AIMA Journal - Edition 118

Includes:

Event risk

Hard Brexit

Responsible Investment

SMCR

Venture Capital

...and more

March 2019

Message from AIMA's CEO

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CEO, AIMA
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I am pleased to introduce edition 118 of the AIMA Journal, which presents our members' expert comment and insights on a considerable range of important topics. I would like to thank all our contributors for their time and engagement.

Inside you will find comment and analysis on topics including event risk, responsible investment for discretionary hedge funds, the benefits of service providers, 'tokenising' venture capital and how we could address a retirement savings crisis.

CME Group explores event and price-gap risk. They identify difficulties in capturing event risk with implied volatility from options prices. They then present a practical approach to event risk probability distribution analysis.

On the regulatory side, **Dechert** offers a succinct **explanation of proposed legislation by the Luxembourg Government.** This would allow UK financial service providers to continue rendering certain services in Luxembourg for a period of up to 21 months after a UK withdrawal from the EU.

This is followed by an excellent summary from **Simmons & Simmons**, which covers the **key changes under SMCR and suggests steps firms should take during 2019 to comply.**

Man Group asks how a discretionary hedge fund can successfully implement responsible investment, especially as allocators and governments place more emphasis on the topic. SS&C explores why a growing number of **leading fund managers are engaging expert third-party loan service providers to reduce operational risk, improve agility and time to market.**

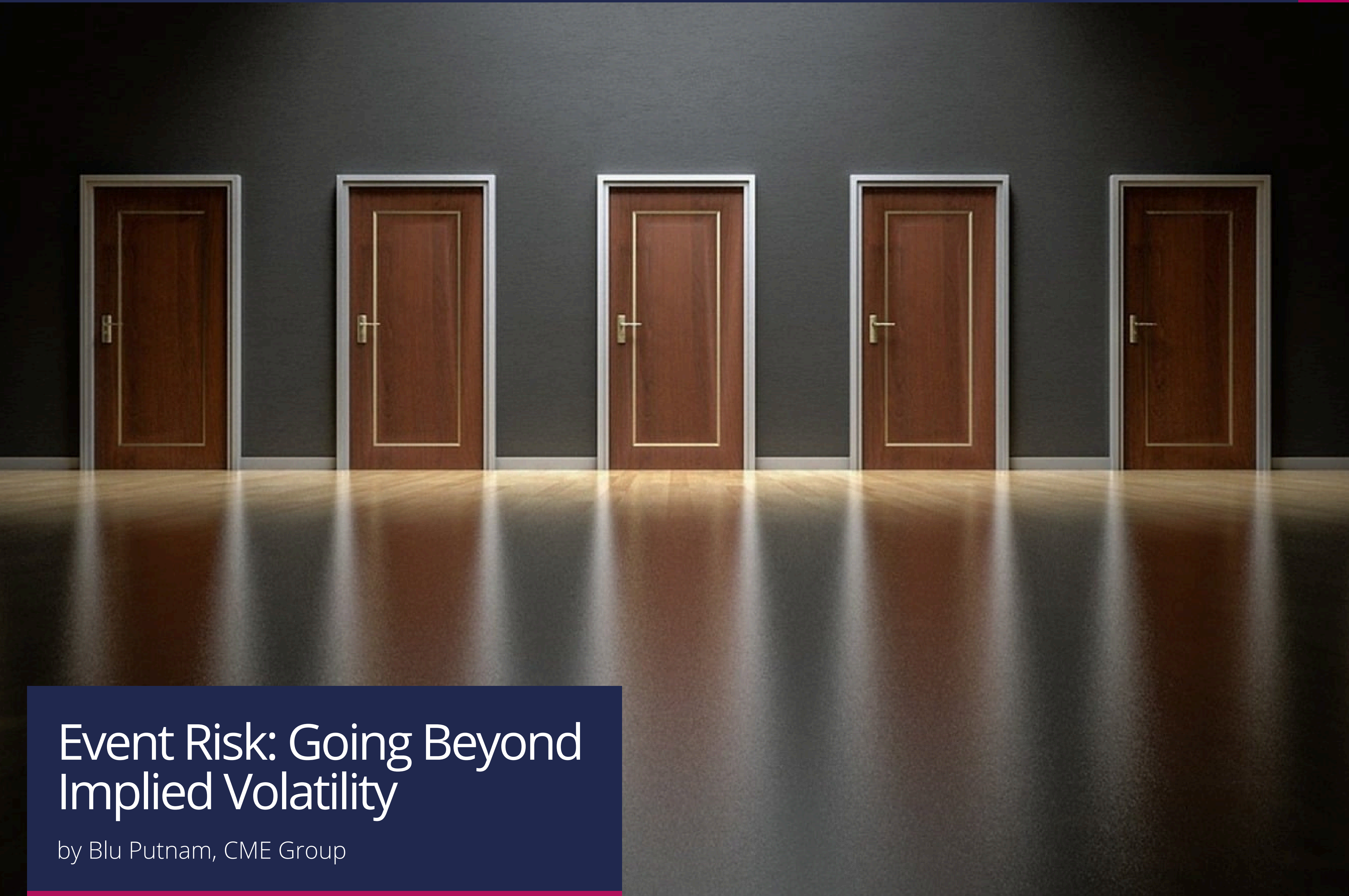
Maples Group explains why Jersey remains attractive for fund managers and particularly hedge fund managers. ENSO **advocates the use of SaaS-based treasury solutions** for fund managers to help them access best-in class analytics and work flow capabilities without the burden of technology hosting, implementation and maintenance.

