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Implementing the SDR: What next?
Clifford Chance

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Message from AIMA's CEO

It's hard to think of a time since the immediate aftermath of the Global Financial Crisis when we were in such a state of regulatory flux. During such times, resources such as the AIMA Journal are even more valuable. Look too long in one direction, and you'll miss something in the other. Today, many are rightly focused on the seismic rule changes emanating from the US Securities and Exchange Commission. However, as this edition will demonstrate, readers cannot ignore the substantial imminent reforms in the UK and EU.

Specifically, this edition offers a timely review of the environment, social, and governance (ESG) rules coming down the pike. In tackling accusations of the definitions around sustainability being too woolly, with opaque terminology, regulators are raising the standards fund managers must live by. This edition will help readers tackle compliance with the FCA's anti-greenwashing rule and understand how to improve their sustainability metrics without changing investment strategies.

Other contributors remind us of the perils of the greater scrutiny facing those who present themselves as leaders in sustainable investment. According to one contributor, legal action against banks and asset managers is on the rise, but there are clear steps readers can take to avoid such challenges.

Compliance is a primary theme of this edition, going well beyond ESG issues to tackle AIFMD and other major rules frameworks currently being developed or updated.

Elsewhere, the topic *du jour* – private credit – is not neglected. As the asset class grows, regulators and tax authorities are taking notice. Policymakers in several major jurisdictions are discussing withholding tax treatment among the rule changes.

Finally, the AIMA Journal's credentials as a publication relevant to all of AIMA's global membership remain strong. The persistent macroeconomic headwinds in Asia Pacific are detailed in an insightful report, while the developments in the British Virgin Islands are also crucial for those managing international businesses.

As always, there is too much high-quality content to preview in this note, so readers must venture further into this Journal to ensure they do not miss out.

My thanks go to all the contributors to the AIMA Journal this year, who ensure it will continue to be one of our most popular and widely read resources going forward.

Sincerely,

Jack Inglis
CEO, AIMA

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23 May	AIMA Next Generation Manager Forum 2024
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16 July	AIMA Putting ESG into Practice 2024
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08-09 Oct	AIMA Global Investor Forum 2024

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Improving sustainability without changing investment strategy

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Co-Founder of the **Global Returns Project**
former CEO of **Finisterre Capital LLP**

In this 'Decisive Decade' for tackling climate change, investment managers face pressure from investors and regulators to improve their approach to sustainability. However, many managers are understandably reluctant to add a layer of complexity to a successful investment strategy. One interesting new approach is to incorporate climate philanthropy into business practice without changing investment style. Systematic donations to high-impact climate charities provide a valuable alternative – or complement – to investment managers' other actions on climate or sustainability.

The science is clear: we are in a 'Decisive Decade' for mitigating the worst effects of the Climate Crisis. The next six years require unprecedented action – by governments, corporations and individuals.

As an industry, investment management understands the vital role it can play in directing capital towards planet-positive outcomes. Such activity has built momentum through initiatives like the Principles of Responsible Investing (PRI), the Net Zero Asset Managers initiative (NZAM) and the Taskforce for Nature-related Financial Disclosures (TNFD).

Unfortunately, initiatives like PRI or NZAM normally place additional burdens on the manager in their reporting or investing processes but remain open to the criticism of being ineffective in terms of genuine measurable impact.

Indeed, investment managers also understand the reputational and marketing benefits of taking the Climate Crisis seriously. In September 2023, for example, a UKSIF survey found that 69% of respondents with financial investments 'would be uncomfortable with their investments being in companies which negatively impact the environment and climate'.[1]

Yet for many investment managers, environmental, social and governance (ESG), 'responsible' or 'sustainable' investing remains the primary focus of their practice's response to climate change. Sustainable investing is important but, on its own, remains insufficient – both for the reputation of investment management firms and for the broader planet.

1 https://uksif.org/lack-of-awareness-and-support-a-key-barrier-in-helping-general-public-invest-sustainably/

From a reputational perspective, an approach that relies exclusively on sustainable investing continues to carry risks of 'greenwashing' accusations. In October, a report from RepRisk found that greenwashing incidents by banks and financial services companies globally had increased by 70% since 2022.[2] Many sustainable funds struggle to fulfil their environmental promises, making them imperfect mechanisms for investment managers to demonstrate positive intentions.

From a planetary perspective, sustainable investing has fundamental limits to its efficacy. Certain essential climate solutions cannot deliver financial returns. These projects therefore fall beyond the reach of even the most effective ESG or 'sustainable' products. They include enforcing environmental law, combatting deforestation, defending ocean ecosystems and more.

Climate philanthropy addresses many of these deficiencies. Charitable giving to climate organisations delivers clear impact on a short enough timescale to satisfy stakeholders and help avoid accusations of 'greenwash'. Philanthropy can also support the 'profitless' projects ignored by most investment products. Climate charities can, for example, restore degraded forests, identify important marine mammal areas, establish marine protected areas and develop data tools on deforestation in supply chains.

Unfortunately, the power of climate charities remains relatively unknown – both for individuals and within the financial services industry. Globally, less than 2% of philanthropic giving goes towards climate mitigation efforts.[3] That figure has remained static over four years of reporting from the ClimateWorks Foundation.

Investment managers stand to benefit from incorporating climate philanthropy into their approach to sustainability. Our planet stands to benefit, too. How might firms take climate philanthropy more seriously? Selection and monitoring of climate and nature charities is clearly a whole new workstream for some, but this work can be effectively outsourced.

For those firms that do not have the internal capacity or resources there are now climate philanthropy specialists who can provide the necessary expertise and capability.

Let's consider a few of the available options:

- Firms might begin by donating to high-impact climate charities regularly as a corporate social responsibility (CSR) action. These donations can be integrated more structurally by tying them to a proportion of revenue or profits.

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2 https://www.tradefinanceglobal.com/posts/report-greenwashing-incidents-up-70-globally-2023/#:~:text=time%3A%203%20minutes-,A%20RepRisk%20report%20released%20on%20Tuesday%20revealed%20a%2070%25%20increase,compared%20to%20the%20previous%20year

3 https://climateworks.org/report/funding-trends-2023/

- Firms might also integrate donations into the fee structure of specific investment products. Donating a defined proportion of the management fee from a fund, for example, builds the philanthropic contribution directly into the product. This donation can be integrated when launching a new fund or when launching a new share class for an existing fund.

- Finally, firms might also donate to climate charities as a complement or alternative to purchasing carbon offsets. Carbon offsets have significant reputational and planetary challenges of their own. Last year, for example, an investigation found that 90% of rainforest carbon offsets provided by the world's leading offset certifier were 'worthless'.[4] From a planetary perspective, offsets struggle to address systemic or hard-to-quantify climate solutions.

Investment managers might choose to donate to climate charities instead of buying offsets, or alongside an offsetting strategy. In these cases, an objective price as set by the regulated carbon credit market might be used to determine a donation amount during annual accounting of carbon emissions.

Investment managers must naturally make sustainability decisions based on both the health of our planet and the health of their own businesses. Climate philanthropy bolsters both. Charitable giving allows investment managers to avoid reputational risks and deliver real impact that matters – for employees, clients, stakeholders and our planet.

In 2023, an investigation found that 90% of rainforest carbon offsets provided by the world's leading offset certifier were 'worthless'.

4 https://www.theguardian.com/environment/2023/jan/18/revealed-forest-carbon-offsets-biggest-provider-worthless-verra-aoe

How should the investment management industry tackle compliance with the FCA's anti-greenwashing rule?

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Greenwashing refers to the practice of making exaggerated, misleading or unsubstantiated claims in relation to the sustainability credentials of financial products and services. The risk of greenwashing claims has risen significantly in recent years, in tandem with investor demand for more sustainable investment products. This has been evidenced not only by well-publicised enforcement action both in Europe and the UK, but also by a flurry of recent claims by NGOs against financial institutions.

For a number of years, the FCA has commented that firms' claims about their sustainability credentials must be *"accurate"*, *"reasonable"* and *"substantiated"*.[1] It is therefore no surprise that the FCA recently designated *"tackling greenwashing"* as *"a core regulatory priority"*,[2] and introduced a new anti-greenwashing rule as part of its wider package of sustainability disclosure requirements (the **SDR Regime**).[3]

The publication of the FCA's recent guidance consultation on the anti-greenwashing rule (GC23/3),[4] alongside its recent comments on how UK authorised fund managers are embedding its *"guiding principles"*,[5] make this an opportune time for investment managers that are exposed in some way to the UK to look closely at how the new anti-greenwashing rule could affect fund distribution and investor-facing communications.

1 FCA | Letter – AFM Chair | July 2021
2 FCA | CP22/20 | October 2022
3 FCA | PS23/16 | November 2023
4 FCA | GC23/3 | November 2023
5 FCA | Testing how Authorised Fund Managers are embedding the Guiding Principles in ESG and sustainable investment funds | November 2023

What is the anti-greenwashing rule, and which firms are in scope?

The anti-greenwashing rule, which is set to apply from 31 May this year, is primarily intended as a mechanism for the FCA to challenge firms and to take appropriate action if it considers that firms are making misleading claims about their products and services.

The text of the rule is set out in the FCA's Environmental, Social and Governance sourcebook (the **ESG Sourcebook**) as follows:

"Anti-greenwashing

ESG 4.3.1R...

(1) This rule applies to a firm (whether it is undertaking sustainability in-scope business or not) which:
    (a) communicates with a client in the United Kingdom in relation to a product or service; or
    (b) communicates a financial promotion to, or approves a financial promotion for communication to, a person in the United Kingdom.

(2) A firm must ensure that any reference to the sustainability characteristics of a product or service is:
    (a) consistent with the sustainability characteristics of the product or service; and
    (b) fair, clear and not misleading".

There are a number of threshold points to note regarding the anti-greenwashing rule's scope of application:

- Firstly, the rule applies to all FCA authorised firms. It will therefore capture UK AIFMs, UCITS Management Companies, portfolio management firms and investment advisory firms. Overseas firms and investment management groups with a UK nexus will need to carefully consider whether and how it applies to their business. Two key points to note in this respect are as follows:

    1. UK authorised firms involved in the distribution of fund units will fall within scope of the rule. Therefore, if a third country investment manager relies on a UK firm to distribute offering documents or negotiate subscriptions with UK-based investors, that firm will need to comply with the anti-greenwashing rule. This effectively imports the FCA's regulatory expectations around greenwashing 'by the back door', given that the distributor will need to assess any sustainability-related claims in marketing or promotional materials which it approves. UK firms that approve marketing materials on behalf of non-UK managers should, in particular, review their governance mechanisms with a view to ensuring that they are able to effectively challenge sustainability claims where necessary;

    2. Similarly, UK authorised firms that provide single managed account services or advisory services will also be caught within scope of the rule. This means that UK sub-managers and UK investment advisers providing intra-group services for the benefit of investment managers will be caught by scope of the rule, as will UK firms providing single managed account services to external clients.

    The wide application of the anti-greenwashing rule contrasts with the narrower range of firms captured by the SDR Regime, which, upon implementation, will apply to: (i) UK managers of UK funds; and (ii) in a far more limited manner, to UK distributors of overseas funds;

- Secondly, the rule applies in respect of 'communications' with a UK-based 'client' in relation to a product or service, and also to the communication or approval of a financial promotion to a UK-based person. Whilst 'communication' is widely defined as *"(in relation to a financial promotion) to communicate in any way, including causing a communication to be made or directed", it is limited by the fact that the communication must necessarily relate to "a [financial] product or service".* It follows that a generic communication about a prospective investee company's sustainability credentials would not fall within scope of the rule, unless it is made as part of a financial promotion (e.g., an inducement to purchase the company's shares as a result of its sustainability credentials);

- Thirdly, such communications must relate to the environmental and/or social (i.e., sustainability) characteristics of such products or services – the FCA's recent consultation paper notes that such claims may *"include, but [are] not limited to, claims relating to the environment, climate or climate change, biodiversity and nature, social issues, or corporate social responsibility"*.[6] Similarly to the Sustainable Finance Disclosure Regulation (**SFDR**), therefore, there is a focus across both environmental and social claims; however, the SDR's reference to *"corporate social responsibility"* is particularly broad-ranging;

- Lastly, whilst the 'fair, clear and not misleading' standard was only recently extended to ESG-related statements, it is familiar from existing regulations on marketing and client communications, and from the FCA's Principles for Businesses. The FCA has notably relied upon the fair, clear and not misleading standard as the basis for a number of non-ESG related enforcement actions, given that its broad nature forms a convenient basis to strike out client-facing communications perceived as misleading in some way.

What additional regulatory guidance is available?

Given that the anti-greenwashing rule is reasonably high level, the FCA has been consulting on more detailed implementation guidance with a view to ensuring compliance by regulated firms. The guidance would require firms to ensure that their sustainability-related claims are:

- Correct and capable of being substantiated by 'robust, relevant and credible evidence';
- Clear and presented in a way that can be understood;
- Complete (i.e., not omitting or hiding important information) and considering the full life cycle of the product or service;
- Fair and meaningful in relation to comparisons to other products or services.[7]

Given that the anti-greenwashing rule is reasonably high level, the FCA has been consulting on more detailed implementation guidance with a view to ensuring compliance by regulated firms.

6 FCA | GC23/3 | November 2023
7 FCA | GC23/3 | November 2023

Asset managers and their UK affiliates should note the FCA's comments below when considering compliance with the anti-greenwashing rule (particularly given that these core features of the FCA's guidance are unlikely to change substantially in the finalised text):

Evidencing claims	It is clear that UK firms should not exaggerate the sustainability credentials of financial products or services (e.g. funds or single managed accounts). However, firms should also ensure that any sustainability-related information they provide is not conflicting or contradictory in any way, and that they are able to support all sustainability claims with *"robust, relevant, and credible"* evidence. Firms should consider specifically referencing supporting evidence alongside any such claims.
Providing a balanced picture	The FCA stresses in its consultation that claims 'should convey a representative picture of the product or service', and that important information with the potential to influence decision-making should not be omitted or hidden. As per the FCA's guidance, firms should ensure that: • Claims do not solely highlight positive sustainability impacts and disguise negative impacts. In other words, claims should be presented in a balanced way and should not focus solely on the positive sustainability characteristics of a product or service, in circumstances where other aspects may have a negative impact on sustainability; • Where claims are only true if certain conditions or caveats apply, those conditions or caveats should be clearly and prominently stated; • The limitations of any information, data or metrics used in a claim should be clearly and prominently disclosed; • The entire life cycle of a product or service should be factored in when making sustainability claims.
Making fair and meaningful comparisons	Any comparisons a firm makes (e.g., between its products and others on the market, or between a previous iteration of the same product and a new version) should be fair and meaningful. In practice this means ensuring that: • Any comparisons between the sustainability characteristics of funds or other financial products make clear what is being compared, how a comparison is being made, and compare like with like; • Claims do not give the impression of making market-wide comparisons where they are based only on a limited sample of data. Firms should also be cautious when making sustainability claims in circumstances where an investment may simply be meeting a minimum standard of compliance with existing legal requirements.

When will the new rules and guidance become applicable?

Both the anti-greenwashing rule and accompanying guidance become effective on 31 May 2024. Whilst the rule is currently included in the ESG Sourcebook, the transitional provisions at ESG TP 1 confirm that the rule does not become applicable until 31 May 2024. Firms subject to the wider SDR Regime should take note of this date, as it falls before other aspects of the regime become applicable, including the labelling and disclosure rules (31 July 2024) and the naming and marketing rules (2 December 2024).

What other practical points should asset management firms bear in mind?

