach and employees more inclined to see out the disciplinary and appeal process as a means of proving their innocence.

Next steps

Assuming that the final model is structured in line with the consultation, asset managers should begin work now to ensure their systems and controls are adequate for the new regime. This is likely to require close cooperation between compliance and HR professionals. The increased regulatory burden on firms undoubtedly poses significant challenges, for firms and individuals, but this only underlines the desirability of advance preparation.

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The MiFID II research challenge / opportunity – Implications for alternative managers

By Neil Scarth, Principal, Frost Consulting

Neil Scarth

MiFID II will have a revolutionary effect on the way that most managers find, value and procure investment research – on a global basis. This requires the immediate attention of senior management given the rapidly narrowing timelines involved (Jan. 3, 2018) and the economic/ competitive implications of MiFID II policy decisions.

The evolving competitive environment also means hedge funds may receive significant regulatory attention surrounding their research valuation policies if they choose to use client money for research – at least in the UK. This is because an increasing number of large long-only funds have elected to pay for research via P&L, meaning many of the MiFID II requirements do not apply. Consequently, hedge funds may be in the regulatory spotlight.

The FCA is expected to systematically request managers' (required) MiFID II Research Valuation Policies in early January, to guide their further supervisory investigations.

The MiFID II-related changes on the asset manager's research process will have knock-on effects on:

- The economics of the sell-side research model (resulting in less research).
- The economics of asset managers whose research funding mechanism will have a profound impact on their profitability and competitive positioning.
- The relationship between asset managers and asset owners, who will be directly involved in the research funding discussion for the first time.

Key MiFID II research requirements

If managers are using client money for the purchase of research (either via the accrual (Swedish Model), or via CSA-funded RPAs,), managers must:

- Present finite monetary research budgets to asset owners in advance, based upon the actual investment products owned by the client.
- Have asset owners approve these budgets.
- Demonstrate, on an ex-post basis, which research services were purchased at the portfolio level and how those services benefited the portfolio
- Value unpriced investment bank research services
- Eliminate fund cross-subsidization.
- Use research budgets for all asset classes.
- Produce a MiFID II Written Research Valuation policy (Equivalent of "Best Ex" policy) that specifies the methodology used by the manager to value research and how the manager fairly divides research costs between clients.

From an operational perspective, these requirements represent an immense change from the historically laissez-faire system in which large amounts of sell-side research were ingested with little consideration given to which of it was used or useful and its actual value. Research payments were via bundled brokerage commission that varied with AUM, turnover and share prices.

Most research commission allocation was done by "broker-vote" systems which regulators have made clear are not sufficient in isolation to meet MiFID II requirements.

The first step is for managers to derive a research budget that meets their needs. However, the requirement that the budget must be tied to the particular product owned by the client means that, for many firms, a firm-wide budget may not be sufficient if the firm runs multiple products in with differing research requirements (geography/sector/asset class).

Many firms will construct strategy-based budgets of funds which consume similar research with the key determinant being that research costs are allocated fairly to clients.

Firms will have to determine what kinds of research are necessary, which producers of that research are essential, and will then have to value it on a strategy-specific basis. Regulators, and asset owners increasingly recognize that all strategies do not require the same amount of research or size of research budget. Consider a small-cap strategy in a limited geography with an investible universe of

200 stocks, versus a global product with a universe of 15,000.

Different strategies may require very different research inputs reflecting their investment process, growth/value/geography/style etc. Fortunately, the regulators recognize that a research service may be worth very different amounts to different investment strategies.

What is the value of an excellent analyst report of Facebook to a deep value investor? (Likely not high as the stock is so expensive that value managers would not be allowed to own it). However, the same product may be critical to a growth investor which has a portfolio dominated by Facebook related thematic investments.

Beauty is in the eye of the beholder. Managers should be able to identify and value the research services their strategies require, and identify those which they don't need and therefore shouldn't spend their clients' money purchasing. Frost views the "right" price of research to be – the amount you have to pay to get the external research that your strategies need to deliver their targeted returns to

investors. By definition, if the strategy does not require external research to generate its returns, than none should be bought – using anyone's money.

However, the vast majority of active equity strategies do require external research, which enhances returns and creates efficiencies for both asset managers and asset owners. They key consideration in the upcoming presentation of initial MiFID II research budgets to asset owners, is for the manager to demonstrate that the proposed research spending directly supports the portfolio objectives that were agreed when the investment was made.

In this, the interests of the asset manager and asset owner are completely aligned: nobody wants the investment product to perform as designed more than the asset owner, as it's in their portfolio and plays a key role in their own targeted return and risk budget calculations.

In the long-term, the global impact of MiFID II will be commercial rather than regulatory. It is the direct involvement of the asset owner which is the key driver.

If nothing else, MiFID II will permanently change the research transparency expectations of European asset owners – who allocate globally. By January, European asset owners will have received many research budget proposals from their European managers, some of whom will be running similar mandates. Which ones will they approve?

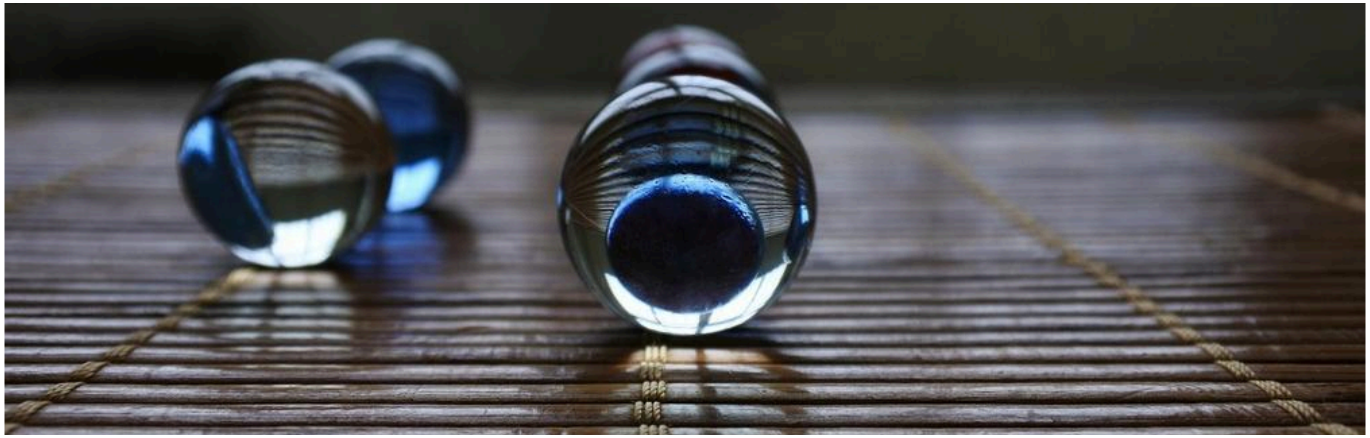
In the US, the moment a trustee receives advice from a manager that money is to be deducted from their account for research, it creates an immediate fiduciary responsibility to challenge that proposal or accepted it. As the European managers of US asset owners deliver proposed research budgets, how are those US clients going to view managers that do not provide that transparency.

Frequently it will be the (compliance-driven) global operating procedures of large managers that roll out MiFID II rules globally, which will alter the competitive landscape in all of the geographies in which they operate.

The implications for asset managers are huge. If asset owners reject research budgets, managers will have to fund research from their own P&Ls, potentially creating an uncomfortable conflict of interest between purchasing the best research for the client versus firm profitability. The profitability of some active equity strategies could fall sharply under those circumstances.

These firms will have less research spending capacity, lower profitability and lower external research service levels than firms which do convince asset owners to continue to fund their research budgets.

Further complications can arise if some investors in a co-mingled product refuse to pay for research



while others remain willing to do so.

For hedge funds with high fee structures, the disclosure of another discrete costs may be unhelpful – particularly if the fund's research budget is higher than long only managers. (Most funds have little idea of how their research spending stacks up against competitors). They will have no idea how competitors are presenting their research budgets (quantum, level of aggregation) – particularly in directly competing or similar products,

The presentation of initial client MiFID II research budgets in 2H 2017 will be a watershed event for the industry. Managers will have to:

- Establish a multi-asset class research valuation methodology
- Develop a strategy for the delivery of client research budgets
- Decide how to handle clients that don't want to pay

Because managers will have no visibility on the approach of their competitors, all they can do is to ensure that their research budgets are aligned with the investment process agreed with the client when the investment was made.

They will have one chance to get this right. Managers who have their initial research budgets rejected by asset owners will find it difficult to reverse this outcome.

Pension funds in the US are already starting to benchmark asset manager research spending (Research "TCA") in anticipation of receiving MiFID II research budgets.

Two dominant approaches have evolved to help managers meet this challenge.

One model, championed by the banks, relies on research product consumption to justify research payments. This raises a number of issues. Does the manager value all the research they've been sent by the producer? Does short-term research product consumption equal long-term research value? (Many analytical relationships take years to develop. PMs may have important analytical relationships with analysts whose reports they never read). Do managers want the banks to determine the value of a manager's research based on unsolicited input from the banks?

An alternative approach values research services based on their expected contribution to risk-adjusted return at the portfolio or strategy budget level. This ensures alignment between the research budget and the portfolio process that has been agreed with the asset owner.

Critically, it allows the asset manager to value any type or bundle of research services (priced/unpriced/independent/investment bank/consultant) based on the managers investment process, investment products, portfolio construction and the way its investment professionals use research. This process creates a manager-specific multi-asset class research valuation methodology which allows managers to independently assess increasingly complex and non-comparable bank research price frameworks to establish which are the best fit/value for the manager, given its unique investment approaches.