Bitspread identifies a possible inflection point in crypto markets and asserts that 'stablecoins' – cryptocurrencies pegged to real-world assets like the US Dollar – could drive change. **On venture capital, Bardicredit** addresses the development of the market and the potential of 'tokenisation' - the 'cutting' of real assets into regulated intelligent securities ('tokens'), tradable in a pre-programmed way on blockchain.

DMS Governance and Pepper Hamilton offer an **overview of the new partnership tax regime in the United States.** The New Audit Rules depart dramatically from the prior 'TEFRA' rules. **ACA Aponix provides five steps for hedge funds to stay on top of CCPA Compliance.**

Many around the world are increasingly conscious of a retirement affordability crisis. **Waypoint Investment Partners** examine this from the perspective of Canadian families today and **suggest developing a 'retirement equation'** linking investment returns, expenditures and liquid assets to help them plan.

I hope you enjoy exploring this edition of the Journal and we wish you the all the best for the next quarter.



Event Risk: Going Beyond Implied Volatility

by Blu Putnam, CME Group

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

Whether we are talking about an election outcome, a fiscal or monetary change of policy direction, the trade war, or even the possibility of a drought in the farm belt, we have event risk. And, event risk typically involves two divergent scenarios. If the two scenarios are far enough apart from each other, then event risk has the potential to create a risk-return probability distribution that may look more like bi-modal distribution than the common single-mode bell-shaped curve. These are rare distributions, more like the two-humped Bactrian camel of Mongolia than the common single-hump Dromedary camel of the Middle East.

Figure 1: Bactrian Camel

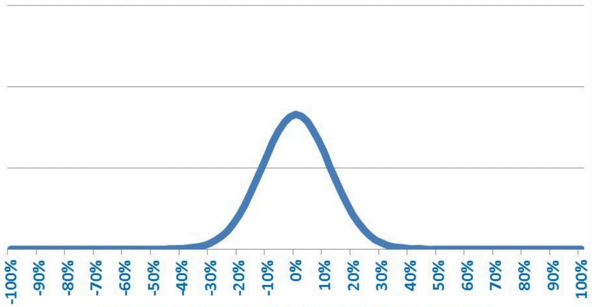
Event risk market environments come with a much greater likelihood of price gaps as well as the potential for a shift in the volatility regime than one would typically capture in a risk model anchored by implied volatilities from option prices or, indeed, any risk model based on standard deviations as the primary metric representing risk. Therefore, it is incredibly important to recognize the market characteristics that warn of event risk, and one needs to have a risk management process that can accommodate these rare and unusual bi-modal distributions.