FCA authorised asset managers and other UK regulated firms will need to consider whether policy updates are required once the finalised guidance is published, and in the meantime consider the following practical points arising out of the draft guidance:

- The FCA's new anti-greenwashing guidance draws on a number of concepts that already appear in the FCA Handbook which many firms will already be familiar with (e.g., the rules in COBS 4.5A on the use of past performance data and performance predictions). Firms may therefore consider leveraging existing internal processes around approving marketing materials;

- Firms should note that information about the firm itself, along with product-level information, may be considered part of the 'representative picture' that clients and investors take into account when making decisions regarding financial products and services. Firms should therefore consider how firm-wide sustainability claims interact with product-level claims, and whether the combination could be perceived to offend against the fair, clear and not misleading rule;

- Firms should also note the wide application of the anti-greenwashing rule, which encompasses, but is not limited to, *"statements, assertions, strategies, targets, policies, information"* as well as *"images, logos and colours"*, all of which can contribute to the overall impression of a sustainability-related claim.[8] Marketing and website materials – particularly any social media marketing – will therefore need to be reviewed in a holistic manner;

- The FCA references both the Advertising Standards Authority (**ASA**) and Competition and Markets Authority in its guidance. Firms should in particular be aware of this dual source of liability and refer to the ASA's guidance on misleading environmental claims where relevant.

8 FCA | GC23/3 | November 2023

Implementing the SDR: What next?

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Core elements of the SDR

The UK's sustainability disclosure requirements and labelling regime (SDR) came into force on 28 November 2023. It will apply to firms authorised by the UK's Financial Conduct Authority (FCA), with a particular focus on UK-based asset managers. Intended to improve trust and transparency around sustainable investment products and to reduce greenwashing, the SDR comprises the following six core elements which apply in phases, starting in May 2024:

1. An anti-greenwashing rule, which will require all FCA-authorised firms to ensure that sustainability-related statements are fair, clear and not misleading, and consistent with the sustainability profile of the product or service in question.

2. Four voluntary sustainability product labels. UK managers may choose whether to use these labels for their products. If they do use a label, managers must ensure that the product meets the qualifying criteria for that label and that the other requirements of the SDR's labelling regime (such as the requirement to product certain sustainability-related disclosures for the product) are satisfied.

   The four labels are:

- **Sustainability Focus** – for products that invest in assets that are environmentally or socially sustainable;
- **Sustainability Improvers** – for products that invest in assets that have the potential to become more sustainable over time;
- **Sustainability Impact** – for products that aim to achieve a predefined, positive, measurable environmental and/or social impact; and
- **Sustainability Mixed goals** – for products that invest in assets that fall into a combination of the above three labels.

3. Restrictions on the use by FCA-authorised managers of sustainability-related terms in the name and marketing materials of certain products for retail clients. For these products, sustainability-related terms may only be used if: (i) the product also uses one of the four voluntary sustainability labels; or (ii) certain criteria are satisfied, which include the production of sustainability-related disclosures.

4. Product-level sustainability disclosure requirements, which include the requirement for FCA-authorised managers to produce short-form consumer-facing disclosures and more detailed pre-contractual and periodic product-level disclosures, but only in respect of certain products.

5. Entity-level disclosure requirements, under which FCA-authorised managers with assets under management of over £5 billion must make an annual Sustainability Entity Report. This must disclose how firms are managing sustainability-related risks and opportunities in relation to products managed on behalf of clients.

6. Requirements for FCA-authorised distributors to communicate labels (where used) and provide consumer-facing disclosures to retail investors. Distributors must also include a notice on overseas products to state that those products are not subject to the SDR.

Managers' implementation projects may be complex as the SDR incorporates a number of different elements, and the scope of application and implementation dates vary depending on the element in question.

For a more detailed overview of the SDR, please see our earlier briefing.

Implementation steps for firms

Managers' implementation projects may be complex as the SDR incorporates a number of different elements, and the scope of application and implementation dates vary depending on the element in question. To structure implementation projects, managers may wish to consider the following five steps:

Step 1: Conduct scoping analysis

The first step that a manager should take is to determine which of its firms and products are within the scope of the SDR. This may be a complex task as the application of the SDR's provisions varies depending on the measure in question. While the substantive elements of the regime (the labelling, naming, marketing, and disclosure rules) currently apply to FCA-authorised alternative investment fund managers and UCITS fund managers (together, managers) with respect to UK funds, there are also targeted rules which apply to distributors of products to retail investors in the UK and a broader anti-greenwashing rule which applies to all FCA-authorised firms. In addition, the rules apply in particular scenarios: some apply only when marketing to retail investors while others apply irrespective of the nature of a fund's investors. Finally, not all elements of the regime are mandatory. The labelling rules, for example, are voluntary, so even if a manager is technically within the scope of the SDR the rules related to the use of labels would only apply if a label were used.

Step 2: Prepare for the anti-greenwashing rule

Having identified in-scope firms and funds, managers will need to prepare for the anti-greenwashing rule. This is the first element of the SDR to come into effect, applying from 31 May 2024. It also applies more broadly than the rest of the regime as it applies to all FCA-authorised firms. Under the anti-greenwashing rule, firms must ensure that sustainability references in client communications and financial promotions are: (i) fair, clear and not misleading; and (ii) consistent with the sustainability characteristics of the product of service. The FCA has produced a consultation paper containing proposed guidance to assist firms in interpreting the anti-greenwashing rule but, at the time of writing, a finalised version of this guidance has yet to be published.

The FCA has produced a consultation paper containing proposed guidance to assist firms in interpreting the anti-greenwashing rule but, at the time of writing, a finalised version of this guidance has yet to be published.

When preparing to implement the anti-greenwashing rule, firms will need to carefully identify in-scope communications. This will require firms not only to identify and review in-scope communications that will continue to be used after the rule comes into effect but to also implement procedures to ensure that in-scope communications created after the anti-greenwashing rule comes into effect are identified on an ongoing basis and subjected to a suitable anti-greenwashing review.

Step 3: Decide whether or not to use a label

From 31 July 2024, FCA-authorised managers may choose to use one of the four voluntary product labels created by the SDR. If a label is used, managers will need to ensure that the relevant product meets the qualifying criteria for that label. In particular, the product will need to have a sustainability objective that aligns with the relevant label. Additionally, at least 70% of the product's assets must be invested in accordance with that sustainability objective (subject to certain mitigants, such as in respect of 'ramp up' periods for products that are not yet fully invested).

If a firm would like to use a label and is satisfied that the relevant product meets the qualifying criteria for that label, it will then need to comply with the remainder of the SDR's labelling regime. This includes requirements to notify the FCA of the use of a label and to produce investor-facing disclosures.

Finally, firms will need to ensure that they create internal frameworks to consider whether labels should be used in respect of future product launches and to ensure ongoing compliance with the SDR's labelling requirements, such as the requirement for the use of labels to be periodically reviewed.

Step 4: Implement the naming and marketing requirements

From 2 December 2024, FCA-authorised managers marketing unlabelled UK funds to retail investors will be prohibited from using sustainability related terms – such as 'ESG', 'environment', 'social', 'impact', 'responsible' or 'sustainable' – in the name or financial promotions for a fund, unless they comply with the naming and the marketing requirements in the SDR. These include requirements to prepare investor-facing sustainability disclosures and publish a 'statement' on the product's webpage/app-page, clarifying that the product does not have a label and stating the reasons as to why.

Managers will need to ensure they are prepared to meet the naming and marketing requirements in respect of existing products from 2 December 2024 and to prepare for ongoing compliance in respect of new and existing products thereafter.

Step 5: Prepare for remaining disclosure requirements

Finally, FCA-authorised managers will need to ensure that they prepare to comply with any additional disclosure requirements not prepared for under steps 3 and 4 above. In particular, managers with assets under management above £5 billion will need to comply with the SDR's requirement to produce an annual, entity-level sustainability report. This report will build on the TCDF Entity Reports that firms produce under the FCA's existing TCFD-aligned reporting regime, considering sustainability matters more broadly.

After that – what's on the horizon?

Firms must also monitor for future developments to the SDR regime. The UK Government has confirmed that it intends to consult on whether to broaden the scope of the SDR to include certain non-UK funds. It is not yet certain when this consultation will be published and how the proposed extension would operate. In addition, the FCA has confirmed that it intends to consult in early 2024 on producing a tailored version of the SDR for firms that carry on portfolio management activities in the UK. While firms conducting portfolio management activities were included within the scope of the SDR at consultation stage, the FCA removed them from the scope of most aspects of the SDR in its final package in response to feedback, opting to proceed instead with a separate consultation on how to apply the SDR to these firms.

Managers will need to keep a watching brief on these future developments as they contemplate their current SDR implementation plans.

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

Greenwashing, financial institutions and securities actions in the English courts - only a question of time

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As society gravitates toward a more sustainable future, the issue of greenwashing is established as a prominent concern within the financial services industry. With the signing of the Paris Agreement and the UK's commitment to achieving net zero by 2050, the demand for Environmental, Social, and Governance (ESG) products and investments has seen significant growth. However, as the spotlight has intensified, financial institutions have found themselves facing increased scrutiny from regulators, shareholders, and customers regarding their ESG credentials. It is therefore vital to understand the implications of greenwashing and why financial institutions should be wary.

What is greenwashing?

The Financial Conduct Authority (FCA) defines financial greenwashing as *"marketing that portrays an organisation's products, activities or policies as producing positive environmental outcomes when this is not the case"*.[1] The Securities and Exchange Commission defines it as *"overstating or misrepresenting the ESG factors considered or incorporated into portfolio selection"*.[2] The European Parliament defines it as *"the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly when in fact basic environmental standards have not been met"*.[3]

1 Financial Conduct Authority, 2018, Climate Change and Green Finance, Discussion Paper DP 18/8, Page 10, Para 4.7
2 US Securities and Exchange Commission, 2022, Examination Priorities, Division of Examinations, Page 13
3 European Union, 2020, Regulation (EU) 2020/852 of the European Parliament and of The Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, Official Journal of the European Union, Para 11

Greenwashing is a complex issue but is essentially an unsubstantiated or false claim that a company's policies, products or services are environmentally friendly. This can result in individuals being misguided into believing that products or services are more environmentally friendly than they claim to be and ultimately serves to undermine trust and confidence in ESG products.

Why should financial institutions be alert to this risk?

In today's climate, financial institutions are a growing target for litigation as they are increasingly seen as being financial enablers to fossil fuel companies through their stewardship role. Last year a French bank was served with a notice that a Non-Governmental Organisation (NGO) would take legal action if it did not change its policies and stop financing fossil fuel expansion. This was the world's first climate lawsuit against a commercial bank.

This appears to be that start of things to come, with The Australian Securities & Investment Commission (ASIC) commencing its first legal action concerning greenwashing, against a pension fund, alleging that the fund misled members about the sustainability claims of some of the investment options. ASIC later went on to file a lawsuit against an investment company's Australian arm in August 2023, alleging that research was not undertaken in regard to a significant proportion of the issuers of the bonds.[4]

An increase in ESG related raids and investigations

Until the matter concerning the French bank, there had historically been an absence of litigation in this area. There had however been an increase in ESG related raids and investigations, with particular emphasis on greenwashing practices, with financial institutions coming under increasing scrutiny from regulators:

- In 2022, German police raided the offices of a German asset management company accused of having made misleading statements in its 2020 annual report regarding claims that half the group's assets were invested using ESG criteria. That led to both litigation and regulatory investigations – a fine of USD 19 million was levied by the US Securities and Exchange Commission (SEC) regarding ESG misstatements.[5]

- In the UK, non-financial regulators are also taking steps and in October 2022, the Advertising Standards Authority ruled that a bank had engaged in greenwashing by misrepresenting its green credentials.[6] This ruling was interesting as it focused on what was not said, rather than what was said in the advertisement.

- October 2022 in Canada also saw an investigation commenced by the Competition Bureau into a bank for "alleged deceptive marketing practices".[7]

The UK Parliament has also stepped in, with The Treasury Select Committee posing questions to the FCA as to what enforcement work it would be doing to target funds who are misleading customers.[8]

4 https://asic.gov.au/about-asic/news-centre/find-a-media-release/2023-releases/23-196mr-asic-commences-greenwashing-case-against-vanguard-investments-australia/
5 https://www.sec.gov/news/press-release/2023-194
6 https://www.asa.org.uk/rulings/hsbc-uk-bank-plc-g21-1127656-hsbc-uk-bank-plc.html
7 https://ieefa.org/resources/royal-bank-canadas-climate-policy-has-come-under-close-scrutiny-its-stakeholders
8 https://committees.parliament.uk/committee/158/treasury-committee/news/194101/financial-regulators-lopsided-plans-to-prevent-investment-funds-from-greenwashing-need-further-work/#:~:text=Commenting%20on%20the%20correspondence%2C%20Harriett,t%20so%20green%20after%20all

Financial products that are marketed as sustainable should do as they claim

The FCA has responded by putting into place new Sustainability Disclosure Requirements (SDR), with the aim that financial products do as they claim, and that there is evidence to support this.[9] The package of measures includes an anti-greenwashing rule which requires that statements concerning sustainability are clear, fair, and not misleading.

The package of measures will also include:

- Four labels to help consumers navigate the investment product landscape.
- Naming and marketing rules for investment products to ensure sustainability related terms are accurate.
- Consumer facing information to provide consumers with better, more accessible information to help them understand key sustainability features.
- Detailed information in pre-contractual, ongoing product-level, and entity-level disclosures, targeted at institutional investors and consumers seeking more information.
- Requirements for distributors to ensure that product-level information (including the labels) is made available to consumers.[10]

Investment labels, naming and market rules will apply to UK asset managers, whereas anti-greenwashing rules will apply to all FCA authorised firms who claim their products or services are sustainable.

Investment labels, naming and market rules will apply to UK asset managers, whereas anti-greenwashing rules will apply to all FCA authorised firms who claim their products or services are sustainable.

However, whilst these measures go some way to making it clearer for consumers, there is no provision for redress for consumers who are misled by companies as to a fund's green credentials. Harriet Baldwin MP said that *"Consumers who invested in funds believing they were doing their bit to save the planet must not be made to bear the cost of moving if they find out their fund isn't so green after all... Without a comprehensive cost-benefit analysis, the regulator's proposals are lop-sided.*

Further work on what the costs are going to be, who will pay, and how the regulator will enforce the rules is clearly necessary".[11]

It is likely that investigations from regulators are likely to increase given greater regulatory oversight. The FCA has now issued a policy statement (PS23/16) on the SDR rules, with the anti-greenwashing rule taking effect from 31st May 2024 and the remaining SDR components coming into force in stages from 31st July 2024.

In the meantime, whilst these new measures are in their infancy and yet to be tested, shareholder activism is on the rise and in light of recent measures, shareholders are now more likely to scrutinise a company's ESG strategy.

There are many avenues where potential claims could be pursued. However, for the purposes of this article we will focus on one, that being claims brought under the Financial Services and Markets Act 2000 (FSMA).

9 FCA,2023, Sustainability Disclosure Requirements (SDR) and investment labels, Policy Statement PS23/16, Page 1
10 Ibid, page 7
11 (n 8)

Section 90 and Section 90A Claims under Financial Services and Markets Act 2000 (FSMA)

The risk of shareholder action and regulatory investigations concerning greenwashing is a significant risk for financial institutions. In addition to customer allegations, financial institutions could see claims brought by their own investors under Sections 90 and/or 90A FSMA.

Section 90 provides shareholders with a statutory right to seek remedy for any loss suffered where "untrue or misleading statements"[12] are made in a prospectus or where information is omitted. Any omissions must concern information that investors would reasonably expect to see in a prospectus.

Greenwashing claims could well be made under Section 90 especially where generalised green statements are made by companies concerning green credentials or where there is a lack of oversight concerning various aspects of a company's supply chain. Section 90 puts the burden on the defendant to prove they were not negligent and under Schedule 10(2), it is enough to show that the defendant *"reasonably believed...that the statement was true and not misleading"*.[13] Section 90 claims may also be brought against directors as well as the issuer (and potentially other people responsible for the prospectus), while Section 90A claims may only be brought against the issuer of the securities.

Section 90A has a broader application and could have wider implications when it comes to ESG related statements and greenwashing allegations. Claims can be brought under this section for statements made in all publications made to the market as a whole and are not limited to statements made in a prospectus alone.

However, the threshold for Section 90A claims is more akin to recklessness. Therefore, there is only liability if the person responsible for making the statements knew, or was reckless as to whether, the statement was untrue or misleading.

Both Section 90 and Section 90A claimants will be required to show that they have suffered financial loss as a result of the false or misleading statements. The claim cannot succeed purely on the basis of ethical or moral grounds.