The primary objective of the first approach is to maximize research revenue to the banks. The priority of the second approach is to maximize the probability of MiFID II research budgets being approved by both clients and regulators.

If an asset manager and an asset owner have agreed a research budget, and, the manager can demonstrate that the research spending directly supported the portfolio objectives agreed between the two, the role of the regulator is vastly reduced. In fact, it is eliminated, as their objectives (and those of the client) will have been achieved.

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Comparison of two fund vehicles: the Hong Kong OFC and the Cayman exempted company

By Mary Nieto, General Counsel at Deacons

Mary Nieto

With the launch of Hong Kong's open-ended fund company (OFC) vehicle tipped for 2018, the Government aims to deliver on one facet of its long-stated policy initiative of bolstering Hong Kong as a full-service asset management hub.

For Hong Kong based managers, the preferred hedge fund structure has tended to be an offshore limited liability company, typically domiciled in the Cayman Islands. In the retail space, managers looking to establish a Hong Kong platform have opted to seek local authorisation for either an offshore vehicle or, more recently, a Hong Kong unit trust. The policy aim of the OFC is to offer an alternative local legal structure for funds and to boost Hong Kong as a fund domicile.

In this article, we examine the key advantages and perceived disadvantages for a Hong Kong manager in using the OFC, based on current proposals, when compared to the most common type of Cayman Islands' investment vehicle, the exempted company (Cayman fund). In its Fund Management Activities Survey published in July 2017, the Securities and Futures Commission (SFC) valued Hong Kong's combined fund management business at $18,293 billion as of 31 December 2016. Will the OFC entice more managers and sponsors to set up their funds in Hong Kong?

Regulatory framework

The legal framework for the establishment of OFCs is set out in the Securities and Futures (Amendment) Ordinance 2016, which was enacted in 2016 and amends the Securities and Futures Ordinance (SFO). It is expected to come into force in 2018. Detailed rules (OFC Rules, subsidiary legislation to the SFO) and a non-statutory OFC code (OFC Code) are the subject of an SFC consultation which closed on 28 August 2017.

Proposals for a profits tax exemption for certain privately offered OFCs are set out in the Inland Revenue (Amendment)(No.4) Bill 2017 (Tax Bill).

The OFC structure is designed to be used by both retail and private funds. Retail funds in Hong Kong must be authorised by the SFC for public sale under the SFO. The conditions for authorisation are set out in the SFC's Code on Unit Trusts and Mutual Funds (the UT Code). As OFCs are collective investment schemes, the OFC regime will be established under the SFO and supervised by the SFC rather than the Companies Ordinance and Registrar of Companies (CR) framework.

Single jurisdiction

The advantages for a Hong Kong manager in setting up an OFC over a Cayman fund largely centre around the savings in management time and money, and the simplicity, in dealing with one jurisdiction instead of two.

Use of a Hong Kong domiciled vehicle by a Hong Kong manager avoids the Cayman layer of service providers – auditors, lawyers, corporate services –

and allows for a single regulator, the SFC, for both the manager and the fund. Instead of dealing with both the Cayman Islands Monetary Authority (CIMA) and the SFC, the manager may focus on dealing with one regulator and complying with one regulatory regime and may enjoy relatively lower regulatory fees.

As an adjunct to the single regulator approach, the SFC is proposing a streamlined application process. The OFC establishment and registration process involves dealing with one authority (the SFC) who in turn will deal with the CR for the incorporation certificate and the Inland Revenue Department for the business registration certificate. Similarly, post-establishment, the SFC has proposed a streamlined process for ongoing filings, with filings requiring SFC approval being submitted only to the SFC and filings not requiring SFC approval being submitted only to the CR.

The OFC also allows for a simpler fund operating structure, with a Hong Kong manager serving a Hong Kong fund and no requirement for an offshore manager - one less entity to establish and maintain – and no requirement for the fund's

directors to be CIMA registered or licensed.

Additional requirements

Drawbacks to adopting the OFC structure largely impact private funds and their managers. The level of prescription and oversight which is contemplated by the OFC regime, whilst familiar to operators of Hong Kong authorised funds, will be new to managers of private Cayman funds. Here we set out some of the key additional obligations and requirements:

- **Constitutional documents:** The OFC's governing document will be an instrument of incorporation with certain provisions prescribed by the SFO, such as a provision as to the kinds of property in which the OFC can invest. Any material change to the instrument of incorporation will require the SFC's approval. The Cayman fund does not have prescribed provisions in, and CIMA's approval is not required for any changes to, its memorandum and articles of association.
- **Name:** The name must end with "OFC" or "Open-ended Fund Company"; must not, in the opinion of the SFC, be misleading or otherwise undesirable; and must not be the same as the name of another OFC. Any change of name is subject to the SFC's approval. In contrast, the name of a Cayman fund must not be the same as the name of another existing company, must not contain certain sensitive words and may choose not to include "Limited" or "Ltd" in its name. No approval is required to a change of name, subject to these confines.
- **Investment scope:** A privately offered OFC may only invest in securities and futures contracts (plus OTC derivatives once the new Hong Kong licensing regime for OTC derivatives comes into effect), cash, bank deposits, certificates of deposit, foreign

currencies and foreign exchanges contracts, with a maximum of 10% of gross asset value in other assets classes. As shares in private companies are not "securities" under the SFO, the OFC will likely not be a suitable option for private equity managers. There are no restrictions imposed by the Cayman regime on investment strategies of Cayman funds or their use of leverage.

- **Directors:** An OFC must have at least two individual directors including at least one director that is independent of the custodian. The appointments are subject to the SFC's approval, and the SFC will require the directors to be appropriately qualified and experienced. By contrast, CIMA requires directors to register but does not impose an approval process nor any requirements as to qualifications, experience or independence.
- **Removal of directors:** It is not uncommon for Cayman funds to be structured with different voting rights so that, for example, one class has the right to vote on the appointment and removal of directors, whilst the other classes have the right to vote on all matters other than the appointment or removal of directors. The OFC Rules as currently drafted prohibit such structures.
- **Custodian:** An OFC must appoint a custodian which is approved by the SFC and meets the eligibility requirements set out in the UT Code, even if it is a privately offered OFC. The custodian is required to take reasonable care, skill and diligence to ensure the safe-keeping of all the OFC's property. A Cayman fund sold in Hong Kong is not required to appoint a custodian unless it seeks SFC authorisation for public sale. In practice, many hedge funds appoint one or more prime brokers, and many prime brokers may not meet the eligibility requirements under the UT Code and may not agree to accept more onerous liability than the Cayman fund model.
- **Investment manager:** An OFC must appoint an investment manager which is licensed by or registered with the SFC for type 9 (asset management) regulated activity. The appointment is subject to the SFC's approval. The investment manager must be and remain "fit and proper" throughout its appointment. Whilst there are no prescriptive requirements for the investment manager of a Cayman fund, in practice a hedge fund manager operating its business in Hong Kong will hold a type 9 licence.
- **Valuations:** The OFC Code requires that the valuation and pricing of the OFC's property is within the investment manager's remit. This is inconsistent with the typical hedge fund model, where valuation and pricing is the responsibility of the board of directors and is typically delegated to the fund's administrator.
- **Ongoing compliance:** The OFC Rules and OFC Code contemplate a number of post-registration compliance requirements which have no parallel in the Cayman regime. For private OFCs, material changes, such as to the OFC's investment objectives and policy or its maximum permitted leverage, require shareholders' approval and are also subject to the SFC's approval if such change involves an amendment to the instrument of incorporation.
- **Termination:** Termination, even for a solvent OFC, requires a submission of proposal to the SFC. The OFC regime grants the SFC the power to terminate an OFC in certain circumstances, such as a breach of the OFC

Rules. No equivalent vetting process is afforded to CIMA for a Cayman fund.

- **Tax:** Transfers of OFC shares will be subject to Hong Kong stamp duty, in contrast to Cayman funds that maintain their register of shareholders outside Hong Kong. Offshore funds enjoy an exemption from Hong Kong profits tax where their central management and control is located outside Hong Kong. Funds authorised under the SFO in Hong Kong are exempt from profits tax. The Government has proposed, in the form of the Tax Bill, a profits tax exemption for private OFCs, subject to a number of conditions and anti-avoidance measures such as the requirement that the OFC is "non-closely held". The proposals have drawn criticism for being both complex and unclear.
- **Safe harbours:** For funds that have a corporate legal structure, the Companies (Winding Up and Miscellaneous Provisions) Ordinance (CWUMPO) provides a number of safe harbours from the SFO prohibition on marketing unauthorised funds to the public. As the OFC will be established and incorporated under the SFO, it will not be a "company" and therefore privately offered OFCs may not enjoy the CWUMPO exemptions but rather must rely on the more limited exemptions under the SFO (i.e. the fund may only be marketed to "professional investors" and/or in other circumstances that do not amount to an offer to "the public").

Hong Kong fund industry participants have welcome the Government's commitment to the introduction of an alternative vehicle for Hong Kong domiciled funds. The level of SFC oversight and prescription in the proposed OFC Rules and OFC Code will be largely familiar to managers and custodians of SFC-authorised funds. However, the OFC regime as currently drafted (together with the complexities of the proposed profits tax exemption in the Tax Bill) faces a significant challenge to tempt private fund managers away from the flexible, simply-established and more lightly regulated Cayman structure. Appetite for the OFC is therefore likely at the outset to be weighted more to the retail sector.