I. Difficulties in Capturing Event Risk with Implied Volatility from Options Prices

Starting from a standard deviation approach, such as implied volatility, may inadvertently make it very hard to estimate when extreme and highly dangerous risk distributions are present. The math behind this observation is quite old and goes back to the Russian mathematician, Pafnuty Lvovich Chebyshev (1821 – 1894). What most people take away from Chebyshev's Inequality Theorem is that if you know only the standard deviation you have a very good idea of the typical ranges in which values will fall most of the time. What we take away from the Inequality Theorem is that if you only know the standard deviation, you know absolutely nothing about the extremes of the distribution where the most dangerous risks reside.

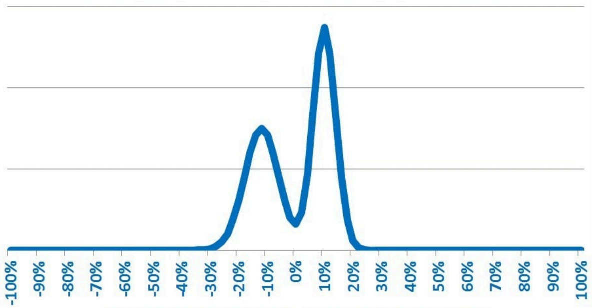
As an example, the two probability distributions in Figures 2 and 3 have the same mean and standard deviation, but they indicate very different risk management challenges. Figure 2 is a normal, single-mode, bell-shaped distribution, while Figure 3 is bi-modal distribution which was created by mixing two normal distributions with highly divergent means and different standard deviations for each scenario. We want to highlight two risk management challenges of note when event risk is present to the degree that it would be reflected in a bi-modal risk-return probability distribution.

Figure 2: Risk-Return Expected Probability Distribution: Normal Distribution



Mean of Distribution = 0%, Standard Deviation = 12%
Source: Chart Created by CME Group Economics.

Figure 3: Risk-Return Expected Probability Distribution from a Two Scenario Mixture



Mean of Distribution = 0%, Standard Deviation = 12%
Source: Chart Created by CME Group Economics.

The first risk we want to examine is that of a price gap when the outcome of the event risk becomes known. If you take the Brexit case, at the time of the referendum, one can get a feel for the price gap risk. At the time of the referendum back in June 2016, it was widely believed that a "Leave" vote would result in an abrupt weakening of the British pound, and that a "Remain" vote would create an instantaneous relief rally, raising the value of the pound. As the "Leave" outcome became clear on the night of the referendum, the pound, indeed, had a sharp 7% dive versus the US dollar. Prior to the event, the market was pricing the probability weighted average of two divergent scenarios, and once the outcome was known, the market immediately moved to a single-mode distribution centered on the "winning" outcome.

In our analysis, we want to try to identify the conditions which might cause price gap risk and to measure the intensity of the potential divergence in the scenarios. The importance of studying the probability of price gap risk is that basic options pricing models, such as Black-Scholes-Merton and straightforward options hedging strategies explicitly rule out any possibility of price gaps. And a large price gap (i.e., a price discontinuity in the language of Black-Scholes-Merton) can effectively destroy a standard delta hedging approach to managing options risk.

The second risk of note coming from event risk is the possibility of a shift in the volatility regime. As in the case of price gap risk, the basic Black-Scholes-Merton options pricing models assume that a volatility regime shift cannot occur. Of course, during the pre-event risk phase, there may be one volatility regime, followed by a shift to new volatility regime, possibly higher or lower, after the outcome is known. This is known as vega risk in the options world and has been well studied, especially since the stock market crash of October 1987 alerted one and all to its implications for options risk management.