What do financial institutions need to do?

Given existing legislation concerning financial misstatements, the current regulatory and litigation landscape, and the emergence of reporting and disclosure requirements, financial institutions should be mindful of all communications made where a statement relating to sustainability is made.

Financial institutions need to ensure that communications are "clear, fair and not misleading" and are "proportionate and not exaggerated".[14] They should also ensure that their business operations, including all subsidiaries, are compliant with the regulations and disclosure requirements. To do this they should ensure that there is regular reporting and monitoring throughout the business and all subsidiaries.

We will continue to monitor this area, with particular focus on how this plays out in the courts as well as how the "clear, fair and not misleading" test is to be applied.

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12 Financial Services and Markets Bill 2000, S90 (1) (b) (i)
13 Financial Services and Markets Bill 2000, Schedule 10 (2), (2)(a)
14 FCA, 2022, Sustainability Disclosure Requirements (SDR) and investment labels, Consultation Paper CP 22/20, Para 6.9

Managing withholding tax on private credit investments

As the granting of relief from withholding tax (**WHT**) on cross-border payments continues to come under increased scrutiny from tax authorities globally, it is important that managers of private credit funds carefully consider the potential impact of investment-level WHT in their funds. In this article, we discuss approaches to managing WHT in respect of private credit investments, taking into account some common themes we have recently observed in the practices of source-country tax authorities and courts.

Treaty relief

Currently, the most common approach to managing WHT in respect of private credit investments is to seek relief under the double tax treaty, if there is one, between the investee country and that of the fund entity that owns the assets.

In a private credit fund, the entity that owns the assets is, in many cases, a holding company which is a direct or indirect subsidiary of the main fund entity or entities. Asset holding companies are used in this context because of the various commercial and administrative benefits they provide, including that they typically have limited liability, are tax-opaque, and facilitate the segregation of different assets or pools of investor capital.

The double tax treaty between the investee country and that of the recipient entity will typically require that, for WHT relief to be available in respect of an amount of income, the recipient must be tax resident in one of the two contracting jurisdictions, the recipient must be the beneficial owner of the income, and the principal purpose test must be met (meaning the arrangements in question do not have a main purpose of obtaining treaty benefits in a manner which is contrary to the object of the treaty).

In the context of an asset holding company, the residence requirement is typically met by ensuring that the company in question is, and remains at all times, liable to tax in its treaty jurisdiction by reason of its place of incorporation or its place of effective management and control. This usually requires governance controls over the composition and procedures of the company's board of directors (or equivalent in the relevant jurisdiction). We discuss below some common themes we have recently observed in the approaches taken by source-country tax authorities and courts when assessing the beneficial ownership requirement and the principal purpose test. We would note that the approaches taken (including the weightings given to each of the factors discussed below) vary between jurisdictions and continue to develop. Fund managers should therefore seek to understand and monitor the practices of each investee country relevant to them.

1. **Privilege to benefit**
   It is common for source countries to consider, as a starting point, whether the recipient enjoys full privilege to benefit directly from the income in question. This condition will generally be met where it can be shown that the recipient is not bound in any legal, commercial, or practical terms to pass that income on to another person.

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For an asset holding company in a credit fund, particular attention should be paid to arrangements surrounding any financing instruments used to fund the company, such as profit-participating loans or notes. Care should be taken to ensure that such arrangements do not contractually or otherwise bind the company to pass its investment income on to the lender, or materially restrict the ways in which the company can use the income for its own business purposes (e.g., covering its operating expenses and investing the income into new assets).

2. **Substance**

Source countries are increasingly taking into account the level of local operational substance in the recipient entity. They may consider various factors in this regard, including employee headcount, where the entity's directors are based, and whether the entity has a physical office space. The concept of substance is receiving increasing attention in tax policy internationally, and in this context fund managers should consider taking measures to ensure asset holding companies in their funds have appropriate local substance.

The measures that are relevant and proportionate will depend on the situation, but could include establishing any new asset holding companies in the same country or countries as those in which the management group has existing operational presence (if appropriate), consolidating (i.e., reducing) the number of asset holding companies used in each fund, employing staff in, or seconding staff to, asset holding companies, and providing asset holding companies with formal access to local office space.

3. **Location of investors**

Some source countries may request information on the tax residence of the ultimate investors in a fund. They may generally be less likely to challenge an arrangement if all or a significant proportion of those investors are tax resident in either the same country as the asset holding company or a country which itself has a treaty with the source country, where that treaty provides equivalent benefits.

4. **Profit margin**

Certain tax authorities and courts may take into consideration the taxable profit margin of the recipient entity. In cases where that margin has been deemed to be too low, this has been used to support the view that the entity is a conduit and not the beneficial owner of the income. The profit margins that have been considered appropriate in this context have varied widely depending on, inter alia, the types of investments held, and the nature of the activities undertaken by the entity. Fund managers should take care to ensure that the taxable profit of each asset holding company appropriately reflects the functions performed, assets owned, and risks borne by that entity.

5. **Other considerations**

When assessing claims for treaty relief, and particularly when considering the principal purpose test, source-country tax authorities and courts can and do take into account any factors that they regard as relevant to a given case. By way of illustration, in the UK, HM Revenue & Customs have indicated in published guidance that they are more likely to grant WHT relief on interest paid to a non-UK resident company which is itself funded by listed debt that would have qualified for the UK Quoted Eurobond Exemption had it been issued by a UK tax resident company.

Before leaving the topic of treaty relief, it is worth noting that certain recently negotiated double tax treaties specifically grant treaty protections to particular types of investment funds that are established in corporate form, deeming them to be tax resident for the purposes of the treaty and the beneficial owner of their income, where certain conditions are met. It remains to be seen whether this becomes a more widespread trend. We expect that asset holding companies will continue to be used, given their commercial and administrative benefits. However, where an asset holding company is owned by an investment fund which would, itself, qualify for equivalent treaty benefits with the underlying investment jurisdiction, it would seem to help support that asset holding company's entitlement to treaty relief. This is an area worth monitoring.

Domestic-law relief

In our experience, seeking treaty relief continues to be the most common approach to managing investment-level WHT in private credit funds. However, we would note that in some cases, one or more domestic-law WHT reliefs may be available in the source country. Where it is available, domestic-law relief can potentially be preferable to treaty relief. This may be the case, for example, if domestic law provides a lower rate of WHT than the relevant treaty or if the two routes provide equivalent relief but the domestic-law route is administratively simpler.

The specific circumstances in which domestic-law relief is available vary considerably between source countries and need to be checked on an investment-by-investment basis. By way of illustration, however, UK domestic law provides (inter alia) the following interest WHT exemptions which may be relevant to some private credit investments.

- **Interest paid on a qualifying private placement (QPP)**

  A QPP is an unlisted debt security which meets certain conditions, including that the term of the security is not more than 50 years and the placement has an aggregate value of at least £10 million, the borrower is not connected with the lender, and each lender has provided to the borrower a certificate confirming they are tax resident in a country with which the UK has a tax treaty containing a non-discrimination clause.

- **Certain UK-to-UK interest payments**

  Interest paid by a UK tax resident company to another UK tax resident company, or to a UK permanent establishment of a non-UK company, is exempt from UK WHT.

- **Interest paid by a qualifying asset holding company (QAHC)**

  Interest paid by a UK QAHC is exempt from WHT. QAHCs are increasingly being used as asset holding companies in various types of private asset fund. This includes private equity funds, where a QAHC may be used as the bidco that takes on leverage from a third-party lender. Although such leverage is typically provided by banks, this funding may in some cases be provided by a private credit fund. Where such a fund has undertaken lending to a QAHC, the interest income it receives should be exempt from UK WHT.

Closing thoughts

As the taxation of cross-border transactions continues to receive increasing attention in tax policy discussions around the world, it is important that managers of private credit funds carefully assess the routes that may be available to them for the management of investment-level WHT in their funds. Although there are certain common themes in the approaches taken by source countries to granting WHT relief, the practices of tax authorities and courts, with regard to both treaty and domestic-law WHT relief, continue to vary between jurisdictions, and managers should seek to understand and monitor the practices of each investee country relevant to them.

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Macro challenges endure in APAC, but investors see solutions in derisking

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Private market investors in Asia Pacific (APAC) are less optimistic than their European and North American counterparts about the macroeconomic prospects for their region.

Fewer than half (42%) of APAC respondents to the State Street 2024 Private Markets Study said they thought inflation had peaked in their region, compared to more than two thirds (68%) in North America and nearly three quarters (71%) in Europe.

The study includes a survey of nearly 500 institutional investors globally, including multiasset managers, private markets managers, pension funds and insurance companies.

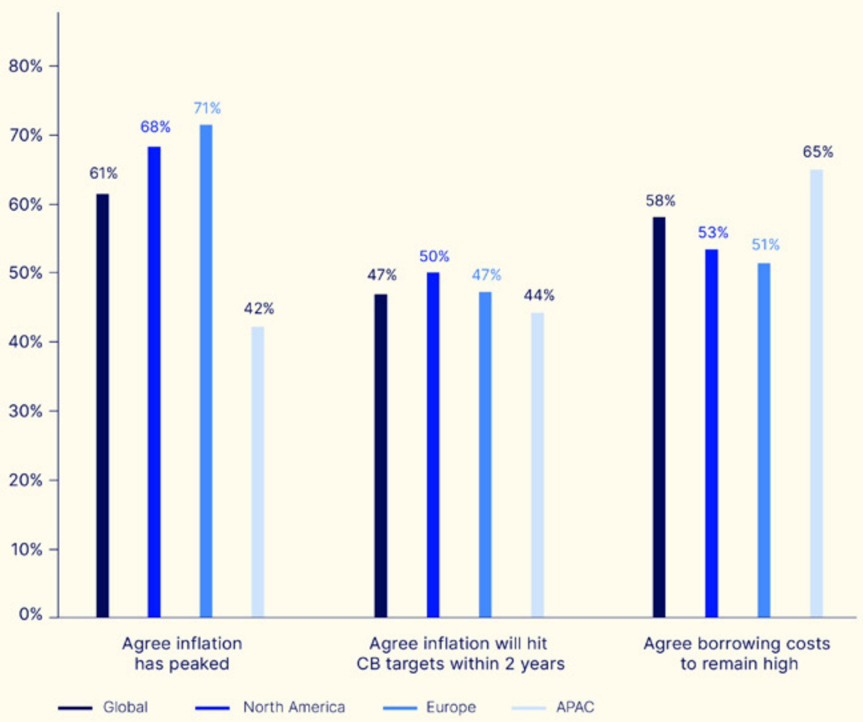
Last year's research showed widespread global concern about the inflation and economic growth environment and its likely impact on investments across private equity, private debt, infrastructure and real estate, particularly in terms of high borrowing costs caused by central banks raising interest rates in response to inflation.

Findings from this year's research suggest a somewhat diminished level of concern. Nonetheless, respondents still anticipate that the lasting repercussions of recent years' low growth and high inflation will continue to influence private market investment in the near to medium term.

However, clearer regional differences have started to appear in the data, when it comes to respondents' views of the economic environment.

In addition to being less inclined to believe their local inflation has peaked than their peers, APAC respondents were also less likely to believe it would come back within their domestic central banks' target levels within the next two years (see Figure 1 below).

Figure 1: Economic and Inflation Outlooks by Region



Source: State Street 2024 Private Markets Study

Additionally, they were considerably more likely to agree with the proposition that borrowing costs would stay high and continue to negatively affect private markets investments.

Part of the reason for this distinction in outlook might be the diverse range of economies represented by the respondents from APAC, which differ in size and economic fundamentals.

Within the APAC region, jurisdictional differences pertain, with majorities in Japan, Singapore and China saying they did not believe inflation had peaked (in particular, only 10% of Chinese respondents believed it had), while at least half of Hong Kong, Australian and South Korean investors said inflation had peaked.

Despite this less optimistic perspective, the impact on deal flow has not been particularly different in APAC than in other regions.

As an example, 59% of APAC and European respondents said they had seen delays of at least three months in their deal pipeline as a result of the economic environment, with 56% of North American respondents saying the same. There was a slight tendency toward longer delays in Asia, but only involving small numbers – 5% of deals delayed by more than a year compared to 2% in Europe and zero in North America.

The ongoing fallout from recent economic conditions has lead, however, to some dominant global themes in firms' reactions, which can be seen clearly in the APAC responses.

In particular, risk at the investment portfolio and operational level has become an increasingly significant area of focus for respondents to our survey.

Against a potentially higher-for-longer interest rates environment in the near term, the focus on underlying investments is critical to portfolio management. Understanding the financials and debt levels at the underlying investments level is critical not only for ensuring portfolio valuations are justified, but more importantly to understanding how new investments can help diversify concentration risks.

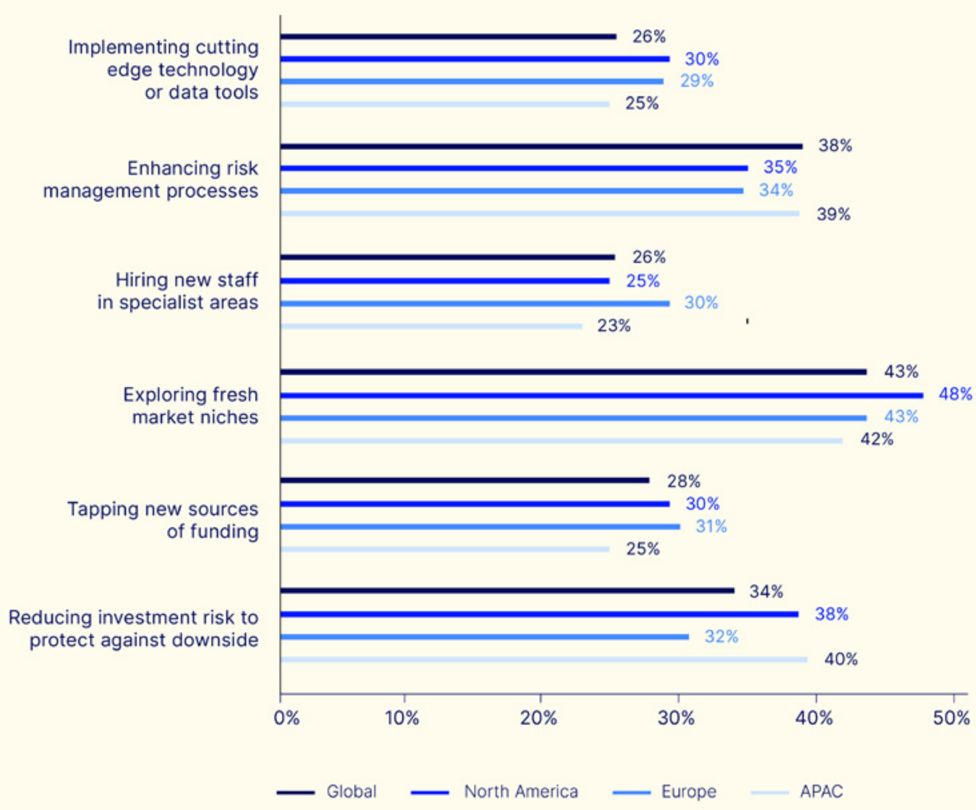
"Justifying risky investments in a high-yield environment" was cited as the number-one contemporary challenge to private markets investment both worldwide (45%) and in Asia (51%). The biggest operational challenge was *"risk measurement and management"*, again for all respondents and in APAC, where 78% and 79%, respectively, put it in their top five challenges.

Unsurprisingly, *"reducing investment risk"* in portfolios and *"enhancing risk management processes"* were the first and third choices for APAC investors (and second and third globally) when asked what measures they were taking to mitigate the economic environment.

In this context, the second most popular choice in APAC (and first globally), *"exploring fresh market niches"* is key for investors as they seek to deploy capital into less crowded investments areas for diversification and to enhance returns.

Unsurprisingly, "reducing investment risk" in portfolios and "enhancing risk management processes" were the first and third choices for APAC investors (and second and third globally) when asked what measures they were taking to mitigate the economic environment.