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Increasing focus on European ETFs

By Jeff Mackey, Financial Services and Investment Management at Dechert

Jeff Mackey

The rise of passive investment strategies and the growing momentum of investment in exchange-traded funds (ETFs) has not gone unnoticed by European regulators. The Central Bank of Ireland (Central Bank) recently released a fact-finding Discussion Paper on ETFs (Discussion Paper).[1] It is expected other European regulators may follow a similar route, with the goal of ensuring that such regulators properly understand, and can efficiently regulate, ETFs.

Specific European ETF guidelines were most recently issued by the European Securities and Markets Association in 2014, and it is uncertain whether, and if so when, any further rules and regulatory guidance on European ETFs will follow.

However, it is clear that as the focus on ETFs by investors continues, so too will the focus of regulators. Accordingly, the matters raised in the Discussion Paper may provide insight as to the regulatory thinking and priorities that may impact ETFs at both a European and global level in the future.

Investor focus

The current flows of investment into European ETFs can be attributed to a multitude of factors, including:

- *Cost verses performance:* The general industry focus on and downward trend in fees is coupled with longer-term comparable performance data for active and passive strategies. In many instances, the data suggests that active strategies are being outperformed by passive, leading to increased flows of investment into passive ETFs.
- *Rise of "Robo-advisors":* The trend towards automation and technology solutions in the investment management industry is demonstrated by the increased use of "robo-advisors" – automated digital platforms that process client data through a set algorithm to offer investment recommendations (or automatic investment). Despite its limitations, robo-advice is gaining significant traction due to the range of benefits offered to certain types of investors. Such benefits include: lower fees; greater portfolio transparency; the ability to control one's own portfolio; and, crucially, the ability to do all of the above online. ETFs are often the financial products that sit beneath the algorithm and are used by robo-advisors primarily because they are low cost while providing access to a broad range of "market" strategies.
- *Additional "buy-side" strategies:* Investment funds have invested in ETFs for many years, as ETFs historically have been – and remain – an efficient and liquid method of investing cash balances. Presently, investment funds are making wider use of ETFs, as they may be used for a variety of investments (such as specific allocation to a strategy or market), as part of a hedging strategy, or as a method of gaining

exposure to a specific index (and thereby avoiding the margin requirements of derivatives).

- *Diverse products:* As the ETF market evolves, particularly in Europe, a diverse range of ETF products and strategies has become available to investors. New ETF products with strategies such as gender diversity or socially responsible investment have been launched. These new products are often developed by traditional ETF providers looking to expand their existing product range. Similarly, active managers are venturing into offering ETFs, either to provide their existing investors with the full suite of products (both active and passive) or as an opportunity for new capital flows. These active managers are bringing their strategies into the ETF arena and expanding the range of products available.

Central Bank of Ireland. (Shutterstock)

As investment flows into ETFs continue at a steady pace, and as more reasons to invest in ETFs become apparent, European regulators are carefully monitoring these developments.

Regulatory focus

The fact that the Central Bank is looking more closely at ETFs is no surprise. Ireland is one of the principal domiciles for European ETFs, with more than $287bn (nearly half of all investment in European ETFs) invested in approximately 688 Irish ETFs.[2] On the release of the Discussion Paper, the Central Bank commented that “ETFs are the most important product development the investment funds industry has seen in the last 20 years – this is evident from their exponential growth.... We encourage both industry and investor representatives and other regulators to enter into dialogue with us.”

It is expected that other regulators will follow suit on seeking to obtain additional information on ETFs. It has been reported that the French regulator, the Autorité des marchés financiers, is examining ETFs and the market in general, while at a global level it is expected that the International Organisation of Securities Commissions (IOSCO) will undertake a review of the ETF industry.

The Discussion Paper provides valuable insight into the regulatory thinking and potential focus for any ETF regulation going forward, both at a European and global level. In the Discussion Paper, the Central Bank indicates it does not currently envisage the Discussion Paper will lead to new Irish ETF regulations – rather, the exercise is primarily intended to contribute to the international debate as well as the risk assessments that regulators continually undertake to supervise the market effectively. However, the Discussion Paper recognises that additional guidance (in consultation with the industry) may be warranted with respect to particular aspects of ETF practices, and that innovative investment products require close regulatory attention "to ensure that the benefits of innovation are delivered within a robust, but enabling, regulatory framework".

Macro themes

The Discussion Paper offers the Central Bank's understanding of a range of ETF-specific matters, including: dealing arrangements; risk factors; market liquidity; and particular types and features of ETFs. The Discussion Paper also raises various questions for response by industry stakeholders, in order to obtain further market insight. The Central Bank discusses these matters and raises questions against a background of what it identifies as "overarching" themes, including:

- *Investor expectation and understanding:* In light of the increased investment in ETFs, and corresponding broadening of the investor base, the Central Bank wants to ensure that investors understand, and can properly assess the risks of, their ETF investments. By way of example, European ETFs are predominantly authorised as undertakings for collective investment in transferable securities (UCITS), which are subject to a range of investor protection mechanisms. However, the Central Bank has queried whether investors in ETFs authorised as UCITS are aware that such investors do not directly benefit from those protection mechanisms (as they are not seen as the investors of record of the UCITS).
- *Liquidity:* The Central Bank looks at an ETF's liquidity risk from two different angles: (i) in relation to the ETF's underlying assets (similar to any other investment fund); and (ii) the liquidity of the ETF's shares as affected by the ETF creation/redemption mechanism and dependence on the role of Authorised Participants (APs).
- *Growth of ETFs and market impact:* The Discussion Paper recognises that the regulatory assessments of ETFs focused on the structure of ETFs at a time when ETFs had a much smaller market share. With the increased investment in ETFs, the Discussion Paper queries whether the original benefits of ETFs remain as the product gains market share, and whether the current regulatory framework can continue to bear the weight of further ETF growth.

Micro themes

The Discussion Paper also has several micro themes as to which the Central Bank is seeking specific information. These include:

- *Unique role of the authorised participant:* The Discussion Paper recognises the unique "link" that APs play in the markets through which ETF shares are traded. APs are not service providers to the ETF – they are commercial market participants with no obligation to create or redeem shares or to provide liquidity. As a result, and given the central role APs play in the operation of an ETF (as the primary channel through which shares are bought from and redeemed by the ETF), the Discussion Paper considers whether it would be beneficial to investors and regulators to require public disclosure of the identity and remuneration models of APs. Similarly, the Central Bank has raised concerns as to how secondary market investors might directly deal with an ETF in circumstances where the AP primary market arrangement has broken down. In light of specific operational issues with the "creation" of shares mechanism in the primary market, the Discussion Paper queries whether share classes should be permitted to be structured having regard to the operational concerns of APs (for example, with differing dealing deadlines). Further, the Discussion Paper queries whether regulators should consider a "scenario analysis" relating to the role of the AP in overseeing the risk management activities of the ETF.

- *Impact of "stressed market conditions":* A recurring theme throughout the Discussion Paper is the impact that extreme or stressed market conditions may have on the operations of an ETF and, in particular, on secondary market investors. For example, the Central Bank notes that ETFs are typically sold as liquid, open-ended funds that trade intra-day with the perception that their open-ended nature is essentially guaranteed. However, in practice, ETFs (similar to other open-ended products) generally do not offer a guarantee of liquidity in all circumstances, but rather have a range of liquidity tools at their disposal in the event of stressed market conditions. As a result of the unique primary and secondary dealing arrangements for ETFs and the role of APs, in stressed conditions investors in the secondary market may face impaired liquidity without having any access to primary dealing with the ETF itself. The Central Bank has expressed concern that secondary market investors could be left "stranded" in the event of stressed market conditions.

  The Central Bank has also raised questions with regard to whether institutional investors have undertaken a realistic assessment within their own liquidity planning as to how ETFs in which they have invested would perform in stressed market conditions.
- *Risk management policies of investment managers:* Linked to the increased focus on the role of the APs and, in particular, on "stressed market conditions" as outlined above, the Discussion Paper raises several risk-planning and management considerations for investment managers. For example, the Central Bank queries whether investment managers should have contingency plans in place for instances where an ETF initiates a liquidity management tool (during stressed market conditions) and the AP withdraws from active trading of the ETF shares as a result. The Central Bank's concern is that this could lead to a scenario where the market price of the ETF shares significantly moves away from the value of the underlying assets of the ETF. Similarly, the impact of an AP stepping away from an ETF, even outside of stressed market

conditions, may need to be assessed. The Central Bank would like to understand in greater detail how ETF providers view these risks and how they would prepare for such a breakdown of the AP creation/redemption mechanism as part of their risk management policies.

- *Interconnectedness of parties to the ETF:* The Central Bank conducted a survey of Irish ETFs in 2016. Certain results of that survey led the Central Bank to query in the Discussion Paper as to the general interconnectedness of parties to an ETF structure. The Discussion Paper notes that, although for the majority of Irish ETFs the APs are independent of the ETF provider, there are instances where the AP is a "connected person" (e.g., a management company, investment manager, or a delegate or group company of such entities). Similarly, the Discussion Paper queries whether the connectedness between APs and collateral counterparties, in particular for synthetic ETFs, impacts the overall risk profile of the ETF.

In addition to the above, the Discussion Paper looks broadly at new and innovative ETF structures being launched in Europe, such as active and inverse ETFs. It also looks at the general concept of establishing ETF share classes within a standard non-ETF investment fund, as well as specific issues this may raise from a regulatory perspective, such as the fair treatment of all investors.

Conclusion

For the moment, the European ETF industry should take comfort that the Central Bank has no current plans for new ETF regulations, and that the purpose of the Discussion Paper is essentially a "fact-finding mission". However, it is clear that European regulators are looking at ETFs in greater depth and are following market developments closely. Should any regulation, reform or guidance follow at some point in the future, it is likely to involve some of the macro and micro themes identified above.