Observing price gap risk from implied volatilities is very tricky. When the date of the event risk is known, such as in the case of a referendum or election, then one can examine options with similar strikes that expire before the known event risk date and afterwards. Differences in implied volatility between the two expiry dates can be attributed, with care to consider other factors that may be operating simultaneously, as a metric indicating the existence of price gap risk.

Comparing options with different expiry dates that bracket the known event risk date, however, breaks down if the event risk date is unknown. [See "The Changing Nature of Event Risk" in AMIA Issue #117, January 2019.] For example, during 2017 in the US, there was an active discussion of a large cut in corporate taxes which would clearly benefit equities. The problem was that one did not know if or when the corporate tax cut would be passed into law. Indeed, during the spring of 2017, when the debate over repealing the health care legislation known as the Affordable Care Act was at its most intense, markets participants appeared to lower the probability of a tax cut passing Congress. Later in the year, however, it became increasingly clear that a large corporate tax cut would be passed and signed by the President into law. This is an example of event risk without a specific decision date. One could argue that the trade war had this type of characteristic. Despite the US setting some short-term deadlines, one never really knew if or when a deal would be agreed. The Brexit negotiations have some of this flavor. While there is a specific end-date to the divorce negotiations, March 29, 2019, there is also the possibility of an extension.

To summarize this discussion, let's examine the type of market expectations captured by a typical bell-shaped curve. With a bell-shaped risk-return probability distribution, one is essentially saying that there is a consensus view around the expected return with incrementally different possibilities of lower probability creating the bell-shaped risk distribution. While the market may shift in increments to a new consensus based on new information, the expected mean shifts are continuous and do not constitute price gap risk, and the expected volatility remains more or less the same. In the case of a bi-modal risk-return probability distribution, there is the possibility of an abrupt shift in the expected mean (price gap risk) and a shift to a new volatility regime.

II. A practical approach to event risk probability distribution analysis

While our research is still at the early stages, we have found a few metrics that are especially enlightening relative to the shape of the probability distribution. Our three primary metrics are: (1) the evolving pattern of put option trading volume relative to call option volume, (2) intra-day market activity, especially high/low spreads, and (3) implied volatility from options prices relative to historical volatility.

Studying put/call volume patterns helps us understand if one side of the market is more at the center of the current debate than the other side.

Intra-day market dynamics help us appreciate risk in a different way. The observed high price to low price intra-day trading spread is informative in helping us assess the degree to which fat-tails might be present. If the relationship between intra-day dynamics and the day-to-day standard deviation diverge in a significant manner, then this is strong evidence that the risk probability distribution is not normally distributed. To inform us about the risk of price breaks we track the evolving pattern of implied volatility relative to historical volatility. While it is usual for implied volatility to exceed recent historical standard deviations, a shift in the pattern toward a much higher implied volatility may indicate that expectations for the potential of a sharp price break are building in the market. And, if a price break occurs, scenarios resolve one way or the other, so we often see a quick decline in the implied volatility representing a shift back to a single-mode bell-shaped distribution.

To gather all our risk information and create a probability distribution, we use a probability mixture technique that is distribution independent – that is, it is not constrained to take on a given specified shape. Most of the time, bell-shaped curves are appropriate descriptions of the probability distributions – balanced risk distributions. Our method does, however, occasionally generate some especially tall distributions (i.e., relatively lower volatility), which we classify as "complacent" and worthy of special study to see if the market may be underestimating risks. We also see on occasion some very flat distributions, not unlike the Wall Street maxim about the equity markets "climbing a wall of worry" which we call "anxious" risk distributions. And, finally, on rare occasions our metrics support the idea of a two-scenario, event risk, bi-modal distribution. Looking at a wide variety of markets, we seem to find event risk being reflected in a bi-modal distribution only about 2% to 3% of the time, with balance risks dominating at about 70% or so, and the "complacent" or "anxious" distributions making up the difference.