Figure 2: Responses to Economic Environment



Source: State Street 2024 Private Markets Study

However, in keeping with the findings of our 2023 study, a major challenge to investors in this space in meeting operational and investment goals like those outlined above, is data. 2024 respondents continued to cite challenges with the quality, timeliness and comparability of their data sources.

In APAC, 60% of respondents said they struggled with the accuracy of their valuations, 56% said frequency and timeliness were a major problem, and 47% pointed to difficulties seeing and analysing all their public and private markets positions together in a whole of portfolio view. Managing that having all portfolio data in one place was particularly important to Asian investors, with close to one third (32%) stating the ability to do so would be "transformational" for their private markets' businesses, compared to approximately one quarter (26%) globally.

In APAC, 60% of respondents said they struggled with the accuracy of their valuations, 56% said frequency and timeliness were a major problem, and 47% pointed to difficulties seeing and analysing all their public and private markets positions together in a whole of portfolio view.

In their responses to these data challenges, institutions globally were increasingly interested in outsourcing their data management. Exactly one quarter of APAC respondents said they were *"very likely"* to do so in the next three to five years, compared to just 6% who have already done so. The results, however, also found that over half (57%) of respondents in APAC noted the cost of outsourcing was a serious impediment alongside 54% who expressed concerns about providers' abilities to communicate with them effectively, after the initial handover.

It is clear from these results that institutions' focus on portfolio risk and the operational solutions to managing it as a response to ongoing economic conditions present an opportunity to harness data for better decision-making and capital deployment. In APAC, where these challenges are still most strongly expressed, the ability for investors to look at outsourcing strategically and create a scalable and resilient operating model will give them a clear and distinct advantage to create better investment outcomes.

Look out for the first in a series of reports based on this research coming soon on StateStreet.com.

Why cash management should be central to alternatives funds' plans

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Interest rates will once again be a key factor in firms' cash management strategies as we move through 2024.

With markets pricing in rate cuts in both the US and UK this year, alternatives funds could be missing out on a performance boost from cash positions if they are not making the most of multi-year high interest rates.

Cash management has become an increasingly important focus for managers in recent years, with Citco's 2023 Middle Office Solutions Report showing the value of treasury transactions set a new record among its client-base last year, up 14% to US$1.55tn.

Whether running fledgling funds or multi-billion dollar strategies, interest rates have clear implications for all alternative investment managers, so a forward-thinking cash management approach is key.

To make the most of cash management, there are a number of operational considerations to take into account.

The changing face of global cash management

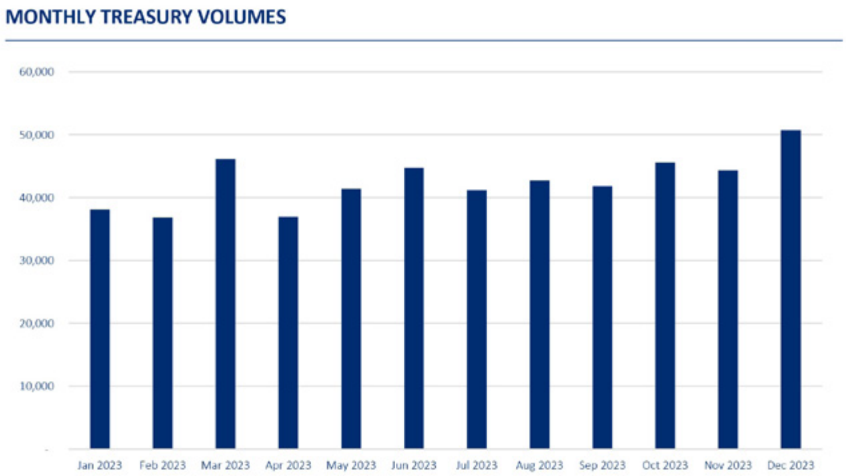
In 2009 when interest rates were cut sharply, managing multiple currencies was low on a manager's list of priorities as differences in spreads were small. However, now interest rates across the globe are significantly higher, cash can have a material impact on a strategy's performance.

This is especially true for some asset classes, such as infrastructure, where cash may be sitting in accounts for some time. Simply put, managers cannot afford to accept lower rates on cash than competitor funds given the drag it can have on performance.

Indeed, for large hedge, private equity and real assets managers, cash may well be in different tranches spread out across the US, Europe, Asia and the Middle East – and so having to manage this in-house, after over two decades of low interest, is far from straightforward and requires expertise that firms may have not previously had.

If a firm holds its cash in multiple bank accounts, in different currencies, they may be earning different returns, have different fixed terms, and new opportunities may be emerging in different jurisdictions.

So again, staying on top of this is a growing and unprecedented challenge for many in-house teams, especially as end investors are demanding greater transparency and more information about all aspects of funds they own.



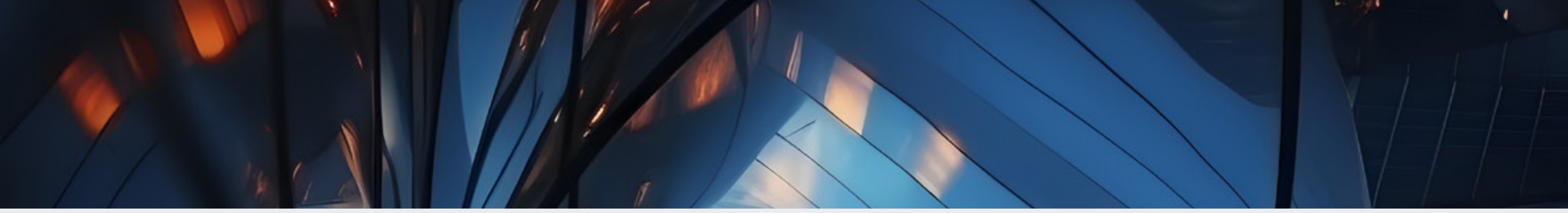
A tale as old as time

The principles around cash management have fundamentally remained the same as time has passed – firms need to manage their cash efficiently and effectively to keep the wheels of their business turning. However, due to low interest rates dominating for the last two decades many have turned their attention away from strategies to maximize the returns it can generate.

By having full oversight of cash positions – whereby managers have a platform where they can see all their cash in one place – it means they can make timely decisions to move excess cash. But the development of such a platform in-house can prove expensive and time-consuming.

This is where partnering with an external provider that can deliver a highly customisable, end-to-end treasury application that provides managers with the immediate ability to review cash across all its bank accounts, putting any idle cash to work in higher interest accounts, or to deploy to another strategy, will ensure that firms are not missing out on opportunities.

Rather than do this manually as some managers do when they handle this in-house, a cash management solution deployed by a specialist provider – that uses a systemic, cloud-based application which gathers the data and provides a clear view as to the state of affairs with all of a manager's cash positions – will free up capacity and allow teams to concentrate on what they do best, generate growth.



Loan origination funds: A new regulatory framework under AIFMD II

AIFMD II completes the AIFMD framework by introducing a new regime for loan originating AIFs and, more generally, for loan origination activities by or on behalf of AIFs. This new harmonised framework will impose operating conditions for AIFMs and introduces various requirements at AIF level.

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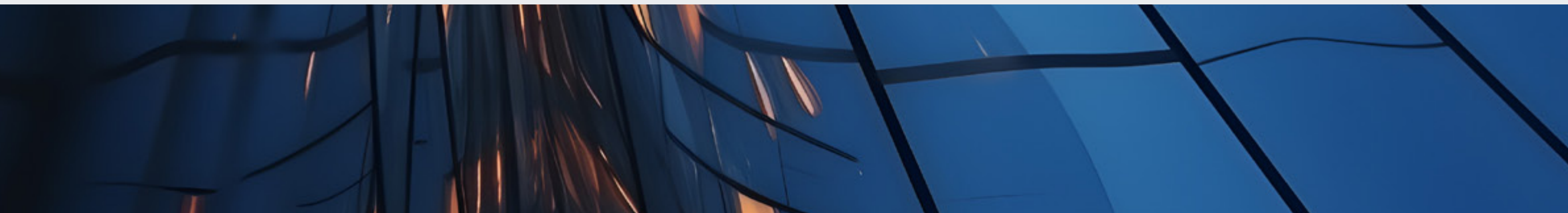
New regulatory framework for loan origination by AIFs

EU policymakers have recognised that private debt and loan origination funds play an essential role in providing alternative sources of funding to certain categories of borrowers, including small and medium-sized enterprises which find traditional lending sources more difficult to access. Most private debt funds operate as alternative investment funds (AIFs) within the general alternative investment fund managers directive (AIFMD) regulatory framework, which does not impose any specific requirements on such funds.

AIFMD II completes the AIFMD framework by introducing a specific regime for loan originating AIFs and, more generally, for loan origination activities by or on behalf of AIFs. The new regime aims to facilitate EU cross-border activities of loan originating AIFs by creating a harmonised framework. AIFMD II's recitals recognise "the right of AIFs to originate loans" and clarify that the new regime's objective is to "make it possible for AIFs to develop their activities by originating loans in all Member States". However, as such, the amendments introduced by AIFMD II do not mean that all Member States will allow AIFs (or allow all AIFs) to originate loans to borrowers under their jurisdiction. It is possible that Member States that already restrict loan origination by AIFs will continue doing so or define certain categories of AIFs that are permitted to originate loans under more restrictive local laws.

In Luxembourg, in principle, lending is a regulated activity if it consists in the granting of loans, on a professional basis, to the public. This activity is subject to specific CSSF authorisation, unless an exception applies (notably, for certain regulated funds such as SIFs). However, the CSSF has usefully clarified that a private lending activity should generally not be aimed at the public where (i) the nominal value of each loan is EUR 3,000,000 or more, and (ii) the loans are granted exclusively to professionals such as defined in the Consumer Code. In practice, most direct lending funds that are non-regulated AIFs are generally able to comply with these conditions.



Scope of new AIFMD II regime

The new regime applies to AIFMs that manage "loan originating AIFs" and more broadly to any AIFM that engages in "loan origination" activities on behalf of AIFs. A loan originating AIF is defined as "an AIF (i) whose investment strategy is mainly to originate loans; or (ii) where the notional value of the AIF's originated loans represents at least 50% of its net asset value". Loan origination is defined as "the granting of a loan directly by an AIF as the original lender or indirectly through a third party or special purpose vehicle, which originates a loan for or on behalf of the AIF or AIFM in respect of the AIF, where the AIF or AIFM is involved in structuring the loan, defining or pre-agreeing its characteristics prior to gaining exposure to the loan".

Certain rules do not apply to an AIF whose only loan origination activity consists in granting shareholder loans, provided the notional value of those loans does not exceed in aggregate 150% of the AIF's capital. For this purpose, a "shareholder loan" is defined as *"a loan which is granted by an AIF to an undertaking in which it holds directly or indirectly at least 5% of the capital or voting rights, and which cannot be sold to third parties independently of the capital instruments held by the AIF in the same undertaking*".

New operating conditions for AIFMs

The activity of "loan origination on behalf of AIFs" is added to the list of permitted activities that an AIFM may perform in the course of the collective management of an AIF. For Luxembourg AIFMs, this is a confirmation of existing regulatory practice, whereby loan origination by or on behalf of AIFs was already considered a permitted activity for AIFMs, so long as the applicable local product law did not prohibit such activity.

To manage AIFs engaging in loan origination, AIFMs will have to ensure, subject to the shareholder loans exception, that they have implemented policies, procedures and processes for the granting of credit, in particular for assessing credit risk and for administering and monitoring their credit portfolio. These rules are broadly consistent with existing regulatory requirements for Luxembourg AIFMs managing AIFs engaging in loan origination.

New transparency obligations are also added, whereby AIFMs managing AIFs that engage in loan origination will have to periodically disclose the composition of the originated loans portfolio to investors.

A "shareholder loan" is defined as "a loan which is granted by an AIF to an undertaking in which it holds directly or indirectly at least 5% of the capital or voting rights, and which cannot be sold to third parties independently of the capital instruments held by the AIF in the same undertaking".

Conditions impacting AIF terms and structures

The new regime also introduces new rules which will have a direct impact on the terms and structures of AIFs: diversification rules for loans to certain types of borrowers, prohibition of loans to certain connected parties, risk retention rules and the allocation of all loan proceeds to the AIF. These rules apply to all AIFs which originate loans, whatever their investment strategy.

- **Diversification limit.** Loans originated by or on behalf of an AIF to a single financial undertaking, an AIF or UCITS cannot exceed 20% of the AIF's capital, subject to certain exceptions (such as a ramp-up of maximum 24 months). For this purpose, a financial undertaking is broadly defined as a regulated entity such as a credit institution, insurance company or investment firm.

- **Prohibition of loans to connected parties.** To prevent conflicts of interests, AIFMs must ensure that AIFs do not grant loans to certain connected parties, including their AIFM and its delegates, and their depositary and its delegates, or to an AIFM group entity.

- **Risk retention rules.** AIFMs must ensure that the AIFs they manage do not adopt an 'originate-to-distribute' strategy whereby the AIFs originate loans with the sole purpose of transferring those loans or exposures to third parties. Moreover, an AIF will have to retain at least 5% of the notional value of each loan originated for a specified period, subject to certain exceptions (such as disposal of a loan due to a deterioration in the risk associated with the loan).

- **Allocation of loan proceeds**. All the proceeds of loans originated by the AIF, minus any allowable fees for administration of the loans, must be fully allocated to the AIF. All costs and expenses linked to administration of loans must also be disclosed to investors before they invest.

In addition, two new rules will apply only to AIFs qualifying as loan originating AIFs: a cap on leverage used by loan originating AIFs, and additional liquidity management obligations for open-ended loan originating AIFs.

- **Leverage cap.** The level of leverage for a loan originating AIF cannot exceed 175% for open-ended AIFs and 300% for closed-ended AIFs, subject to the shareholder loans exception. For this purpose, leverage is calculated according to the AIFMR commitment method.

- **Open-ended loan originating AIFs.** A loan originating AIF must be closed-ended, unless the AIFM is able to demonstrate to its competent authorities that the AIF's liquidity risk management system is compatible with its investment strategy and redemption policy. ESMA will develop draft regulatory technical standards to determine the criteria with which an open-ended loan originating AIF must comply.

The new rules apply to all AIFs without prejudice to stricter or specific limits applying under local product laws or EU laws, such as the ELTIF Regulation.

Next steps

The final text of AIFMD II has been agreed and is expected to be officially published by the end of Q1, 2024. Member States will have up to two years to implement the changes into national law, which means that the new regime will apply at the latest as of a date to be determined in Q1, 2026.

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However, EU policymakers have recognised that, due to the potentially illiquid and long-term nature of the assets of loan originating AIFs, AIFMs might experience difficulty in complying with changes to regulatory requirements introduced during the life cycle of the AIFs that they manage without affecting investor trust and confidence. Therefore, AIFMD II contains certain grandfathering and transitional rules, which refer to AIFMD II's date of entry into force, not the Member State implementation date.

An AIF constituted before AIFMD II enters into force that does not raise capital after the entry into force, will be permanently grandfathered from the diversification limit, the leverage cap and the additional liquidity management rules for open-ended loan originating funds. If the fund is still fundraising on the date of entry into force, it will be grandfathered from these rules for 5 years.

However, the new rules on procedures for granting credit, allocation of loan proceeds to the AIF, prohibition of loans to certain connected parties and risk retention, will apply to all new originated loans, subject to any transitional rules adopted under local law.

The Economic Crime and Corporate Transparency Act 2023: A questionable late Christmas present for companies and senior managers

Francis Kean
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McGill and Partners

On 26 December 2023, the attribution rules relating to corporate criminal responsibility for economic crimes were extended to senior managers under The Economic Crime and Corporate Transparency Act 2023 (ECCTA). So, who are senior managers for this purpose, and should they be worried? ECCTA also introduces a new corporate offence of failure to prevent fraud which will come into force when the Government publishes relevant guidance (expected early 2024). What are the implications of this for companies and their employees?

Background

The Serious Fraud Office and other prosecutorial authorities in the UK have long been campaigning for reform of the so called identification principle. The position in common law dating back to a House of Lords decision in 1971 is that only if those persons identified as the *"directing mind and will"* of a company commit an offence (and have the requisite guilty mind to commit such offence), will the company be guilty of it.