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Footnotes

1) Central Bank Discussion Paper 6 – Exchange Traded Funds, 2017.
2) Id.

How well can the market predict the next Bank of Canada rate hike?

By Kevin Dribnenki, Contributing Columnist, Fixed Income Derivatives at TMX, Montreal Exchange

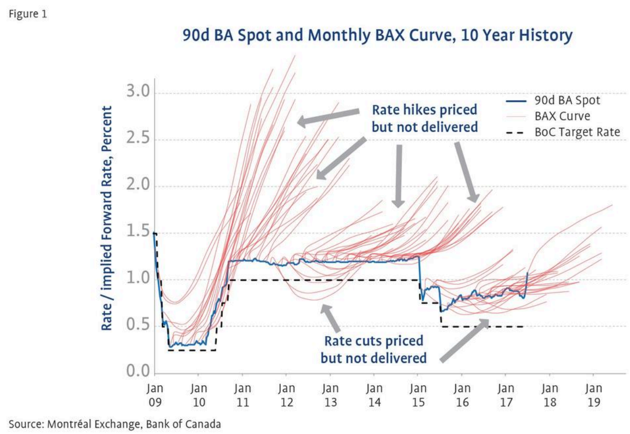
Kevin Dribnenki

Given the Bank of Canada's (BoC) recent rate hike, the first since mid-2010, and the first rate hike delivered by the current Governor; we visit the evolution of the BAX term structure and examine how well it has predicted BoC monetary policy action over the past decade. Investors unfamiliar with the "spaghetti plots" presented here and how to interpret them can refer to a brief explanation in the Appendix.

Predictive capacity of the market

The term structure of the BAX market has been a poor predictor of actual BA rates over the past decade as we will see in Figure 1. For active investors, this is a beneficial feature of markets as it has provided opportunities to outperform.

Figure 1



Source: Montréal Exchange, Bank of Canada

We can see in Figure 1 that the red "spaghetti" lines which represents the BAX curve[1] each month for the past decade, have been consistently above the blue 90d BA spot line for nearly the entire period.

The most prominent exceptions have been the two periods where the BAX curve predicted BoC rate cuts between late 2011 and mid-2012 as well as mid-2015 to mid-2016. These rate cuts weren't delivered in both cases but are obvious in Figure 1 as the red lines are well below the blue.

Another prominent exception occurs around late 2009 and early 2010 when the BAX curve predicted a series of rate hikes that were ultimately delivered but perhaps earlier or more quickly than the market had priced.

Easy rolldown

The consistent market pricing of rate hikes that are not delivered[2] has created past opportunities that have been exploited by active investors. For nearly a decade, active, leveraged investors have been able to buy, for example, the 5th BA contract and hold it to cash settlement for an easy rolldown trade, as the predicted rate hikes failed to come from the BoC. In fact, as tabulated in Figure 2, an investor could have done this trade 97 times since the start of 2009 and notched up a winning trade percentage of 74%, averaging gains of 31 basis points (bps) per trade after subtracting the losses[3] on losing trades.

Figure 2

Figure 2

Long BA5 Every Month, Hold to Settlement

	COUNT	PERCENT	GAIN (bps)
Total Trades	97	100%	31
Wins	72	74%	47
Losses	25	26%	-17

Source: Montréal Exchange

Source: Montréal Exchange

If an investor had resolved to do the trade only when the expected rolldown was positive (i.e. rate cuts were not priced at the time of the trade), he or she could have racked up an 80% winning streak and averaged +35 bps per trade, as shown in Figure 3.

Figure 3

Figure 3

Long BA5 if Rolldown Positive, Hold to Settlement

	COUNT	PERCENT	GAIN (bps)
Total Trades	64	100%	35
Wins	51	80%	48
Losses	13	20%	-17

Source: Montréal Exchange

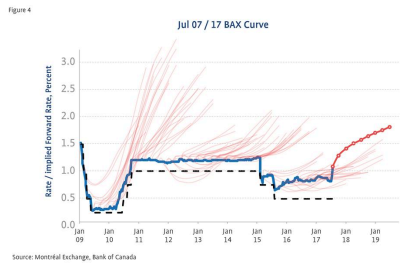
Source: Montréal Exchange

While we've described the above strategy as "Easy Rolldown," the active investor was taking risk and was rightly rewarded for recognizing that a BAX curve that prices aggressive rate hikes was an anomaly worth exploiting.

Opportunity or end of an era?

The Easy Rolldown trade came to an abrupt end in the last month as spot (and forward) BA rates rose rapidly on communications from the BoC. The question now is whether the persistent anomaly of forward curves are again pricing more aggressive policy tightening than will be delivered...or if the current forwards, with at least three rate hikes priced into the BAX contracts in the next two years, as shown in Figure 4, will be realized.

Figure 4



Source: Montréal Exchange, Bank of Canada

We note three observations from the past decade that investors should take into consideration when

making their decision:

Spot BA rates have not risen that much in comparison to the hiking cycle of 2010 as is evident from Figure 1. The recent “pain” in the BAX rolldown trade stems largely because forwards were very flat prior to the BoC changing their bias last month.

Even in the most recent, albeit brief, hiking “cycle” of 2010, rising spot rates were generally priced before the actual change in the BoC target rate. The market predicted much more aggressive rate hikes than were actually delivered through most of that cycle.

If investors refer to Figure 5 in the Appendix, they may note a similarity between the BAX curve today and the BAX curve on July 20th, 2011. The July 20th, 2011 term structure predicted slightly more policy tightening than the BAX curve today but it is notable that those hikes were not delivered by the BoC since, within a month, external factors[4] repriced BAX contracts as well as many other markets. The 5th contract yield fell by almost 100 basis points in a single month as the BAX term structure swung from pricing several rate hikes to pricing several rate cuts, entirely due to factors exogenous to Canada’s economy.

Appendix: Interpreting the “spaghetti plot” of BAX

While the charts presented here can seem complex and overly busy, they attempt to convey a great deal of historical information in a relatively accessible manner. Generally, the charts show the term structure of the BAX curve every month for the past 10 years and give a good visual indication of whether the market has been an accurate predictor of Bank of Canada policy[5].

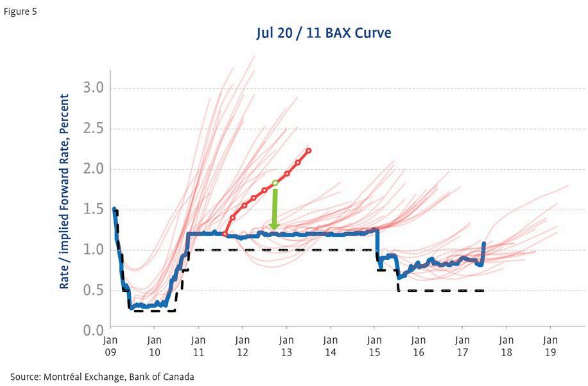
To begin to interpret the “spaghetti” we can examine Figure 5 where we have accentuated the BAX curve on July 20th, 2011 relative to the other curves. Here, without as much noise from the other curves on different dates, we can see the bright red term structure of BAX forward rates emerging from the spot (blue) 90d BA rate. The first eight BAX contracts are all shown in the red line and represent the predicted (forward) 90d BA rate for the next two years starting at the expiry date of each contract. For example, the 5th BA contract on July 20th, 2011 is shown in green.

One can readily determine that a buy-and-hold investor who bought that contract on July 20th, made roughly 60 basis points of profits if they held the contract to cash settlement because the contract yield fell (green arrow) from 1.8% to 1.2% (the spot rate 15 months later, blue line) over the life of the contract as rate rises that were priced into the term structure were not delivered by BoC policy.

To speak more generally, when the red “spaghetti” is above the blue spot line, an investor made money by being long the BA contracts in the term structure and profited from the passage of time as the forward rate rolled down to the spot rate. The multitude of red lines in Figure 1 are simply the BAX curve generated once per month for the past 10 years and plotted together on the same x-axis.

In some cases, the blue spot line is above or rises through the red BAX curve lines which indicates a period of time where being passively long the BAX contract was a money losing trade.

Figure 5



Source: Montréal Exchange, Bank of Canada

[1] These forward curves utilize only the first eight BAX contracts, the fronts (whites) and reds. Greens (the next four contracts) are also traded but have less open interest and clutter the chart without adding any additional insight.

[2] Or, occasionally but not as reliably, rate cuts that are not delivered.

[3] Note that the final 12 entry points have not settled yet. Many of them would have lost due to the recent rise in spot BA rates and they are included in this analysis for the sake of accuracy. Since cash settlement prices are not yet known, they are marked to market as of July 7th, 2017.

[4] On August 6th, 2011 S&P downgraded US Treasuries leading to fears of additional contagion from the European sovereign debt crisis. The S&P fell more than 6% on August 8th and European stock markets fell even further in some cases. Easy monetary policy followed from almost every central bank in the world, including Canada's.

[5] Active managers hope for markets that are poor predictors of the future as that creates opportunities to add value by monetising a market view different from the consensus.

How can you turn MiFID II into an opportunity?

By David Ririe, UK Sales Director at b-next

David Ririe

On 3rd January 2018 the Markets in Financial Instruments Directive (MiFID II) will come into force. For some, the directive is an unwanted and costly burden for which they are ill prepared. An alternative is to view MiFID II as an opportunity, where regulation builds momentum for long-term restoration of reputations, improved efficiency and cost savings. But how can asset managers achieve this when the clock is ticking and resources are scarce?