Luxembourg Proposes 21-Month Grandfathering Period in a "Hard Brexit" Scenario

by Gus Black, Patrick Goebel, Marianna Tothova and Christine Renner, Dechert LLP

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The Luxembourg government has proposed legislation (Draft Bill)[1], which would allow UK financial service providers to continue rendering certain services in Luxembourg for a period of up to 21 months after the date when the UK withdraws from the EU (Exit Date). This would potentially allow UK-based AIFMs or UCITS management companies to continue to directly manage their existing Luxembourg funds following a "hard Brexit" during the transitional period.

Purpose

The Draft Bill aims to entrust the Luxembourg supervisory authority of the financial sector, the Commission de Surveillance du Secteur Financier (CSSF), and the Luxembourg supervisory authority for the insurance sector, the Commissariat aux Assurances (CAA), with certain limited powers to safeguard financial stability should the UK withdraw from the EU without an agreement. The purpose of the Draft Bill is to allow the CSSF and the CAA to take temporary measures to limit the risks that might be caused by such a "no-deal" withdrawal, and ensure an orderly transition with the aim of continuing the proper functioning of the financial markets and safeguarding the interests of the Luxembourg financial sector, its participants and their clients.

Powers to the CSSF and CAA

For a period of 21 months after a "no-deal" Brexit, the CSSF and the CAA, each within its field of competence, would be able to allow UK credit institutions, payment institutions, investment firms, UCITS management companies, AIFMs and insurance and re-insurance companies (each, a UK Service Provider) to continue servicing their Luxembourg-based clients, by creating a legal fiction that their pre-existing EU passport continues to be in effect. However, such measures may be applied only where the UK Service Provider: (i) has properly passported its services into Luxembourg before the Exit Date; and (ii) has entered into an agreement with the relevant Luxembourg client prior to the Exit Date, or after the Exit Date but only for so long as such agreement is connected closely to agreements entered into before the Exit Date.

Should the Draft Bill be approved, a UK-authorised AIFM or a UK management company could be allowed to continue to manage a Luxembourg UCITS or AIF for a maximum period of 21 months after the Exit Date. If the entity marketing the relevant Luxembourg UCITS or AIF was notified in Luxembourg prior to the Exit Date, such entity could also be allowed to continue to market the relevant UCITS or AIF in Luxembourg.

While the Draft Bill notes that the CSSF and the CAA may continue to apply the relevant provisions relating to the passport, it unfortunately does not provide guidance as to the process to be followed by a UK Service Provider to benefit from this grandfathering.

European inspiration

The Luxembourg government points out in the recitals to the Draft Bill that the proposal follows similar legislative initiatives of the German and French governments.

The German draft bill provides that similar powers would be given to the German supervisory authority, Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), after this bill has been lodged with and discussed in the German Bundestag. A short bill on the national transposition of the withdrawal agreement had been lodged previously.

France adopted an omnibus law in January of this year that derogated powers to the government, but no sector-specific laws have yet been adopted or lodged.

Similar to France, Ireland has prepared an omnibus bill comprised of 17 parts that, if passed, will be implemented by the relevant individual Ministers at the appropriate time.

Next steps

The Luxembourg Budget and Finance Commission will discuss the Draft Bill in one of its next sessions. The State Council will also review the Draft Bill and might request further clarification regarding the roles of the CSSF and the CAA, as these roles are arguably vague in the current text. Time pressure to enact the Draft Bill is high, with the Exit Date (currently expected to be 29 March 2019) less than 50 days away.

Conclusion

It was recently announced that an MoU will be entered into between the EU regulators and the FCA in case of a "no-deal" Brexit. This MoU would aim to ensure that delegation of portfolio management to UK asset managers by EU AIFMs and management companies will continue to be allowed in case of "no-deal" Brexit.