The problem here is that companies are legal constructs. For those corporate offences which require knowledge or intent, prosecutors must establish that such knowledge or intent resides with one or more individuals. That proved a challenge especially for companies with large executive teams which presided over complex businesses. (English courts, unlike the counterparts in the US, do not permit knowledge or intent to be aggregated between individuals.) Therefore, by expanding the net of individuals whose acts and knowledge can be attributed to the company, ECCTA addresses this issue for certain categories of crime while the common law rules are preserved for the rest.

Who are senior managers?

For better or worse, ECCTA borrows the definition from the Corporate Manslaughter and Corporate Homicide Act 2007 (CMCHA) under which "*senior management*" means any person who plays a significant role in:

(a) the making of decisions about how the whole or a substantial part of the company or partnership's activities are to be managed or organised, or
(b) the actual managing or organising of the whole or a substantial part of those activities.

The Explanatory Notes to the CMCHA state that this covers both those in the direct chain of management and those in, for example, strategic or regulatory compliance roles. Whilst directors and officers are plainly and deliberately in scope, it is less clear whether all those involved in taking decisions relating to corporate strategy and policy in areas such as finance, risk management and legal affairs will also be. Much will depend on the size and structure of the company concerned.

An obvious question is as to the meaning of *"substantial"* in this context. This has yet to be litigated under the CMCHA but prosecutors are likely to look at what an individual's role and responsibilities are within the organisation and the level of managerial influence they exert, rather than solely their job title. A further fact-sensitive question (and requirement under ECCTA) is whether the particular senior manager has acted within the scope of his or her "*actual or apparent authority*".

The new offence of failure to prevent fraud

In addition to the expansion of the scope of corporate criminal liability to all companies and across a long list of offences based on economic crime including fraud and theft, Section 199 of ECCTA introduces a new criminal offence of failure to prevent fraud. This is modelled on the equivalent offence created under Section 7 of The Bribery Act 2010 and applies to "*relevant bodies"* who are guilty of an offence when *"a person associated with that body commits a fraud offence intending to benefit the relevant body".*

"Person" for this purpose is not limited to senior managers but extends to all employees and arguably also to other entities within the company's supply chain.

"Relevant Body", however, is limited to large organisations i.e., ones which in the year preceding the fraud:

- Have a turnover exceeding £36 million; or
- A balance sheet total of more than £18 million; or
- Employ more than 250 employees.

As with the Bribery Act offence, a defence is available if the relevant body can demonstrate that it had in place fraud prevention measures that were reasonable in all the circumstances (or that it was reasonable not to have any). The Government has promised to publish guidance on what it considers constitutes *"reasonable fraud prevention measures"* early in 2024 and the new offence will come into force after that. It is nevertheless likely that large organisations will already be conducting reviews of their systems and controls aimed at preventing fraud and that this issue will (or should) be finding its way onto boardroom agendas in the near future.

Conclusion

A bit like London buses, after waiting a long time, two significant criminal legislative changes have come along at the same. Interestingly there does not seem to have been much discussion so far of the potential interplay between the two. It is now unquestionably, easier to bring a prosecution for fraud (among other economic crime offences) directly against virtually any company based on the extension of the identification principle to senior managers. At the same time, an additional weapon has been added to the prosecutors' arsenal but only in respect of large organisations for failing to prevent fraud. It seems not impossible, however, that prosecutors may opt to pursue both options on the same set of facts.

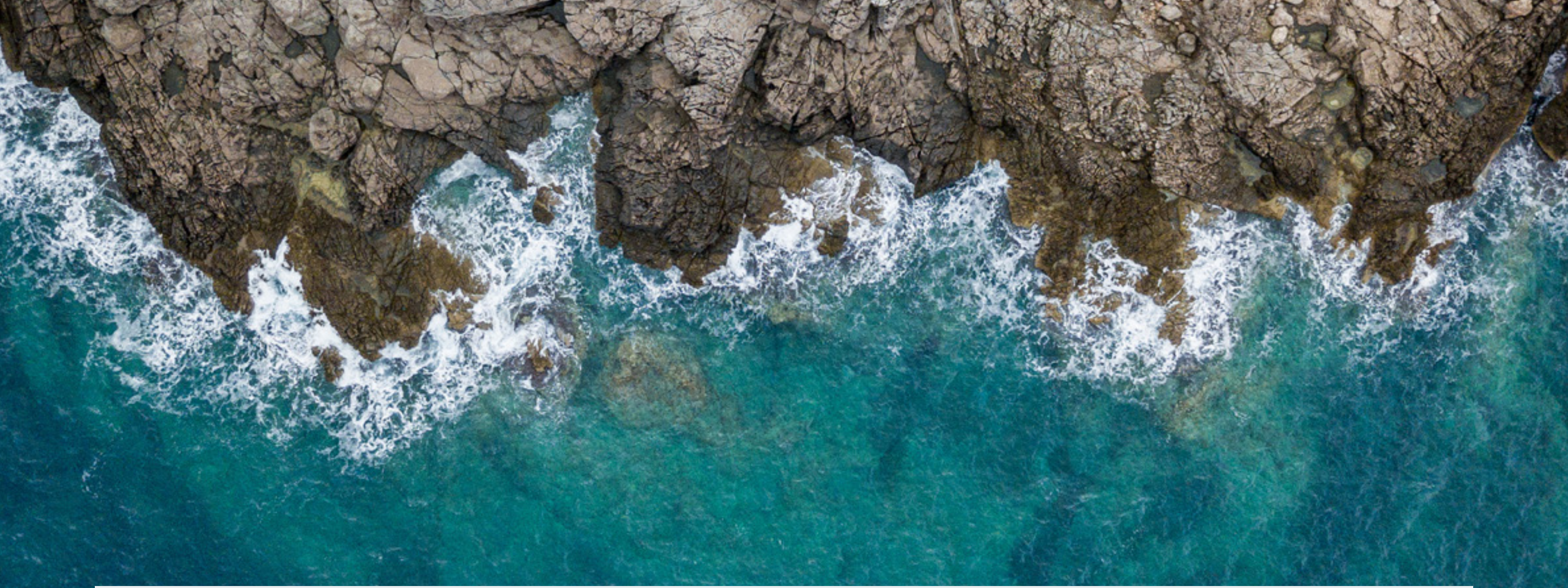
What does this mean in practice for companies and senior managers? It is likely that companies will be taking advice from HR consultants, lawyers and others as to which categories of employees in a large organisation might qualify as *"senior managers"* and thus be potential vehicles for the new corporate offence. (It is worth emphasising that under the new attribution rules, prosecutors do not need to establish that the senior manager was seeking through his or her conduct to benefit the company in any way). Additionally, they may wish to focus on the particular job and role descriptions of such individuals and especially on the question as to their *"actual or apparent authority"* within the relevant company on which corporate criminal responsibility also rests.

It is likely that companies will be taking advice from HR consultants, lawyers and others as to which categories of employees in a large organisation might qualify as "senior managers" and thus be potential vehicles for the new corporate offence.

Whilst the legislative changes may not directly increase personal liability of senior managers or other employees for any new substantive offences, they do place a new spotlight on the conduct of such individuals and make it perhaps more desirable than ever before that such individuals have access to independent legal advice before submitting to what may turn out to be a gruelling series of external and internal interviews regarding their conduct. In that context, it may be desirable to ensure that such advice is covered and paid for under any directors and officers (D&O) liability insurance.

Finally, a potential effect of this increased scope for corporate criminal liability in respect of future prosecutions is the corresponding increase in scope for deferred prosecution agreements between prosecutors and companies. Here, the scope for pursuing separate subsequent criminal proceedings against individuals based on their own conduct is usually expressly preserved.

Again, in this context, D&O insurance is likely to be of prime importance to senior managers, not least because the company may have little interest in indemnifying the individuals concerned.



Requiem for reengineering

John Sergides
CEO
MUFG Investor Services

The global alternatives marketplace is undergoing an unprecedented transformation as retail investors pour new capital into alternative investments, and fund managers and their outsourcing partners reengineer operating models for this new paradigm.

For decades, institutional investors were the mainstay of global alternatives—including hedge funds, private equity, infrastructure, private capital, and real estate—creating a large, but relatively finite universe of capital flowing between the funds. Like other markets, the alternatives ecosystem has been impacted recently by global geopolitical conflicts, inflation, rising interest rates, and market volatility.

Despite ongoing uncertainty however, the scope and scale of the alternatives market is expected to expand significantly in the coming years. Industry studies predict that high-net-worth and mass affluent retail investors, exploring ways to diversify their portfolios, will bring an estimated US$500 billion to US$1 trillion in new capital in the next three years, effectively creating a new marketplace.

At the same time, regulators are demanding increased transparency and disclosure to ensure those retail investors have a clear understanding of the investment risks. Technology will play a key role in driving most aspects of the changing industry, as new automated platforms replace outdated legacy systems.

The dizzying pace of change is creating new opportunities and challenges for fund managers who must decide whether to spend resources in-house to reconfigure their existing operating models—training staff, rebuilding processes, and replacing legacy technology—or to bring in an outsourcing partner to help develop and implement that new model. That work runs the gamut from helping with specific process issues to providing a comprehensive review of their operational infrastructure with suggestions for reconfiguring technology, systems, and processes to cut costs and minimise risk.

This approach is a natural extension of the role that outsourcing partners already are playing. Fund managers, who once outsourced back- or middle-office functions such as post-trade settlement or accounting, are increasingly looking for support across the full trade lifecycle to coordinate front-office 'decision' functions, including client onboarding, trade execution, and investor reporting.

In one case, fund managers are outsourcing lengthy and time-consuming Know Your Customer (KYC) and anti-money laundering (AML) processes to eliminate challenges with delays in opening client accounts. As the volume of retail investors grows, so will the need for a highly efficient process that aggregates accurate and consistent data sources.

As the alternatives markets' transformation continues, fund managers will need to have operating models that can provide greater information about performance and management fees and costs, increase education about products for advisors and investors, develop new distribution and marketing channels, ensure product liquidity, and meet new regulatory and compliance requirements around the world.

Finding the balance between what will be outsourced and what will be kept in-house will be determined by evaluating current operating models, existing service level agreements, and the unique future needs of individual funds. Outsourcing partners will then help tailor a new operating model to address those plans.

One element of the new paradigm is abundantly clear: firms relying on outdated, legacy technology will not be able to move fast enough to accommodate the necessary changes for new operating models, which will be powered by new cloud-based data solutions and platforms.

Whether these new platforms are developed to integrate with current systems or are provided by partner firms, the days when teams work effectively with Excel spreadsheets are rapidly ending. Funds must embrace automation—underpinned by artificial intelligence and cutting-edge programs supporting the platforms—to better process volumes of new data, create new products, improve investment strategies, use data across platforms, and develop applications.

In a second example, a large investment manager who was planning to market in multiple European jurisdictions moved to an outsourcing firm's new platform, which harmonises data and provides automatic, verified reporting for each jurisdiction's requirements rather than having the client file several separate submissions—a substantial savings of resources.

Heighted data security is more important than ever before, given the tremendous amount of new information entering the alternative marketplace. It's vital that funds and their partners work closely to provide a secure, continually monitored environment to reduce operational risk, prevent data leaks, and defend against attacks by cybercriminals.

A tenet of our industry is that all alternative investments are unique, and that each company has its own needs and goals, which means there could be as many different operating models as there are funds. The industry is undergoing dramatic changes, and, at times, it may be difficult to prioritise one area over another. New capital invested by high-net-worth, and mass affluent retail investors will certainly have a significant impact on every aspect of the alternatives marketplace.

As our industry transforms, fund managers who act now to reassess where they are and where they want to be—often collaborating with trusted partners to reengineer their models to realise that new vision—are most likely to lead the way in the future.

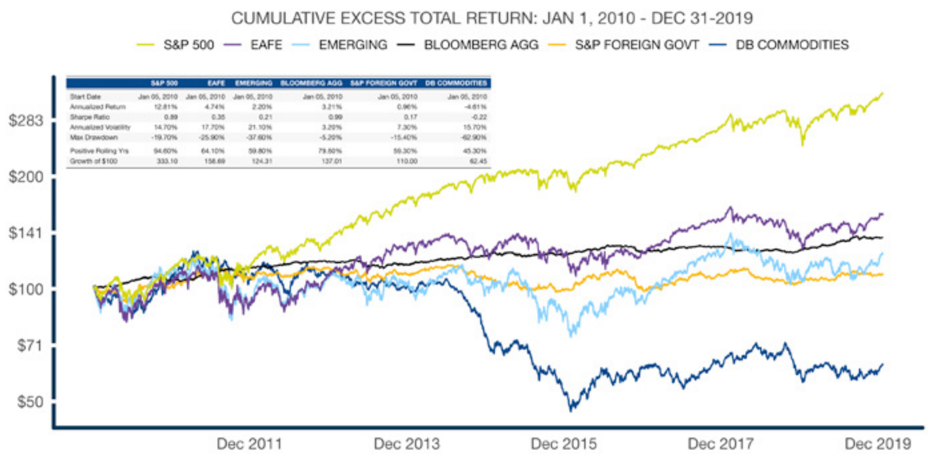
Portable alpha for all: Return stacked strategies for diversification without sacrifice

Adam Butler
Chief Investment Officer
ReSolve Asset Management Global

Diversification is the cornerstone of investing. This principle, fundamentally understood as not concentrating all resources into a single investment, inherently seeks to minimise risk while potentially smoothing out returns over the long term.

By spreading investments across uncorrelated assets, investors may more reliably cushion against sector-specific downturns and geopolitical risks. Moreover, diversification serves not only as a defensive mechanism against losses, but also as a proactive strategy to capitalise on opportunities across a broad spectrum of investments. Thus, embracing diversification unequivocally enhances the resilience and performance potential of investment portfolios.

The 2010s mocked attempts at diversification as returns were highly concentrated in US large-cap equities. Driven by the pursuit of higher returns, investors increasingly allocated capital towards US equities, neglecting other asset classes. This trend not only underscored the challenges in achieving genuine portfolio diversification but also reflected a broader skepticism towards non-equity investments.



	S&P 500	EAFE	EMERGING	BLOOMBERG AGG	S&P FOREIGN GOVT	DB COMMODITIES
Start Date	Jan 05, 2010	Jan 05, 2010	Jan 05, 2010	Jan 05, 2010	Jan 05, 2010	Jan 05, 2010
Annualized Return	12.81%	4.74%	2.20%	3.21%	0.96%	-4.61%
Sharpe Ratio	0.89	0.35	0.21	0.99	0.17	-0.22
Annualized Volatility	14.70%	17.70%	21.10%	3.20%	7.30%	15.70%
Max Drawdown	-19.70%	-25.90%	-37.60%	-5.20%	-15.40%	-62.90%
Positive Rolling Yrs	94.60%	64.10%	59.80%	79.60%	59.30%	45.30%
Growth of $100	333.10	158.69	124.31	137.01	110.00	62.45

Source: Employed US listed ETF Proxies for investable returns: S&P 500 (SPY), EAFE (EFA), EMERGING (EEM), BLOOMBERG AGG (AGG), S&P FOREIGN GOVT (BWX), DB COMMODITIES (DBC). Returns are total returns in excess of 3-month US Treasury bills. Data from Bloomberg. Past performance is not indicative of future results.

Despite a dearth of rewards to diversification, the 2010s saw a marked acceleration in the proliferation of liquid and accessible alternative mutual funds and ETFs. These funds significantly democratised access to previously exclusive market segments and strategies, allowing even small-scale investors to partake in the benefits of a diversified investment strategy.

The return experience of the 2010s is unlikely to repeat in the 2020s. For one, valuations may exert substantial headwinds. The preceding decade's significant equity valuation increases may necessitate a recalibration of investor expectations. By one reliable metric,[1] US cap-weighted equities are poised to deliver total returns at a rate of 0.7% below inflation over the next decade.[2] This phenomenon, reminiscent of other historical 'Lost Decades,' underscores the cyclical nature of financial markets.