The countdown to MiFID II is well underway, with less than six months to go to the deadline, many market participants are still unprepared. A recent survey found that 90% of buy-side firms across Europe believe they are at high or medium risk of not being fully compliant by 2018.[1] The same research found two thirds of buy-side firms are still in the relatively early stages of their MiFID II programmes.

Recent media reports also suggest that around 25% of smaller funds are struggling to get ready for the deadline.[2]

MiFID II requires compliance in the areas including record-keeping, best execution and also recording and retrieval of voice and other digital communications. As you prepare to comply with this new regulatory mandate, automated technologies can help you to seize an important opportunity to strengthen your business, fast track compliance programmes, while reducing risk and costs.

The potential complexity, magnitude and dynamic nature of the surveillance and reporting task required by MiFID II cannot be underestimated. The task is unsuited to manual processes, but ideally suited to automated data processing and analytical technologies that offer advanced multi-venue, multi-asset class surveillance and compliance with MiFID II and other regulatory mandates.

Automated surveillance technologies can alert you to market abuse attempts early on. By identifying suspicious situations based on a number of pre-defined scenarios, trade surveillance systems can help prevent market abuse from escalating.

These systems can also help you to manage the best execution requirements of MiFID II cost effectively. Examples of functionality available include:

- Identification of the best venues for executing client orders
- Revelation of opportunities for improving trading systems / desks
- Profitability and competitive analysis functions
- Proactive management of customer requests, e.g. daily, monthly, and quarterly reports
- Version management of policies
- Ability to create a best execution policy for specific customers / customer groups

Advanced speech and digital text analytics technologies have also been combined with trade surveillance, addressing the voice recording and retrieval requirements of MiFID II. These systems allow you to search and analyse voice call recordings and digital text communication including email, chat and social channels. This can be done by time frame, trader, counterparty and trader desk. The technology makes it possible to search, find, analyse and report on voice and text-based data, all at incredible speeds.

The benefits of implementing automated solutions can be summarised as follows:

- Quick response to regulatory changes and reporting requirements
- A reduction in workload and associated costs
- Proactive management of suspicious trends
- Improvements to the quality of market abuse monitoring
- Improvements to risk management and compliance oversight

Rather than dwelling on the additional workload and costs associated with compliance, the buy-side must embrace the opportunity that MiFID II presents to improve processes, maximise returns and restore hard won reputations. MiFID II will likely be followed by further regulation in years to come, perhaps in the shape of MiFID III. Technology will be pivotal in helping firms to do the right thing in terms of compliance, while also driving efficiencies that will help to reduce long-term costs, improve execution standards and increase transparency. Such outcomes can only be of benefit to the financial sector as a whole.

Footnotes:

[1] Who is ready for MiFID II? JWG July 2017

[2] Financial Times 27 January 2017

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Changing with the times

By Graeme Rate, Head of Hedge at SANNE

Graeme Rate

South African hedge fund investment managers as well as investors welcomed change in 2015 when Finance Minister Pravin Gordhan declared that hedge funds would form part of Section 63 of the Collective Investments Schemes Control Act, No. 45 of 13 December 2002 (CISCA). The regulations became effective from 1 April 2015 through the implementation of Board Notice 52, which meant that all portfolios that fell within the definition of a 'hedge fund' were to be regulated. Hedge fund managers were given six months to register their Management Company and portfolios with the Financial Services Board (FSB), and were given 12 months from their date of registration to comply with the provisions of the Act.

Looking back prior to 2015

Hedge funds in South Africa were unregulated products primarily structured through either limited liability partnerships or trusts.

The Financial Advisory and Intermediary Services Act (FAIS) No. 37 of 2002 was established to provide a framework for all financial services providers in which to operate. In August 2007, a separate classification was enacted which differentiated the requirements for hedge fund managers from other discretionary portfolio managers. This included the demonstration of specific experience in managing such portfolios as well as the managing of specific assets that may constitute a hedge fund portfolio. This amendment for the first time defined a 'hedge' (in the context of a position taken), 'leverage', 'net short position' as well as a 'hedge fund' within South African legislation.

A hedge fund was thus defined as 'a portfolio which uses any strategy or takes any position which could result in the portfolio incurring losses greater than its aggregate market value at any point in time and which strategies or positions include, but are not limited to, leverage or net short positions'.

From 2007 to 2015 only the investment manager was regulated in terms of the FAIS Act and subsequently to the declaration in February 2015, hedge funds were now regulated under CISCA, along with Collective Investments.

Why the need for regulation?

The FSB's purpose for the regulations was first and foremost to provide protection to investors. Secondly, it assists in monitoring and managing systemic risk in the industry and thirdly, to promote integrity and transparency in the hedge fund industry.

The structures that are permitted under the Act are either a collective investment scheme trust arrangement or en-commandite partnerships, with the former being the most popular in terms of approved portfolios to date. These structures may house one of two permitted hedge fund types, a Retail Hedge Fund (RHF) or a Qualified Investor Hedge Fund (QIHF).

Regulations for qualified and retail funds

As the name implies, a RHF is permitted to access the retail investor market, whereas a QIHF may only permit investors that are deemed 'knowledgeable and experienced investors'. The criteria for such qualified investors are those who invest a minimum of ZAR 1,000, 000 (approximately US$ 75,000) and can illustrate that they understand and can assess the risks and rewards of hedge fund investments, or those who have appointed a regulated advisor who has the requisite knowledge and experience to undertake this and to advise the investor.

Overarching principals, legislation and investor protection

Hedge funds are required to limit the liability of an investor to give effect to the principle that an investor will not suffer any loss in excess of the value of their investment in the portfolio.

Other legislated requirements are that the Management Company must appoint either an independent custodian or administrator, manage the liquidity of underlying investments in line with the liquidity profile of the portfolio and may not take delivery of physical commodity positions.

More specific guidance is provided to RHF's whereby exposure (or VAR), liquidity terms, counterparty exposure and the instruments permitted to be traded are more tightly regulated as opposed to QIHF's, with the view that investors would be better protected in a more regulated product.

The Act further requires a Management Company to appoint service providers that are approved by the FSB, these include the Prime Broker, Administrator and Trustee. Further requirements require the Management Company to establish and document a valuation and pricing policy, a remuneration and reward policy (in order to align the interests of investors with the manager), have a risk management policy (to provide for the management of operational, business, liquidity and credit counterparty risks), ensure best execution in transacting and to provide detailed performance, risk and expense reporting to both investors as well as the FSB.

Treating customers fairly

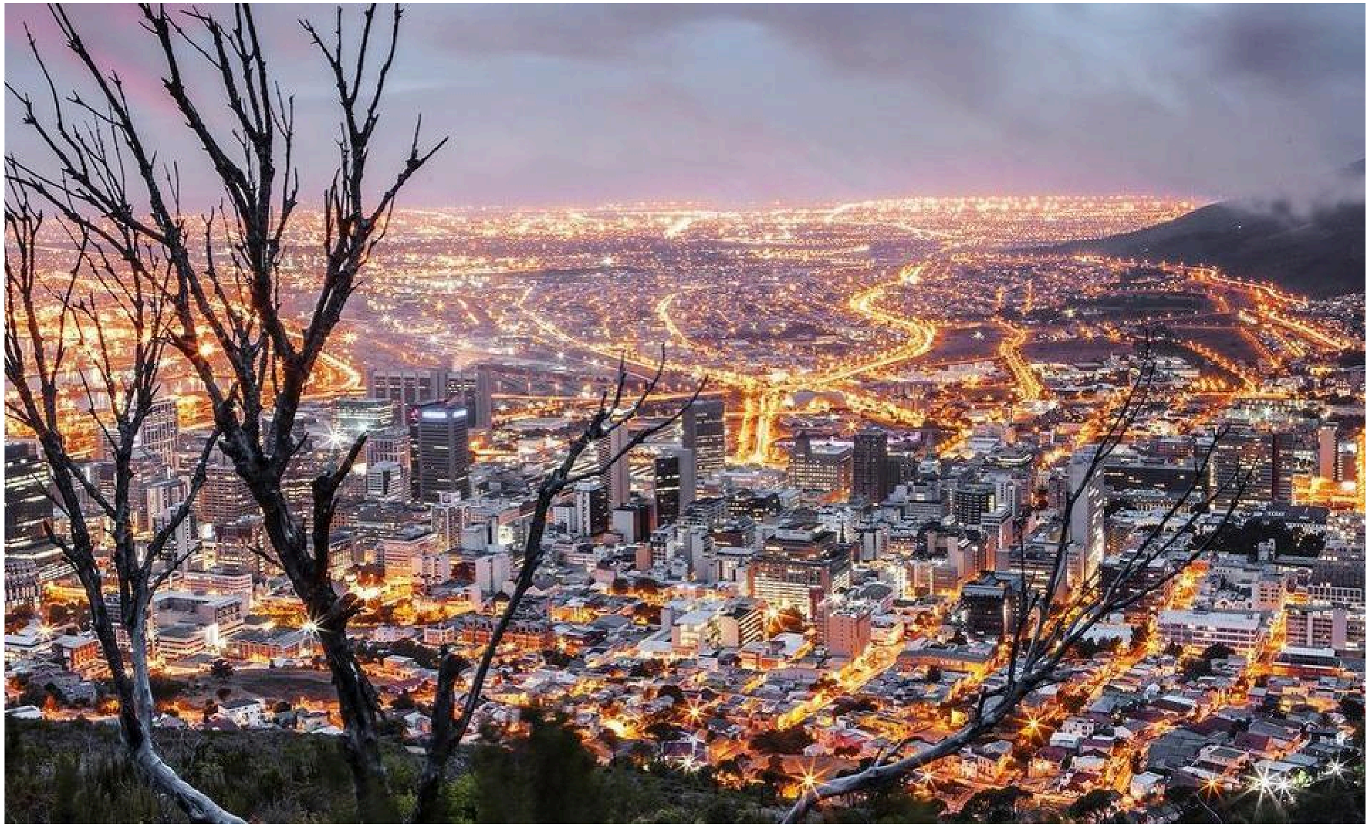
Disclosure to investors is paramount and detailed guidelines are provided in the regulations. Marketing and solicitation rules that apply to unit trusts, also apply to hedge funds. All advertising material, application forms, key investor information documents, monthly minimum disclosure documents and quarterly general investor reports must now be provided to investors and submitted to the FSB for review.