Calendar 2022, characterised by a global inflation spike driven by a confluence of demand and supply shocks, may be more representative of what investors might expect in the 2020s. Broader themes of higher and more volatile inflation dynamics and large fiscal deficits are likely to persist. Historical precedents indicate that once inflation thresholds are breached, a new normative baseline often emerges, suggesting a protracted period of elevated rates of appreciation in global prices.[3]

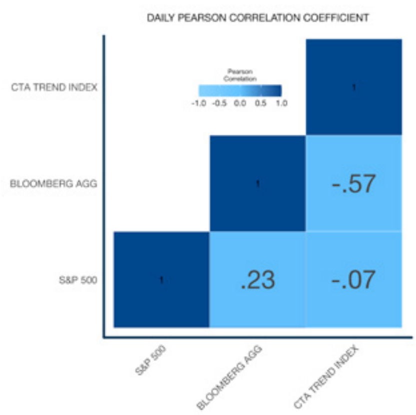
There are several reasons why inflation might gain an entrenched foothold. Aside from the long-term supply-chain effects of "onshoring" policies in the wake of critical supply gaps during the COVID pandemic, and commensurate deglobalisation efforts, supply is also likely to be pressured by an escalation in geopolitical conflict analogous to the last sustained inflation supply shock in the 1970s. Conversely, while unprecedented deficits due to COVID have moderated, the fiscal outlook for the United States includes large and rising deficits and debt levels for most of the coming decade.[4] US Congressional Budget Office projections indicate a rising federal debt-to-GDP ratio, expected to reach 110 by 2032.[5]

Investors have many choices for diversifiers across inflationary regimes, including commodities, inflation protected securities, and active strategies. In the active category, managed futures trend following experienced a renaissance in 2022.[6] Despite attention-grabbing performance in the 2008 Global Financial Crisis, managed futures endured a lackluster 2010s amidst a general lack of macroeconomic dispersion.[7] Strong performance in the post-COVID inflationary shock highlighted the strategy's potential capacity to navigate the volatility and inflationary pressures that have become more pronounced in the wake of the pandemic. This is consistent with the category's low historical correlations with equities and bonds.

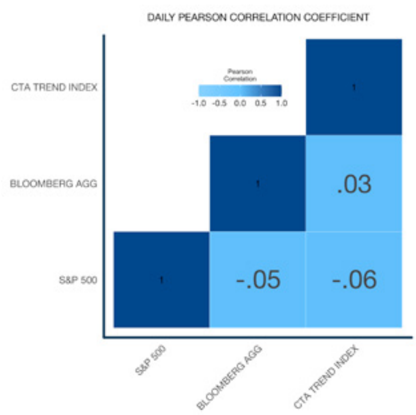
1 https://www.philosophicaleconomics.com/2013/12/the-single-greatest-predictor-of-future-stock-market-returns/
2 https://www.morningstar.com/news/marketwatch/20240122131/the-latest-from-the-single-greatest-predictor-of-future-stock-market-returns
3 https://haymaker.substack.com/p/making-hay-monday-november-6th-2023
4 https://www.cbo.gov/publication/58946
5 https://www.pgpf.org/expert-views/inflation-interest-and-the-national-debt/five-fundamental-changes-for-us-fiscal-policy
6 https://www.etftrends.com/managed-futures-channel/2022-the-year-of-managed-futures/
7 https://thehedgefundjournal.com/managed-futures-d1/

Source: Employed US listed ETF Proxies for investable returns: SPY 500 (SPY), BLOOMBERG AGG (AGG). CTA TREND INDEX is proxied by the Société Générale CTA Trend Index. Returns are total returns in excess of 3-month US Treasury bills. Data from Bloomberg. Past performance is not indicative of future results.

Correlation of Daily Returns: Jan 1, 2021 – Dec 31, 2023



Correlation of Daily Returns: Jan 1, 2000 – Dec 31, 2023



Source: Employed ETF Proxies for investable returns: S&P 500 (SPY), BLOOMBERG AGG (AGG). CTA TREND INDEX is proxied by the Société Générale CTA Trend Index. All data from Bloomberg. Returns are total returns in excess of US 3-month Treasury bills. Past performance is not indicative of future results.

Seasoned professional investors may endorse the view that complex markets motivate portfolios diversified against a wider array of risks, but less experienced investors may be loathe to reduce exposure to core equities and bonds to make room for diversifiers. For many, the incredible mega-capitalisation focused rebound in 2023, primarily in US technology stocks riding a wave of AI enthusiasm,[8] feels like vindication. The fear of missing out on traditional market gains often outweighs the theoretical benefits of diversification. Consequently, portfolios remain skewed towards higher-risk and concentrated investments.[9]

This prompts a question: how can asset managers nudge investors into more diversified portfolios without requiring them to sell coveted core products to make room for alternatives? As institutions have understood for decades, futures can be easily layered on top of cash equities or bonds to maximise capital efficiency . Futures are also well understood by regulators, and regulations accommodate leverage derived from futures much more flexibly than the leverage drawn by cash equity market-neutral or long-short strategies.[10]

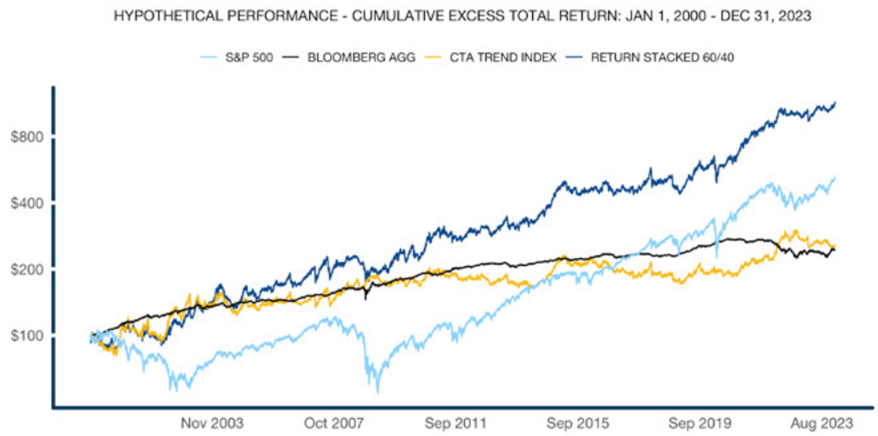
Return Stacked strategies have emerged as a streamlined and approachable mechanism to offer investors of all sizes access to "portable alpha" strategies previously only available to sophisticated

8 https://www.statista.com/chart/30318/sector-contributions-to-sp500-return/
9 https://en.wikipedia.org/wiki/Portable_alpha
10 https://www.jdsupra.com/legalnews/sec-adopts-new-regulatory-framework-for-50828/

institutions.[11] By collateralising an active futures strategy with passive equities or bonds, Return Stacked strategies allow investors big and small to maintain full exposure to core positions while stacking reliable diversifiers on top.

Managed futures stand out as an especially complementary tool for Return Stacking on top of cash backed equities and bonds. But astute readers will have identified a potential complication.

Specifically, traditional managed futures benchmarks like the Société Generale CTA Index are not directly investable. Rather, they are constituted from a universe of large, mostly private performance funds.[12] Large institutions may invest in a large cross section of constituent funds to minimise tracking error, or search for above-average managers.

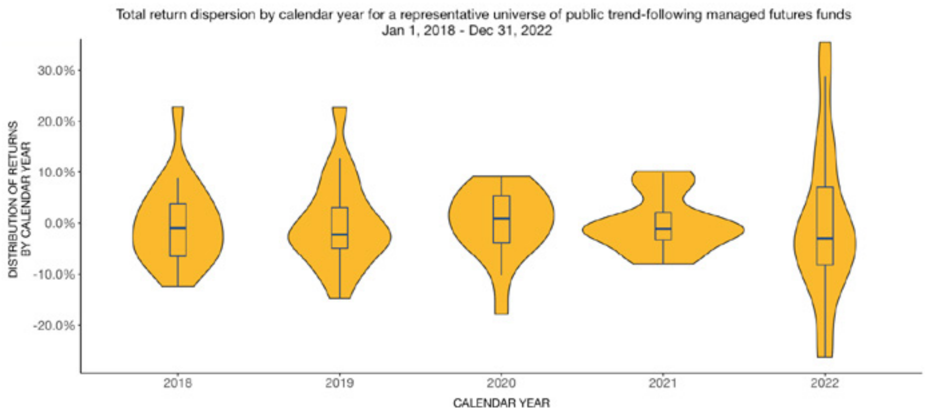


Source: Employed ETF Proxies for investable returns: S&P 500 (SPY), BLOOMBERG AGG (AGG). CTA TREND INDEX is proxied by the Société Générale CTA Trend Index. RETURN STACKED 60/40 represents a monthly rebalanced portfolio of 60% S&P 500 (SPY), 40% BLOOMBERG AGG (AGG), and 100% Societe Generale CTA Trend Index less the 3-month US Treasury bill rate and an additional 0.4% annualised assumed excess funding rate. The portfolio is rebalanced back to target weights at the end of each month. All data from Bloomberg.

The above chart presents HYPOTHETICAL PERFORMANCE results that do not reflect actual trading and are not indicative of future results. They are designed to demonstrate what performance might have looked like if certain strategies had been employed. Returns are total returns. Past performance is not indicative of future results.

Smaller investors may choose to allocate to just one fund or perhaps a small sample of funds. This may be problematic for those seeking category-like returns most years. That's because there is a great deal of variation in how managed futures funds operate. Managers may choose different universes of markets to trade, utilise different trend lengths and definitions, apply various weighting schemes, use diverse risk management techniques and stop-losses, or include exposures to other systematic factors like carry. As a result, the returns to trend-following managed futures funds can exhibit large dispersion from year-to-year.

11 https://investresolve.com/inc/uploads/pdf/return-stacking-strategies-for-overcoming-a-low-return-environment.pdf
12 https://wholesale.banking.societegenerale.com/fileadmin/indices_feeds/SG_CTA_Index_Methodology.pdf



Source: Funds were selected from the Morningstar Systematic Trend category. Funds with less than five years of continuous data through January 2023 were excluded. Funds used (by ticker symbol) include ABYIX, ACXIX, AHLIX, AMFNX, AQMIX, CSAIX, EQCHX, EVOIX, GMSSX, LCSIX, LFMIX, LOTIX, MFTNX, PQTIX, QMHIX, RYIFX, SUPIX, WAVIX. Past performance is not indicative of future results.

Over the five years from 2018 through 2022 the returns to individual trend-following managed futures funds[13] deviated from the average of all funds by 9 percentage points about half the time. The 95% range of dispersion was almost 27 percentage points. This dispersion motivates a search for methods to gain exposure to the underlying theme of trend-following with minimal tracking error.

Rather than choosing one or two funds to represent the index, investors may be better served by trying to replicate a popular benchmark index quantitatively. The task is challenged by limited disclosure from constituent fund managers regarding their current positions and strategies. Replication strategies, therefore, must infer the weighted average holdings of the benchmark's constituent managers.

This deduction is based on a thorough understanding of the common markets traded by managed futures funds, the typical strategies they employ, and the reported returns of the index, ensuring a methodical approach to closely emulate the desired return trajectory.[14]

In conclusion, the evolving landscape of global financial markets underscores the enduring importance of diversification and the strategic implementation of alternative investment strategies. The 2020s present a complex array of challenges and opportunities, necessitating a recalibration of investor expectations and strategies. Managed futures and trend-following strategies, in particular, may offer a viable pathway for navigating market volatility and inflationary pressures, providing a complementary hedge to traditional asset classes. The advent of Return Stacked strategies and the pursuit of methods to minimise tracking error in managed futures investments further democratise access to sophisticated diversification tactics. Investors, therefore, must remain vigilant and adaptable, leveraging these innovations to enhance portfolio resilience in an increasingly uncertain macroeconomic and geopolitical environment.

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13 Funds included in the analysis include ABYIX, ACXIX, AHLIX, AMFNX, AQMIX, CSAIX, EQCHX, EVOIX, GMSSX, LCSIX, LFMIX, LOTIX, MFTNX, PQTIX, QMHIX, RYIFX, SUPIX, WAVIX.

14 Source: Peering Around Corners: How to Replicate Managed Futures Strategies

Beyond alternative investment fund compliance: Navigating the complexities of risk monitoring

Geraldine Gibson-Dautun
Founder & CEO
AQMetrics

Evolving regulations, complex investment strategies, diverse asset classes, and the need for real-time oversight can turn investment monitoring into a complex task for any alternative investment fund (AIF). The dynamic nature of financial markets and the constant changes in regulatory requirements make it difficult for AIFs to ensure they are continually monitoring the right things. Additionally, the data and transactions involved require sophisticated systems and continuous vigilance to detect and address potential investment risks effectively.

Unlike Undertakings for the Collective Investment in Transferable Securities (UCITS) or 40 Act Funds, AIFs do not have to adhere to strict regulatory constraints, such as investment restrictions and risk diversification rules. AIFs are subject to the Alternative Investment Fund Managers Directive (AIFMD) in the European Union and to Securities and Exchange Commission (SEC) rules for Private Funds in the USA, but they generally have more flexibility in their operations and investment approaches compared to UCITS funds. AIFs are not yet concerned with harmonising compliance across multiple jurisdictions and adapting to different regulatory landscapes. That indeed may come with more SEC regulations and AIFMD2 in Europe but for now, AIFs focus is on investment risk monitoring rather than investment compliance monitoring.

AIFs have a broader scope for investment strategies than UCITS, Mutual Funds and Money Market Funds (MMFs) and can include a wider range of asset classes, including alternative and illiquid investments. AIFs often cater to professional or sophisticated investors who are willing to take on higher risks. With higher risks comes a need for enhanced risk monitoring and management. AIFs, given their broader investment scope, may engage in more complex and less liquid strategies. It is for this reason that risk monitoring for AIFs is less about compliance monitoring per se. AIFs risk management focuses on the specific risks associated with alternative investments, including valuation challenges and potential illiquidity issues. This heightens the need for robust risk management frameworks and reporting structures tailored to the specific nature of alternative investments.

AIFM risk monitoring in Europe compared to the USA

Further, investment monitoring for alternative funds in the USA and Europe differs due to variations in regulatory frameworks, legal structures, and market practices. In the USA the regulatory landscape includes both federal and state-level regulations, with the SEC playing a significant role. In Europe, the AIFMD governs alternative funds. This directive provides a harmonised framework across the European Union for the regulation of alternative investment fund managers and their funds.

Managers are required to have robust systems to value assets and manage risks.

The SEC emphasises the importance of effective risk management and valuation practices for alternative funds. Managers are required to have robust systems to value assets and manage risks. In Europe, AIFMD mandates that AIFs implement risk management processes and establish proper valuation procedures, including independent valuations for certain assets.

While there are overarching principles, the nuances in regulatory approaches and specific requirements highlight the importance of understanding the multi-jurisdictional landscape and local regulatory environments when it comes to investment monitoring for alternative funds in the USA and Europe.

Being independent of portfolio management, investment risk monitoring enables appropriate corrective actions when needed, such as currency or interest rate hedging, or monitoring more closely the evolution of certain risk exposures. Notwithstanding, monitoring and measuring risks associated with private equity and real estate investments as well as their evolution is a live issue for funds in both the USA and Europe.

Liquidity risk monitoring of hard-to-value securities

Illiquid or hard-to-value assets are common in AIFs. Mechanisms for fair value determination and dealing with complex securities are challenging for AIFs. The lack of quantitative data and the illiquidity of alternative investments make a risk measurement framework challenging for AIFs. Quantitative risk indicators such as changes to exchange rates and interest rates, microeconomics such as tenant default rates and rent hikes and macroeconomic indicators including GDP growth and inflation rates help risk monitoring, but capturing all material risks of private equity and real estate funds and proper monitoring of the same requires going beyond key risk indicators. Some risks lie within the valuation process and important factors such as discount rates require close monitoring. It is for this reason that advanced risk modelling techniques enable AIFs to combine the various risk indicators to derive an assessment and monitoring of risk through estimated distributions of internal rates of return (IRR) over a given time horizon.

This certainly helps when an AIF has to focus on liquidity risk measurement and control. A software solution must be able to independently determine value in portfolios containing hard-to-value securities is a must when it comes to integrating a comprehensive and robust risk monitoring framework that includes liquidity risk and valuation of hard-to-value securities.

Scenario analysis and stress testing

Scenario analysis and stress testing capabilities are essential. Software should enable AIFs to model different market scenarios and assess the potential impact on the portfolio and liquidity buckets, helping them make informed decisions. Stress testing requirements introduced by the AIFMD in Europe and SEC liquidity rules in the USA are a challenging factor for many private equity and real estate managers. Stress testing can leverage work already performed in the valuation of private equity or appraisal of real estate properties, by taking a forward-looking view. This can result in the assessment of the impact of adverse scenarios on the NAV of the fund.

Choosing software for investment risk monitoring

So, what key factors should an AIF consider when selecting investment risk monitoring software? Firstly, the software must align with the unique characteristics of alternative investments. The software must support a diverse range of alternative asset classes, including private equity, hedge funds, real estate, commodities, and other non-traditional investments relevant to the fund's strategy. Accommodation of fund-specific risk metrics, investment strategies, and reporting requirements is a must. Software flexibility is crucial to adapt to the dynamic nature of alternative investments. AIFs use many systems, including portfolio management, accounting, and reporting tools and the software for investment risk monitoring must be able to easily integrate and plug into these existing tools. Integration streamlines data flow, reduces the risk of errors and enhances overall efficiency.

Given the sensitivity of data across a myriad of integrated systems, the software an AIF selects for investment risk management must be equipped with robust security measures to protect against data breaches. Compliance with data privacy regulations is essential to ensure the confidentiality of sensitive information.

Tracking exposure limits and investment guidelines and staying up-to-date with evolving regulations is a challenge for AIFs already trying to gain alpha at all costs. Software must remain effective and efficient as the AIF expands its operations and assets under management. AIFs need an investment risk monitoring solution that can scale with the growth of the fund.

Key to AIFs is the reputation of the software vendor, their experience in the financial industry, and the level of customer support they provide. A reliable vendor with good support can be instrumental in addressing issues promptly. By carefully evaluating risk management software based on these criteria, alternative fund managers can enhance their ability to identify, measure, and manage risks associated with their unique investment strategies.

Disclaimer:

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The SFC's Revised Business and Risk Management Questionnaire: Start early

Stuart Somer
Director
S2 Compliance Limited, Hong Kong

I. Overview

On 23 December 2022, the Hong Kong Securities and Futures Commission (SFC) issued a Revised Business and Risk Management Questionnaire (BRMQ) for completion annually by managers in connection with their recently enhanced risk supervision of Hong Kong Licensed Corporations. This new document must be used in respect of their financial year end commencing on 30 November 2023 and thereafter. Firms with a financial year ending December 2023 must use this new document, due for submission to the SFC on or prior to **30 April 2024**.

II. Background

Pursuant to Section 156(1) of the Securities and Futures Ordinance, a manager must complete and submit the BRMQ to the SFC within 4 months after the end of each financial year. In 2019, the SFC issued a significantly revamped BRMQ. The document increased scrutiny on management accountability and oversight and indicated the SFC expected firms to have established protocols addressing and escalating all material compliance and risk management issues it faces, with due regard to their size, complexity, and scope of business activity.

The scope of the BRMQ's questions provides the SFC with a 'snapshot' of a manager's operations and associated key risk elements comparable to the level of detail ordinarily available to them only following a routine inspection. Further, the wide-ranging scope of BRMQ inquiry allows the SFC to gain insight into areas of a manager's operations which could not reviewed during the inspection, which is both time-constrained and topic-limited. The BRMQ facilitates the SFC's assessment of the soundness of managers' risk and operational procedures, the adequacy of their corporate governance, and in the case of Hong Kong offices supported by large global organisations, the latter's financial health.

III. BRMQ Overview

The SFC has revised the BRMQ for 2024 to collect additional information on a variety of functions and business activities to enhance the effectiveness of its risk-based supervision of managers and to assess their compliance with recent changes to AML guidelines. The topical coverage of the BRMQ is the same, however additional questions have been added, and certain questions have been reconfigured, both to provide the SFC with additional detail concerning, inter alia: financial health of group companies, operation of bank accounts via online banking and relevant security measures, exit plans in case of closure of business, AML review of cross-border correspondent relationships, and more detail on the advisory services provided by asset managers to investors. Similar to prior years, the revised BRMQ is required to be completed and submitted through SFC WINGS.

The revised BRMQ consists of Section A and Section B with certain changes.

1. Section A

This section consists of questions relating to operational functions and arrangements generally relevant to all managers. When preparing responses, they should consider existing compliance and risk management protocols and management escalation procedures and be prepared to disclose what could be potentially sensitive information regarding prior operational or risk breaches which occurred or were identified in the course of internal or external audits.

This section is to be completed by all managers regardless of whether or not there are any relevant business activities conducted by them during the financial year.

2. Section B

This section consists of questions specific to various business activities. Significantly, given the overlapping definitions of Regulated Activities, questions are not keyed to the specific Regulated Activity types for which managers are licensed, but rather, references the actual business activities undertaken or service provided by them. As such, most firms will be required to complete significantly less than the entire document.

This section should be completed by managers on the basis of the specific business activities undertaken or services provided by them during the relevant financial year.

IV. Implications

1. Time required for completion

For newly licensed firms, completion of the BRMQ will most likely require a significant amount of time for them to review, discuss, and prepare. Firms with a fiscal year ending in December must submit the BRMQ to the SFC on or prior to **30 April 2024**. The comprehensive and wide-ranging scope of questions encompassed in the BRMQ will require input from various individuals and/or departments, and there will be questions which are subject to varying interpretations owing to their ambiguity. We encourage our clients to start planning for completing the new BRMQ as soon as possible.

For managers who have completed the BRMQ previously, it is our recommendation that you may use the prior document as a starting point and update the responses as required. Certain sections are unchanged, other sections have been completely rewritten with various available responses to questions having been amalgamated into other questions; in such cases answers given in prior years will not be helpful.

2. General approach

Common sense would dictate the SFC will use the BRMQ as an extremely precise analytical tool to triage their limited inspection resources so as to direct them to specific business activities and firms which they view as presenting more risk to the market as a whole or to specific investors. However, following issuance of the revised BRMQ in 2019 and in the 4 years thereafter this has not been indicated to any material degree. Save for one isolated item regarding responses to AML questions, we have noted no instances of the SFC querying firms, either ad hoc or at the time of their routine inspection, concerning non-compliance with both applicable regulations and implied expectations solely on the basis of their BRMQ responses. We anticipate, but cannot conclusively confirm, this practice will continue with the revised BRMQ.

3. Supporting your response

Every answer provided should be true and correct, and firms should be prepared to demonstrate they have policies, procedures, and management oversight of processes where they have responded affirmatively to questions asking whether such items exist in the event they receive queries from the SFC on such matters. Certain of the BRMQ questions relate to operational breaches or other events; respondents will have to make a business decision as to the scope of such questions and materiality of breaches disclosed. Where there are minor breaches not disclosed, respondents should be prepared to assess and document internally the rationale for determining such an event is not of a threshold being material so as to require its reporting in the BRMQ.

4. Responding negatively

There is some concern regarding the consequences of indicating “no” to questions generally, with the presumption being that if the question is asked then there is an expectation that the manager must establish and maintain the referenced process, or such response indicates a lack of sound control procedures and senior management oversight. While this is a valid concern, the application of the BRMQ by the SFC should be viewed in the larger context of its regulation function. This document is addressed to and is completed by all managers which can range significantly in size, sophistication, scope of Regulated Activities, and support from overseas group companies, and accordingly all questions raised will not necessarily be applicable to all firms, and the responses offered should not be viewed as express requirements.

In particular, it is our view that certain BRMQ questions are applicable solely in the context of a large multinational financial services businesses, or large retail-oriented firms concurrently conducting various lines of business which have inherently conflicting attributes, and which may have common internal control and business units supporting their activity.

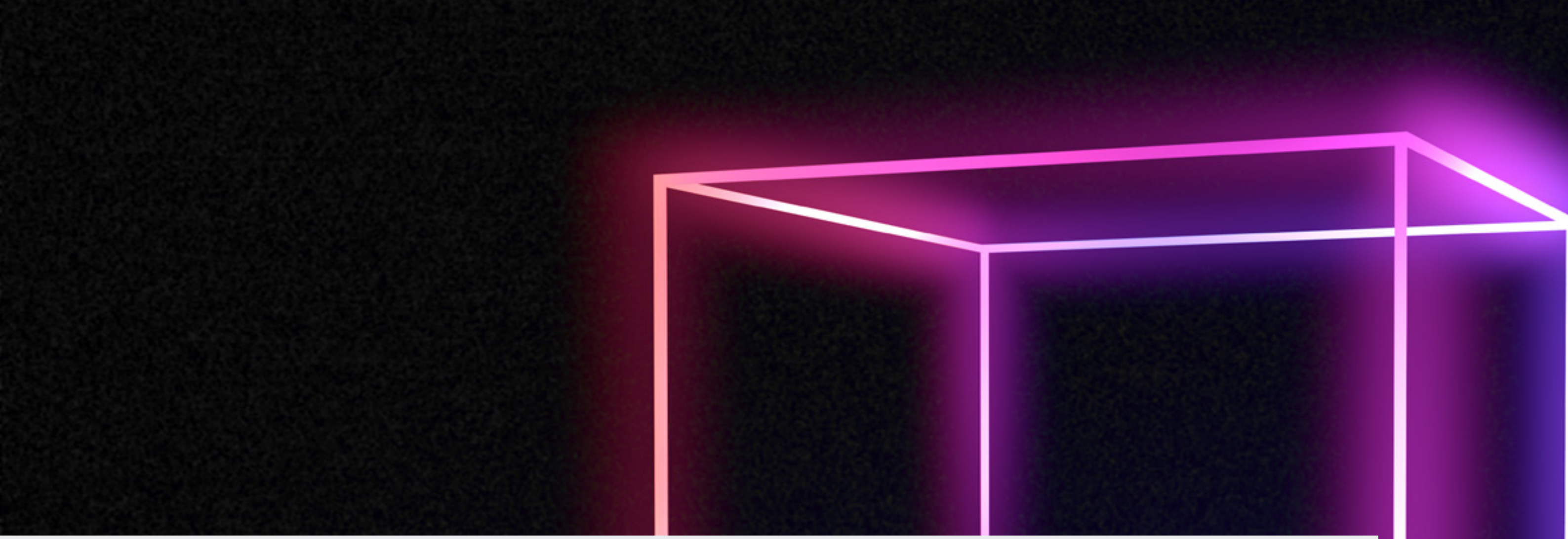
Accordingly, answering “no” to a question is not indicative of a breach of a requirement, as the question itself merely reflects the SFC’s survey effort, and is not an explicit SFC requirement or implicit expectation in most cases. This view is consistent with the SFC’s principles-based approach which informs all of its regulatory oversight. It is suggested managers adopt this approach when reviewing questions and in certain contexts, for example being licensed for a single Regulated Activity type or having a narrow scope of Regulated Activities such as distribution of investment products to Professional Investors or supporting the activities of overseas group companies. Such firms, in our view, may confidently answer “no” to questions with little concern that such response will trigger SFC scrutiny and a finding of non-compliance with requirements.

5. Remarks and supplementary information

For questions which appear ambiguous or not directly relevant to a firm’s activities, where the available answer options do not completely describe its situation or processes, respondents can provide additional, relevant information to supplement or clarify answers given. A reminder that each question in a given section (e.g. A1, A2) applicable to the firm must be addressed.

6. Support from group or parent company

For managers relying on a group or parent company to provide support for certain activities or perform certain controls or oversight functions, it is recommended your firm avoid choosing “No” or “N/A” from the answers. As appropriate, firms may wish to consider selecting the answer(s) which best describe the activities supported by or controls exercised from its group or parent company and make appropriate remarks to describe the support the firm obtains. Before responding to such question, it is suggested to confirm with them the exact scope of their support.



Starting a new fund:
5 thoughts on making the big leap

Making the transition from being a fund management star to running an asset management business is exciting but it can be fraught with pitfalls. To stand the best chance of success, you not only need a great track record in outperforming in both bull and bear markets, but also expertise in a wide range of other areas, including business planning, raising capital, accounting and HR. This may sound daunting but help is at hand to support you every step of the way.

Having spent over a decade helping funds to get off to a successful start – and supporting them on their growth journey – Ortwin Gierhake, Marex Prime Services is well placed to advise fund managers on making the big leap. Here he shares his top five tips for fund managers starting a new fund.

Ortwin Gierhake
Director
Marex Prime Services

1. **Take a cold, hard look at who would be the right CEO**

   If you're a successful fund manager, it's easy to imagine running your own hedge fund. The question is, are you actually able to? Many people in that situation will have only run very small teams, with a few assistants. Suddenly, you have an actual business to look after, which means you're outside of your comfort zone.

   For me, the CEO is key. The person needs to have the right blend of skills and experience. Too often, when a fund is formed, the initial team will pick someone from their own ranks to run it based on whatever is most expedient. If need be, consider a new face, someone external to the start-up team.

2. **Think in terms of an elevator pitch**

   Often, someone who has little or no experience running a business does not understand the importance of crystalising their strategy in a tight 30-second statement. If you can begin to do that – and not ramble –that is progress. As you move into marketing, if you don't have an elevator pitch, it becomes immediately apparent.

   Your fund does not need to be unique. In fact, when I hear people say they have something totally unique, I begin to worry. They are either unaware of industry dynamics or they could be making promises they won't be able to keep. You just must have something that makes a lot of sense.

3. Understand the value of independence

The boss should make decisions purely on evidence, not based on prior relationships. I've seen situations where the compliance officer or the risk officer is related to the CIO. How is that supposed to work?

If a fund wants to manage its own money, or the money of friends and family, then cosy relationships like that may work. But if you want to get bigger, you need to take on a more professional approach from Day 1. An institutional investor looking at your operation will expect to see that.

4. Focus on team dynamics

Managing the team is a critical function. Far too often, new funds begin to fray because individual managers have created their own realities, with too many yes people who were unprepared to push back. It's vital to have someone running the fund who understands how to create the right team dynamic, to cut through the noise and focus on what matters.

There are so many potential ways that stress can enter the scene in the first 12-24 months. A fund CEO needs to have an eye on all of that, getting people to keep talking to each other and being open. Allocators will be able to sense if the team is not functioning well.

5. Be organised right from the start

Funds have a brief window of opportunity when they are launching. They need to use the time wisely. At the beginning, we often see funds get overwhelmed. They go to conferences and collect cards and feedback, but they don't take notes and categorise them. After a month, they have lots of leads, but they don't know which are hot, cold, or worth forgetting. It is imperative to have somebody who takes initial inquiries, answers the easy questions, and ensures that investor leads are handled correctly. This doesn't necessarily need to be Investor Relations person, but it needs to be someone who is allocated these responsibilities as part of their remit.

You can't do justice to a subject as nuanced and complex as this in just a few short tips. However, be mindful that a supportive prime brokerage partner can bring a wealth of expertise. Successful funds need more than great trading ideas. They need great business leaders. That kind of greatness can be learned, with the right helping hand.

The British Virgin Islands Approved Manager Regime

The Investment Business (Approved Managers) Regulations (As Revised) (the Approved Managers Regime) (as supplemented by the Approved Investment Managers Guidelines (As Revised) issued by the British Virgin Islands (BVI) Financial Services Commission (the FSC) came into force in the BVI in 2012 and was designed to be a regulatory 'light' regime for qualifying investment managers and advisers who are incorporated or formed in the BVI (Approved Managers). The systemic risk posed by start-up and existing midsized managers of both open-ended and closed-ended funds is generally acknowledged to be lower than for those managing larger sums of investor money. Such managers are, however, often subject to the same regulatory regime as larger managers, leading to a disproportionate level of regulatory compliance costs. To help address this, the BVI adopted the Approved Managers Regime.