Any changes to any terms of the portfolio such as the mandate, is required to be balloted and approved by the majority of investors, providing an additional layer of comfort that the manager cannot unilaterally amend the terms of the investor engagement or the way in which the portfolio is managed.

Marketing of non-South African funds

Bringing hedge funds into the regulated space further provides opportunity for non-South African hedge fund managers to solicit investments from members of the South African public by obtaining authorisation through Section 65 of CISCA. This is dependent on the products offered being of a similar structure and risk profile as to those offered under the CISCA regulations for locally domiciled funds and being approved by the FSB.

For investment managers that either do not have the infrastructure nor the capability to create their own Management Company, regulations permit an established Management Company to offer a platform that host a number of different portfolios which are managed and administered independently of each other. The majority of hedge fund managers have opted to utilise such platforms, with the largest platform hosting 73 portfolios managed by 29 different investment managers.



Yesterday, today and tomorrow

The South African hedge fund market now offers investors a wide suite of regulated products, which are well-regulated, easily investable and offers the ability to protect capital in the event of a market correction. The South African hedge fund industry envisages that changes will lead to increased investor confidence which should translate into increased asset flows and a bright future for South African hedge fund managers.

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The securities and antitrust class action litigation industry has risen at a record pace in 2017

Kevin Doyle, Global Head of Marketing and Bob Williamson, Vice President, Sales, Battea – Class Action Services, LLC

Kevin Doyle

Bob Williamson

Billions of dollars are available to eligible investors, but the extensive class periods, vast array of instruments, and complex loss calculations make filing your claim a challenge.

Introduction

There has been incredible growth across securities and antitrust class action litigations and settlements, particularly as they have unfolded in 2016 and the first 3 quarters of 2017. The number of new cases and new settlements from traditional securities litigation to antitrust rate rigging, spread inflation and other forms of collusions are at an all-time high and shows no signs of slowing down.

- In the first half of 2017, there were 226 new federal securities class action cases filed.
- This surge in U.S. securities class action filings is more than 130% higher than the 120 first half filings in 2016.
- Of the new cases filed in 2017, 135 cited "violations of SEC Rule 10b-5 or of Section 11 or 12 of the 1933 Securities Act."
- The 2017 first half filings are the highest in history, and should this pace continue, total annual filings would represent a 67% increase from 2016.

As new cases are introduced or settle, the claim and loss analysis, litigation research, and rigorous data auditing and monitoring required for these filings have become increasingly complex both in the U.S. and abroad. In addition to the size and complexities of many derivatives and FX trading cases and settlements, the sheer volume of more traditional securities cases is exploding in the US and abroad.

International vs domestic claims filing and complex securities

How Do International Collective Actions Differ from U.S. Class Actions?

Every foreign country has its own unique requirements for filing a securities class action-type litigation, and Battea is well-versed in fulfilling each of these specialized requirements. Below, at a glance, a table illustrates the key differences between U.S. class actions and international collective actions, and what it means to you as a potential plaintiff:

	LEGAL FRAMEWORK	INVESTOR ACTION REQUIRED	LEGAL AND COURT EXPENSES	RECOVERY ACTIVITIES
US	"Class action litigation": A U.S./Canadian legal framework exists so damaged investors can pursue litigation as part of a "class".	All members of the class are automatically included, unless they opt-out of the class.	Law firms bear legal expenses in anticipation of obtaining a percentage of the overall settlement or in the case of a trial verdict, a percentage of damages awarded.	Settlement recovery activities take place post-litigation. If a settlement is reached, claims are filed and awards collected on behalf of the client. Investors must file confidential claims to collect their portion of the settlement.
International	"Collective actions": No legal framework equivalent to a U.S. "class". Damaged investors must collectively pursue legal action for potential reimbursement for damages.	Depending on jurisdiction, an investor is not included in any potential awards or settlement unless they "opt-in" or proactively join the action.	In International litigation forums, "loser pays" generally means the losing party must pay the prevailing party's legal and court costs. If there is an unsuccessful verdict, litigation funders provide insurance-like mechanisms to protect investors, in exchange for a portion of any potential settlements.	Investors must take early action to be eligible to participate and in some jurisdictions, investors are required to file public claims.

Antitrust litigation

While most antitrust cases are not specifically securities class actions, sometimes these two legal subsets overlap, and the result is antitrust securities class action litigation. Examples include the credit default swaps antitrust litigation (which settled for $1.86 billion in 2015), the Private equity settlement for $590 million, the LIBOR, EURIBOR, and TIBOR scandals, and the FX-rigging case.

While these settlement funds are established to primarily benefit damaged institutional investors, many of these products transact over the counter (OTC) and accordingly are not easily identifiable with traditional securities identifiers. Special diligence is required in the filing of these types of claims or investors risk leaving vast sums of money on the table.

With many mega multi-billion dollar litigations related to Libor, Euribor and Tibor rates and spreads manipulation across a vast set of financial instruments and major multi-billion litigations in Foreign Exchange related trading, the hedge fund community is first in line to cash in from these and other regular events.

With nearly $4 billion available to eligible claimants across a variety of cases, ensuring your eligibility by properly filing your claim is an absolute necessity. Here are a few updates on some the larger available settlement funds:

EUROYEN (TIBOR) LITIGATION SETTLEMENT UPDATE

Recently two new defendants had agreed to contribute $148 million to the litigation settlement fund surrounding the manipulation of the Yen Libor and Euroyen Tibor benchmark interest rates. The preliminarily approved settlement fund now stands at $206 million.

FX INSTRUMENTS LITIGATION SETTLEMENT UPDATE

In the past two months, six new defendants that have agreed to contribute more than $300 million to the litigation settlement fund, pushing the preliminarily approved settlement fund to $2.31 billion regarding the manipulation of benchmark rates, price spreads at which currencies were bought and sold, and exchanging confidential customer information in an effort to trigger client stop-loss and limit orders. However, with one defendants still yet to settle their case, we anticipate this settlement fund to increase even more.

US DOLLAR LIBOR LITIGATION SETTLEMENT UPDATE

The current settlements in this case, Barclays Bank for $120 million and Citibank for $130 million, are considered “ice-breakers”. In addition to the monetary contribution, the settlement requires cooperation with the Plaintiffs in their on-going litigation against the Non-Settling Defendants. This is expected to increase the leverage the Plaintiffs have in the settlement negotiations.

The list of Non-Settling Defendants is lengthy and includes 16 major banks. It is most likely that additional Banks will fall in line and settle; and with each settlement the Settling Bank will be required to cooperate with the Plaintiffs in their on-going litigation against the remaining Non-Settling Defendants. With each settlement, the Settlement Fund will continue to grow. It is expected that the total Settlement Fund will be in excess of $1 billion.

The time to act is now

With such significant sums available to damaged investors, it is crucial that you take action to establish your claim. For the US and Canada FX litigations, eligible investors are automatically included in the class but must file claims to collect their settlement dollars.

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Electronic communications recording requirements of MIFID II

By Lee Stonehouse, Founder of VENNCOMM

Lee Stonehouse

The MIFID II financial regulations come into force in just a few months. Just like tier-one banks, AIMA members remain confused and challenged about complying. The changes introduce a raft of new rules but amongst the most onerous are new requirements that all text, IM, social media, email and phone calls potentially relating to financial transactions must be recorded and logged. To be sure this is subjective and the only risk free solution is to record everything. Anything less means unacceptable risk of big fines and even personal prosecution.

Capturing emails is one thing, but few banks or hedge funds are geared up to record all comms and to add to the burden; regulations not only affects businesses based in Europe, but also those doing business here.

To be prudent then, any firm trading with an EU partner, or even another outpost of their own firm, should record & store all communications.

The impact of BYOD and employees using banned consumer apps like We Chat and What's App for doing business are also profound. Voice calls VoIP services like on What's App cannot be recorded technically or perhaps legally under imminent data protection laws like GDPR.

Moreover, ephemeral messaging apps like Snapchat leave no permanent record of what's been said, by who, to whom, so its clear they have to be stamped out with harsh penalties.

When the new regulations come into force, on 3 January 2018, this could prove a compliance bombshell.

As a former regulated money manager, I worried about the looming clash between the demands of the new rules and a world in which people are used to powerful consumer Apps.

To respond to these trends while being compliant isnt simple but banning the use of unauthorised apps is one vital step. The other is to make use of OTT enterprise technology - deployed on employee's own and company devices- that logs and records every business communication across all authorised channels to meet the new rules.

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Smaller firms remain the lifeblood of the hedge fund industry

By Jack Inglis, CEO, AIMA

The hedge fund industry comprises two branches. One includes firms managing $1bn or more in assets. This group's star managers feature regularly in the pages of The Wall Street Journal and the Financial Times. It contains about 10% of the industry in terms of the number of firms, but manages about 90% of the assets.

Much attention focuses on this group - the "billion-dollar club". Industry research and performance indices tend to be skewed to the larger firms. Consultants' lists of approved hedge funds are dominated by the larger brands. Many of this group's constituents are big institutionalised businesses whose clients include some of the largest institutional investors in the world, such as sovereign wealth funds and public sector pensions.

The second branch contains firms that each run less than $1 billion in hedge fund assets. Their investors can include large institutions but family offices, funds of funds and private banking assets are more prevalent. These are small businesses led by entrepreneurs. They are often the cradle of the industry's innovations, being able to invest in niche markets without capacity concerns. Frequently, they are among the industry's best-performers. Yet the press, in general, tends to look elsewhere. The gaze of many investors, too, can be drawn to larger brand names. In some cases this is because they are unable to allocate to smaller funds due to size limitations. Other factors can include infrastructure demands, length of track record and other checklist items that can be difficult for some smaller managers to meet.

The bifurcation in the industry is nothing new, but the concentration of assets among the largest firms has become steadily more apparent since the financial crisis. Hedge fund firms with $5 billion or more now manage about two-thirds (69%) of total industry assets, according to HFR – up from about 60% in 2009. For firms managing over $1 billion in hedge fund assets, the proportion is 91% (up from 86% in 2009).

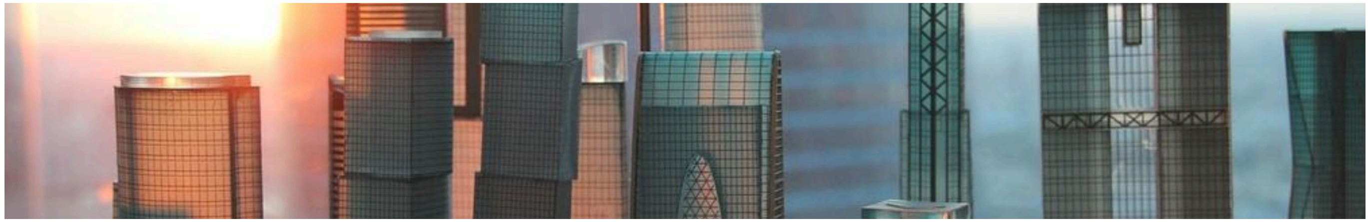
Previous widely cited pieces of research suggested that hedge fund managers needed at least $300 million in assets to reach profitability. Taken at face value, the research in effect had written off hundreds, if not thousands, of fund managers as

loss-making. This segment of the universe includes many firms that have been operating for years. Either we accept the premise that many of them are comfortable making losses year after year, or we assume that those research pieces may have been misleading.

Industry averages, in a sector so diverse, can be imperfect. We know that this often impedes average performance analyses. In terms of break-even analysis, it of course stands to reason that a firm with hundreds of employees, a myriad array of funds and fund structures and institutional clients in numerous jurisdictions would cost more to run than, say, a five-person outfit managing a single fund for a small number of clients (as well as its own money).

As far as we were aware, no one had attempted to find the break-even average just for smaller firms. This is why we decided to take it upon ourselves, in partnership with the prime broker GPP, to ask this very question (and related others). The headline finding of the report we published in July, titled Alive and Kicking, was that the break-even point for firms managing less than $500 million is currently around $86 million in assets. And that was only the average; a significant minority of respondents said they reached profitability when running less than $50 million.

Click to watch AIMA's Jack Inglis discussing the research on CNBC



If those figures strike people as surprisingly low, then part of the explanation may depend on a factor that is difficult to quantify in a survey like this. Clearly, some founders will take a pay cut, or draw no salary at all, during the start-up phase. In that respect, hedge fund founders are no different to entrepreneurs everywhere, who accept that sacrifices may be necessary, particularly in those all-important first years of operating. Their motivations also may be different if they are primarily managing their own money and that of their friends and families.

Easier to quantify is the degree to which smaller firms in recent years have embraced outsourcing in order to keep costs down. This effort undoubtedly has been helped by increased competition among all kinds of service provider businesses today, which has helped to raise standards and reduce fees. Our survey found that legal services, HR and technology are the functions most often obtained from external providers.

Also clear from our research was how industry-wide trends such as fee pressures, rising compliance costs and investor demands for ever greater alignment of interests are applicable to smaller firms as well as larger ones. This underlines that while bifurcation has taken place, firms operating in both branches of the industry are experiencing many of the same issues, challenges and opportunities. Smaller hedge fund firms are the lifeblood of the industry and remain an essential constituency for AIMA. Sub-$500m firms comprise about two-thirds of our fund manager members. Some of them may break through to be the mega hedge fund firms of tomorrow. We wish them all success.

This article first appeared on FINalternatives

Full steam ahead: Private credit industry to hit $1 trillion by 2020

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

Jiri Krol

The Alternative Credit Council's (ACC's) latest Financing the Economy research paper, produced in collaboration with Dechert LLP offers further evidence that private credit is now a permanent fixture of the lending landscape. Having experienced a 20% compound annual growth rate since 2000, the global private credit market is on track to reach $1 trillion by the end of the decade.

This is no mean feat considering that this rate of growth has not been witnessed by a subset of the asset management industry since the earlier years of the hedge fund industry. Private credit has now established itself around the world as a credible alternative to traditional sources of finance.

Our research highlighted a number of positive features of the private credit sector. SME and mid-market companies remain the biggest recipients of private credit, with one-third of committed capital being used to finance these businesses. Lending to larger corporates is also on the rise - accounting for a fifth of all private credit. As the market expands beyond its traditional mid-market base we also see private credit managers drawing on their expertise and experience to offer specialised finance solutions to particular sectors.

Private credit's increasing influence in countries outside the US and the UK is also becoming more apparent. Our survey identified Germany as being the most attractive country for private credit managers beyond those two markets, with France and Canada also seen as attractive propositions.

The growth of private credit in new markets is partially a consequence of regulatory reform to encourage alternative sources of finance. The ACC will continue to work with policy makers across the globe to encourage further reform and support the sustainable development of private credit. Private credit managers do not appear to be phased by the current uncertainty regarding Brexit with nearly 40% saying it won't affect their appetite to lend to UK businesses.

Borrowers continue to appreciate the flexibility of private credit and how it enables them to rapidly secure financing on terms tailored to their circumstances. The attractiveness of private credit to borrowers is also evident in the growing trend of repeat business.

Whilst competition in the market is undoubtedly placing pressure on pricing and covenants several hallmarks of private credit remain unchanged. Private credit managers continue to primarily use closed-end fund structures, the use of leverage across the market as a whole remains modest and lending standards and due diligence remain robust. These results are in keeping with the overall character of the industry: cautious and rigorous in its approach to lending.

As the sector matures, this rigour will be an essential ingredient in the sustainable growth of the private credit industry.

These strong foundations mean that private credit is well placed to continue financing businesses, helping them to invest, grow and create jobs around the globe. As stakeholders become more aware of the value of private credit we expect that the momentum generated by private credit will continue into 2018 and beyond.

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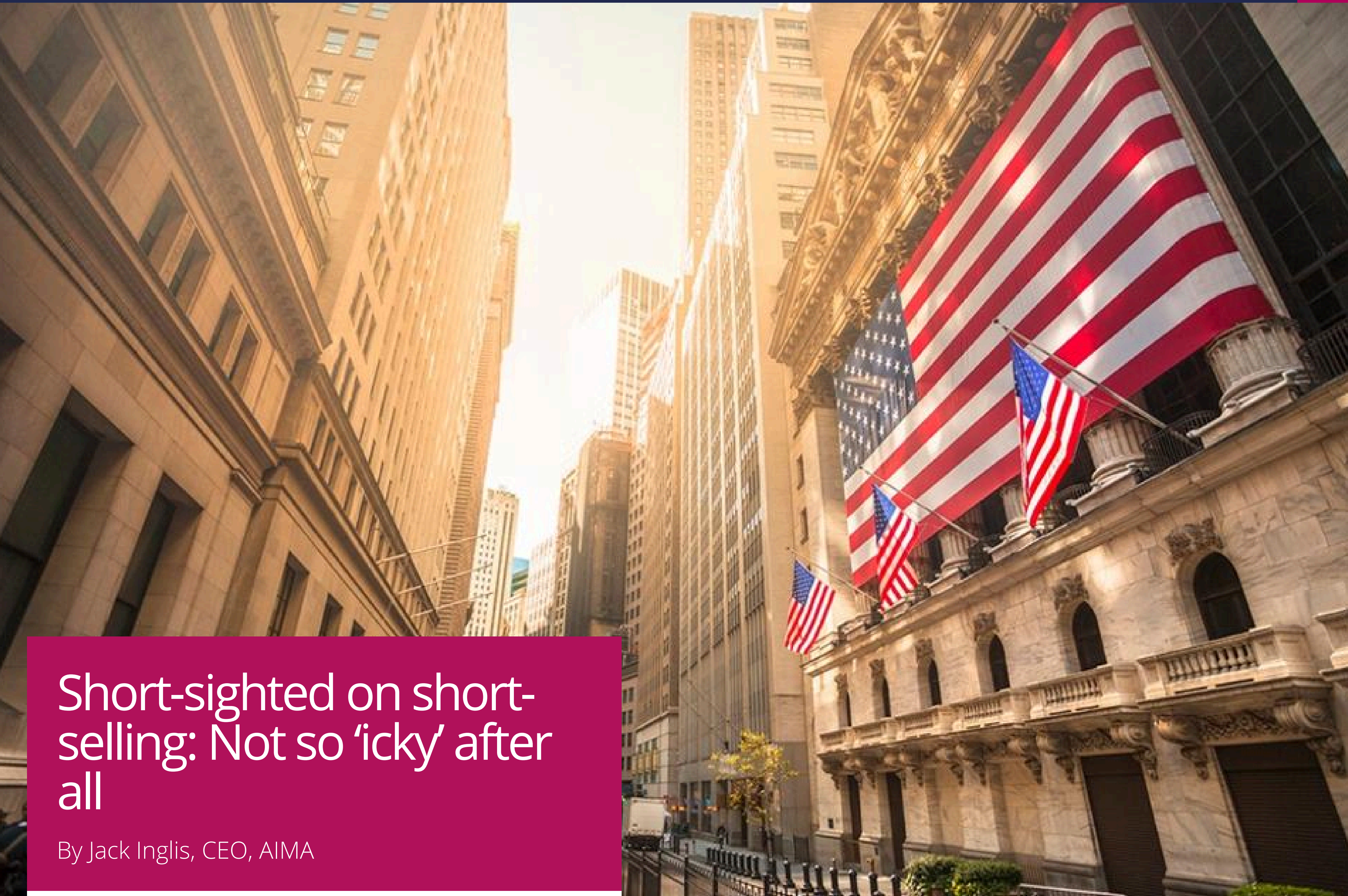