While a welcome introduction to the jurisdiction for the existing private and professional fund regime and growing closed-ended fund formation business, it was limited in scope as it was initially only available, subject to certain AUM caps, to qualifying BVI Managers that acted as investment manager or investment adviser to private or professional funds recognised under the Securities Investment Business Act (SIBA), closed-ended funds incorporated, formed or organised under the laws of the BVI and having the characteristics of a private or professional fund and feeder funds into such funds and affiliates of those funds.

Recognising that the regime, as originally enacted, was too restrictive the Investment Business (Approved Managers) Amendment Regulations were introduced in 2014 extending the scope of the Approved Managers Regime to include the ability for funds from 'recognised jurisdictions' that have equivalent characteristics to BVI private or professional funds to be managed or advised by investment managers or investment advisers approved under the Approved Manager Regime.

Joanna Russell
Partner
Maples Group

Ruairi Bourke
Partner
Maples Group

Scope of the Approved Managers Regime

Following the revisions, the Approved Managers Regime became available to qualifying BVI managers that act as:

(a) An investment manager or investment adviser to private or professional funds recognised under SIBA, feeder funds into such funds and affiliates of those funds, as well as funds from recognised jurisdictions that have equivalent characteristics to BVI private or professional funds, provided the assets under management in such open-ended structures are US$400 million or less;
(b) An investment manager or investment adviser to closed-ended funds incorporated, formed, or organised under the laws of the BVI or any recognised jurisdiction and that have the characteristics of a private or professional fund, together with their feeders and affiliates, provided the assets under management, i.e. aggregate capital commitments, in such closed-ended structures are US$1 billion or less; and / or
(c) An investment manager or investment adviser to such other person as the FSC may approve on a case-by-case basis on application – this can include managed accounts.

The application process is straightforward and Approved Managers are subject to fewer continuing obligations than managers holding a full license under SIBA. Notably, where a person is approved as an investment manager or investment adviser under the Approved Managers Regime:

(a) The BVI Regulatory Code (As Revised) does not apply;
(b) No requirement for the appointment of an auditor or a compliance officer; and
(c) No requirement to maintain a compliance procedures manual under the Financial Services Commission Act (As Revised) (FSC Act).

Notwithstanding these lighter touch provisions, an Approved Manager is still subject to the BVI's anti-money laundering (AML) regime, automatic exchange of information (AEOI) regime and supervision by the FSC.

Recognised jurisdictions

The recognised jurisdictions for the purposes of the Approved Managers Regime are currently Argentina, Australia, Bahamas, Belgium, Bermuda, Brazil, Canada, Cayman Islands, Chile, China, Curacao, Denmark, Finland, France, Germany, Gibraltar, Greece, Guernsey, Hong Kong, Ireland, Isle of Man, Italy, Japan, Jersey, Luxembourg, Malta, Mexico, Netherlands, New Zealand, Norway, Panama, Portugal, Singapore, South Africa, Spain, Sweden, Switzerland, United Kingdom and the USA.

The Approved Manager Regime also permits an investment manager or adviser to provide services to a fund that is not from a recognised jurisdiction where such funds invest all or a substantial part of their assets in a qualifying fund based in the BVI or a recognised jurisdiction. In determining what amounts to a 'substantial part', account should be taken of whether the aggregate of the fund's investment in the qualifying fund amounts to more than 50% of its total assets.

The application process and commencement of business

The application process under the Approved Manager Regime involves the completion of a straightforward application form submitted to the FSC together with supporting documentation and the US$1,200 application fee. The required information includes:

(a) The constitutional documents of the BVI manager;
(b) Details of each director or general partner and senior officers and each person who owns or holds an interest in the BVI manager;

(c) A written declaration by the BVI manager that each director or general partner and senior officer of and any person who owns a significant interest in, the BVI manager is fit and proper in accordance with Schedule 1A of the Regulatory Code;
(d) The number and details (including the name, address and place of incorporation) of the funds the BVI manager intends to manage or advise;
(e) The date on which the BVI manager intends to commence relevant business;
(f) Copies of the investment management or investment advisory agreement between the BVI manager and each fund;
(g) Confirmation of which individual will be carrying out the day-to-day investment business functions;
(h) Details of any delegation of any relevant business functions;
(i) Confirmation from the BVI manager's BVI legal practitioner that they have agreed to act for the BVI manager; and
(j) A declaration from the BVI manager's authorised representative or BVI legal practitioner that the application is complete and meets the application requirements of the Approved Manager Regime.

An application must be submitted to the FSC at least seven days prior to the intended date for the commencement of the relevant business, unless the FSC accepts a shorter period. Assuming all is in order, the application should be processed within 30 days of submission date.

A qualifying BVI manager applying to register as an Approved Manager can commence and carry-on relevant business for a period of up to 30 days from the date of application submission. That period may be extended for an additional period of 30 days on application. If the FSC does not grant application approval within the original 30 days or any approved extended period, the qualifying BVI manager is required to cease carrying on relevant business upon the expiry of the original 30 days or any approved extended period.

Once approved, the FSC will register the Approved Manager in the register of approved investment managers and issue the Approved Manager with a certificate of approval as an approved investment manager.

Continuing requirements for Approved Managers

Fees and Filings with the FSC

The fees currently payable to the FSC for registration as an Approved Manager are a one-off application fee of US$1,200 plus US$1,800 annual renewal fee.

An Approved Manager is required to file an annual return with the FSC no later than 31 January and file an AML return with the FSC annually by 31 March.

Approved Managers are required to submit their financial statements to the FSC within six months of the end of the relevant financial year together with a director's certificate and report on the Approved Manager's affairs for the financial year. Financial statements do not have to be audited but must be signed by a director / general partner, depending on the Approved Manager's structure.
Approved Managers must always have:

(a) At least two directors (one of whom is an individual) where the Approved Manager is a corporate entity, or at least one general partner where the Approved Manager is a limited partnership;
(b) An authorised representative in the BVI; and
(c) Must engage a BVI legal practitioner.

Where an Approved Manager exceeds the assets under management caps noted above, the Approved Manager must notify the FSC in writing of that fact within seven days of exceeding that amount and is required to cease to carry on business as an Approved Manager unless within three months of the date it exceeds the assets under management caps:

(a) It no longer exceeds the assets under management caps;
(b) It submits an application to be fully licenced under SIBA; or
(c) The FSC, having regard to any risk that may be associated with the Approved Manager, approves in writing that it may continue to function as an Approved Manager.

Approved Managers must notify the FSC in writing of:

(a) Any change to the information submitted as part of the application as noted above within 14 days of the change; and
(b) Any matter in relation to the Approved Manager or its conduct of a relevant business, which has or is likely to have a material impact or a significant regulatory impact with respect to the Approved Manager or the relevant business.

Anti-money laundering

BVI Approved Managers are subject to the BVI Anti-Money Laundering Regulations (As Revised) (AML Regulations) and the provisions of the BVI Anti-Money Laundering and Terrorist Financing Code of Practice. This includes, among other things, requirements to (a) appoint a money laundering reporting officer; and (b) maintain policies and procedures with respect to client identification, record keeping, internal reporting and internal controls and communications, which meet the requirements set out in Regulation 3 of the AML Regulations.

AEOI

An Approved Manager and related entities that are considered a Financial Institution (FI) under FATCA and the OECD's Common Reporting Standard (CRS) (each as implemented in the BVI) have certain obligations including a requirement that they register with the BVI International Tax Authority (the ITA) and, for BVI Reporting FIs, conduct due diligence on, and submit returns to the ITA in respect of any financial accounts held in it by US or other persons resident in a Reportable Jurisdiction (under and for the purposes of CRS), as well as a requirement to establish, implement and maintain written policies and procedures for the purposes of CRS compliance.

Typically, an Approved Manager can fall within an exemption under FATCA and will have no 'financial accounts' for CRS purposes and so compliance with its AEOI obligations can be fairly straightforward by registering with the BVI International Tax Authority and completing a 'nil return'.

Data protection

The BVI Data Protection Act (As Revised) will apply to an Approved Manager in relation to 'personal data' of its directors / general partner and shareholders / limited partners, as well as investors in the funds the Approved Manager manages or advises.

Economic substance

The statutory definition of 'fund management business' does not currently require an Approved Manager to maintain substance in the BVI unless its activities also require an investment business licence under SIBA.

Asset repackaging:
Applications for managers and funds

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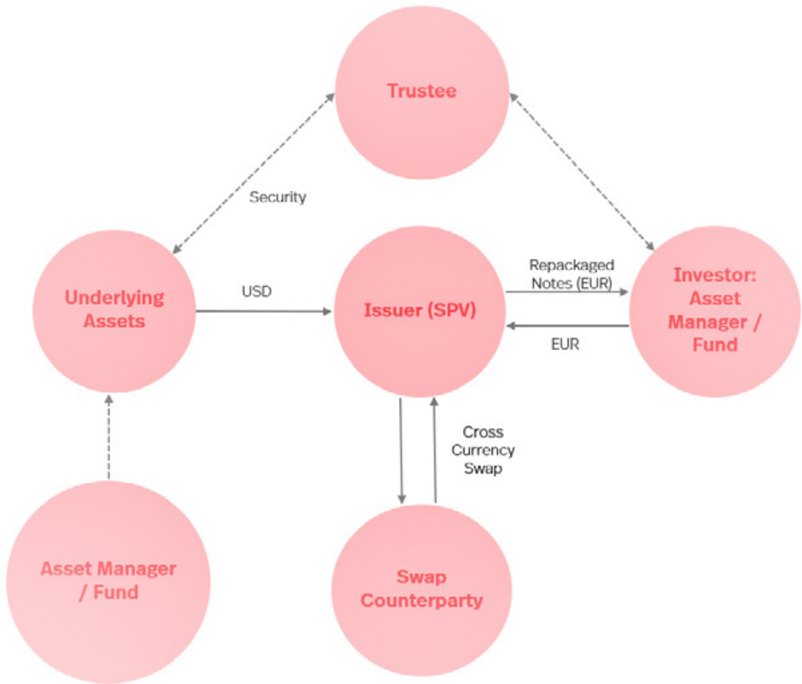
Cracks are beginning to appear in the wall of structurally higher interest rates which western economies have experienced in recent years – an environment not seen since before the Global Financial Crisis of 2008. Futures markets indicate cuts to rates starting around the middle of 2024. If so, the cracks are likely to grow and to unlock the potential for structured finance in various asset portfolios.

All else being equal higher 'risk free' interest rates present competition for funds as sources of return for investors. While the competition for funds from higher interest rates has increased over the last two years, so too has the demand for investment especially from investors with a focus on the net zero and wider ESG agenda. Structured products have a role to play in providing investors with a solution to enable them to appropriately access the returns available from physical assets. Funds and managers are becoming more involved in the structured finance market either as buyers or potentially as arrangers of structured debt products. Such structured products are bespoke in nature and so can also help to differentiate investment managers from the competition in a crowded marketplace.

A key building block of structured finance is **asset repackaging**: the transformation of a variety of underlying assets into asset backed debt instruments. This technique can be used for a range of commercial purposes including enhancing liquidity and raising financing.

This article outlines what asset repackaging is and then considers the reasons why asset managers and investment funds might use this form of structured product where they might otherwise typically use fund structures to obtain similar commercial outcomes.

What is asset repackaging?



Asset repackaging typically combines bond issuance and a derivative, usually in the form of a swap transaction. A special purpose vehicle (SPV) issues debt instruments secured on specified underlying assets. SPVs are off-balance sheet companies usually set up in tax efficient jurisdictions such as the Cayman Islands, Luxembourg or Ireland. Other than the underlying assets the SPV has no other resources to make payments under the debt instruments. An investor's recourse is therefore limited to the underlying assets (and the SPV's rights under the swap agreement, if there is one) which are secured in favour of the trustee for the benefit of the investors thereby providing collateral for the debt instruments issued by the SPV. There is no recourse to the arranger of the asset repackaging transaction.

The debt instruments issued by SPVs can be issued in a number of forms such as notes, certificates or loans and can be listed or unlisted. The proceeds from the debt instruments are used to purchase the underlying assets. There can be a wide variety of different underlying assets; these will usually generate a cash flow for the SPV. A swap transaction exchanges the cash flow on the underlying asset for a return which enables the SPV to pay sums on the debt instruments issued by it (and those returns can be tailored to the investor's requirements). An asset manager or fund (or possibly the investor in the debt instruments) may itself be selling the underlying assets into the structure and thereby monetising an otherwise illiquid asset. Or, they will be buying the debt instrument issued by the SPV. Asset repackaging programmes are established to allow for time and cost efficient issuance of debt instruments on a regular basis.

Range of underlying assets

A wide range of assets can constitute the underlying collateral for a repackaging transaction. Asset classes include: corporate securities, government bonds and ABS. Illiquid assets that may constitute underlying assets include loans, real estate assets and receivables. Such assets can include assets from emerging markets including: emerging market loans, securities and deposits. Examples of physical assets in repacking transactions include commodities and carbon credits. A potential growth area in asset repackaging involves cryptocurrencies and digital assets.

Why might managers and funds use asset repackaging?

There are a number of commercial drivers behind an asset manager or fund structuring a repackaging transaction and one of its benefits is the flexibility and adaptability of the basic structure to allow for the bespoke transfer of risk. Each structure will involve careful legal, regulatory and tax analysis.

Some of these reasons are summarised below:

Enhanced returns: A repackaged note can combine different physical and synthetic assets in such a way as to generate a higher return than might be available from each asset individually.

Financing: From the fund and asset manager perspective, repackaging can be a source of financing under which the value of illiquid assets may be realised more efficiently, for example by making such assets more liquid and capable of being used as collateral for other transactions or as part of a wider financing transaction. Asset repackaging may also provide an alternative means of capital raising from different investor classes who may be more familiar with, or prefer, debt instruments.

Market access: Asset repackaging can give investors exposure to risk profiles/assets not otherwise available to them. Examples of this might include:

- Where a fund is holding/illiquid/exotic assets for example private market assets, fund interests or digital assets;
- The democratisation of private or illiquid assets: offers of repackaged notes to high net worth individuals;
- The diversification of investment portfolios to include private assets in debt instrument form; and
- Providing synthetic exposure to an asset class in debt form which may not otherwise meet an investor's investment criteria.

Operational efficiency: Asset repackaging allows an investor to hold a single financial instrument (as opposed to holding the underlying assets and hedging the transaction by entering into a separate swap) without the need for derivative reporting, or margining.

Investor demand: A repackaged debt instrument can be structured either physically or synthetically to provide investors with a specific risk / return profile not otherwise available in the market.

Asset allocation: Allocation of illiquid assets such as a loan by an asset manager or fund to individual funds/sub-funds. Asset repackaging allows an SPV to structure the original exposure to the underlying asset for the benefit of individual funds.

Wider distribution: Certain funds may have investors who want access or exposure to an asset held by the fund but they want the exposure in the form of a debt instrument rather than a fund share. Repackaging can be used to offer exposure to a wider range of investors.

Transferability/liquidity: Debt instruments issued by SPVs in the context of an asset repackaging are freely transferable (which may be of particular benefit when the underlying asset is illiquid). Investors may want exposure to assets in a securitised form where such securities are rated and/or listed.

Thank you for reading the Edition 137 of the AIMA Journal.

If you would like to contribute to future editions, please email Caterina Giordo and Lucy Robinson.

PUBLICATION PLAN 2024

- **Q2 Edition 138**
  Deadline for submission 5pm UK time Monday 20 May | Publication Monday 17 June

  Please note the deadline for reserving a spot for the Q2 edition of the AIMA Journal is 5pm UK time Friday 6 May.

- **Q3 Edition 139**
  Deadline for submission 5pm UK time Monday 29 July | Publication Monday 23 September

  Please note the deadline to reserve a spot for the Q3 edition of the AIMA Journal is 5pm UK time Friday 12 July.

  Q4 Edition 140
  Deadline for submission 5pm UK time Monday 21 October | Publication Monday 18 November

  Please note the deadline to reserve a spot for the Q4 edition of the AIMA Journal is 5pm UK time Friday 4 October.

Please note that availability is limited, and we cannot accept any additional contributions once all the spots have been filled.

We kindly advise all contributors to email us prior to submitting to make sure we can include the contribution. We can’t guarantee the inclusion of any last-minute submissions.

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