Short-sighted on short-selling: Not so 'icky' after all

By Jack Inglis, CEO, AIMA

Jack Inglis

Short-selling hit the headlines recently when the New York Stock Exchange's Group President, Thomas W. Farley, described the practice as "icky" and "un-American".

Going after short-sellers is a recurring, historic theme. Mr. Farley didn't say he wanted to ban the practice but that it left him feeling uneasy.

I don't want to knock Mr. Farley or second-guess how he intended his point to come across. The reality is that some people do think short-selling amounts to betting on a company's failure. That it is somehow mean-spirited. Why, critics say, would you want to take a shot at a company that's trying to make a profit for its employees and shareholders? Can't the short-sellers just cut it out?

This misses the point of short selling. For most asset managers, it is an essential risk management tool; a tool that investment managers use to protect their investors' money and limit the risk of losses. It gives investors flexibility, diversifies their income streams and is a smart way for them to express a sentiment other than "everything's going up".

Let's say I like a few stocks in a particular sector and invest in them. If I spot that another stock is overvalued relative to shares of the other companies in the sector that I'm invested in, I can assume that its price is likely to fall more sharply than that of its peers in a downturn. And I can use that analysis to protect my investors by shorting the stock. It's hedging and it's not manipulative: I'm just making sure that my investors don't experience a bumpy stock market ride. The company I short can be perfectly well-run, it's just that it may be overpriced.

Ultimately the reality is that markets are inefficient. Sometimes securities are mispriced. And that's precisely why investors hire asset managers – to root out those inefficiencies and translate them into profit. If their analysis is right, they make a profit. And if they call it wrong, they lose out. Doing it right takes skill and expertise and is fundamental to a healthy financial market.

Also, think about what would happen in a market where you have long position-holders only. Prices will tend to keep going up. What happens when you have investors who can potentially make a profit by saying, "hang on a minute, this company has not got its act together"? Bubbles are less likely. Capital is more likely to flow to the firms that can use it productively to grow their business.

Sometimes short-sellers even help to blow the lid off corporate fraud, Enron being the ultimate case in point. Some of the first people to have spotted that the energy giant was coming off the rails in a big way were short-sellers. There are countless other examples.

So short-selling is neither icky nor un-American. It represents the essence of what capital markets are for – a meeting place of people with different viewpoints who express those viewpoints by buying and selling securities. It fuels the process of price formation.

Part of Mr. Farley's point was that there should be greater transparency regarding firms' short positions. We don't disagree, but the devil is in the detail. If regulators need that data to assess risks of market abuse or systemic problems – after all, at times shorting can be comparable to an early warning system, a canary in a coal mine – then that is fine.

But disclosing short positions to the public is a different matter. Research has shown that such disclosure dampens buying and selling of stocks and undermines the aforementioned benefits to markets and investors. Asset managers' views can be copied, creating disincentives to carrying out research or innovating, and they can be refused access to issuers' senior management even it is unclear if they ultimately intend to buy or short the stock. This can distort trading activity and lead to the misallocation of capital. Policymakers need to think long and hard before changing the existing rules, otherwise there's a real risk of harm to capital markets.

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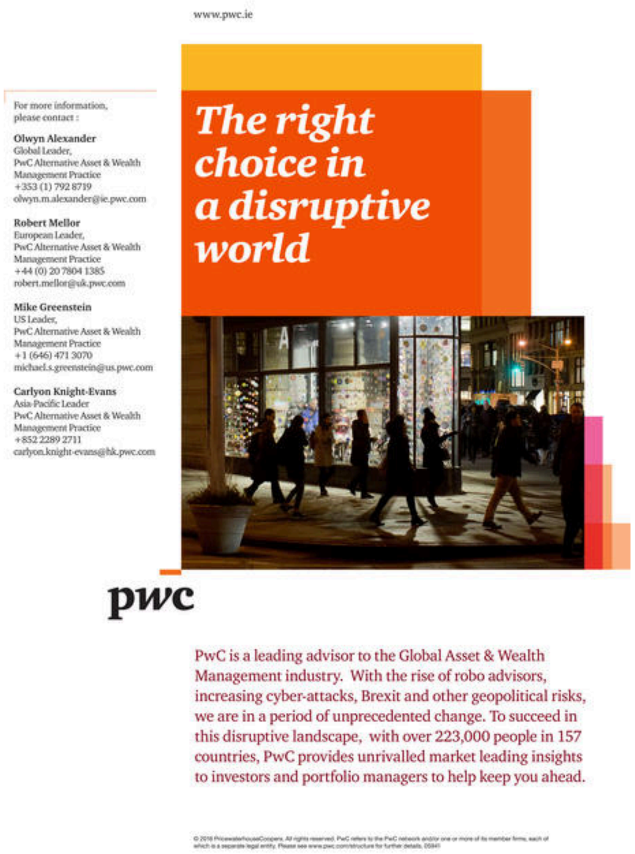

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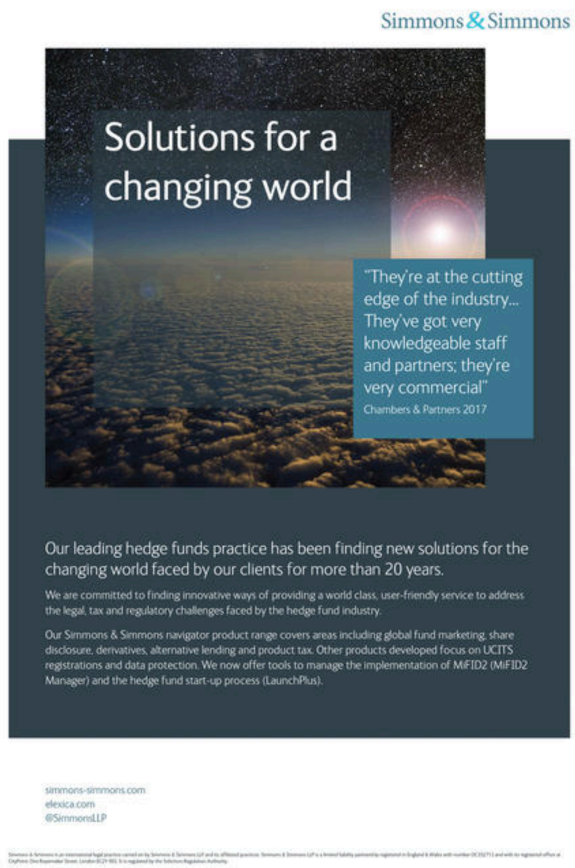

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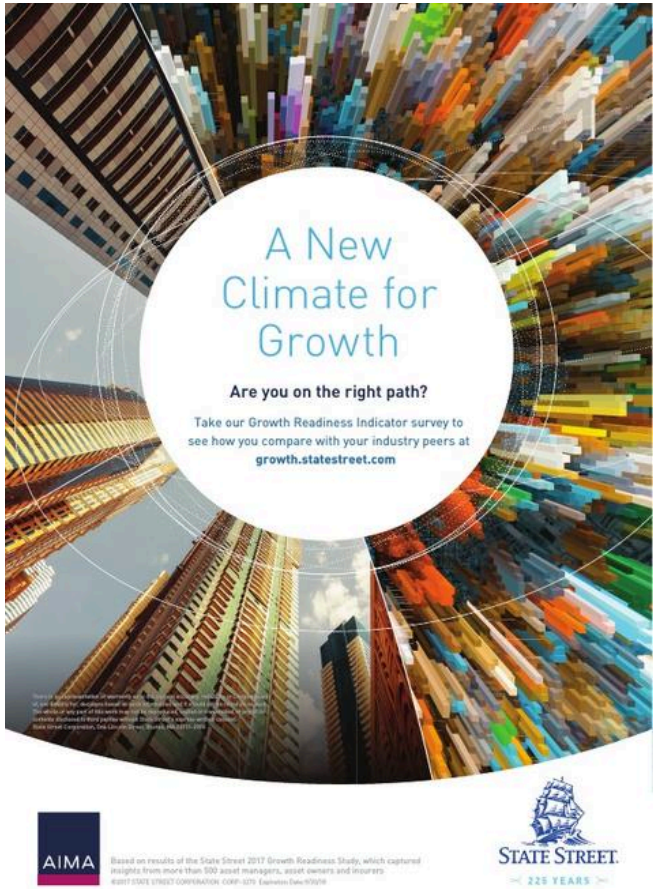

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