The Draft Bill presents an important attempt by the Luxembourg government to ensure the stability of the Luxembourg financial markets, by allowing UK AIFMs and UK management companies to continue providing certain services in Luxembourg for a period of up to 21 months after the Exit Date. This would provide UK asset managers with additional time to rearrange their activities and adapt to the new regulatory landscape as it unfolds in the coming months.

www.dechert.com

Footnotes

1 Projet de loi relative à des mesures à prendre en relation avec le secteur financier en cas de retrait du Royaume-Uni de Grande Bretagne et d'Irlande

du Nord de l'Union européenne. Bill of law n°7401 on measures to be taken in relation to the financial sector in case of withdrawal of the UK from the EU. The Draft Bill was lodged with the Luxembourg Parliament on 31 January 2019, and proposes to amend, inter alia: the law of 5 April 1993 on the financial sector, as amended; the law of 17 December 2010 on undertakings for collective investment, as amended; and the law of 12 July 2013 on the alternative investment fund managers, as amended.

Implementing Responsible Investment at Discretionary Hedge Funds

by Carol Ward, Man Group

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Introduction

Can hedge funds do good and do well at the same time?

As former US Vice President Al Gore puts it, “Outdated conceptions of fiduciary duty cannot be allowed to stand in the way of progress toward a better economic system. At stake is a low-carbon, prosperous, equitable, and healthy planet in which human civilization can flourish”.[1] At Man GLG, we couldn’t agree more. Indeed, there are countless studies that demonstrate how hedge funds can do good and do well at the same time.

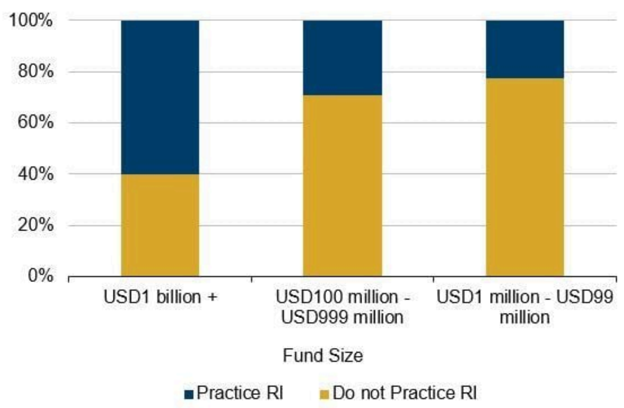
The more important questions, we believe, are how serious a hedge-fund firm is about responsible investment (‘RI’) – is it a box-ticking exercise, or is there a genuine culture of RI – and following that, how can a discretionary hedge fund successfully implement RI?

Demand on hedge funds to pay attention to RI is growing

RI is going to play an increasingly important part of a discretionary hedge fund’s investment decisions, as both allocators of money and governments alike place more emphasis on the topic.

The EU, for example, wants asset managers and other financial firms to disclose how they account for sustainability risks when allocating capital.[2] The UN, aiming to “better align investors with broader objectives of society,” has proposed a due dilligence questionnaire for hedge funds as it tries to enforce its six principles of RI.[3] According to research from AIMA and the Cayman Alternative Investment Summit (‘CAIS’), in May 2018, half of the 80 investment managers surveyed said that they had seen an increase in demand for RI from both current and prospective clients.

However, even with this increased demand for RI, there isn’t much of an appetite by hedge funds to engage in RI. According to a recent survey by AIMA and CAIS, only 60% of hedge funds with more than USD1 billion in assets are engaged in RI.[4] This ratio dropped dramatically for both hedge funds with less than USD100 million in assets and those with assets ranging from USD100 million and USD999 million.



Source: AIMA.[5]

Figure 1: Bigger Hedge Funds Are More Active in RI Than Smaller Counterparts. Survey Respondents Were Asked: 'Do You Engage in RI?'

The opportunities of implementing RI at discretionary hedge funds

Traditionally, RI has been thought of something that long-only strategies can really implement. However, discretionary hedge funds that apply RI can do just as well, and we would argue even better, than long-only strategies.

1. The Ability to Go Short

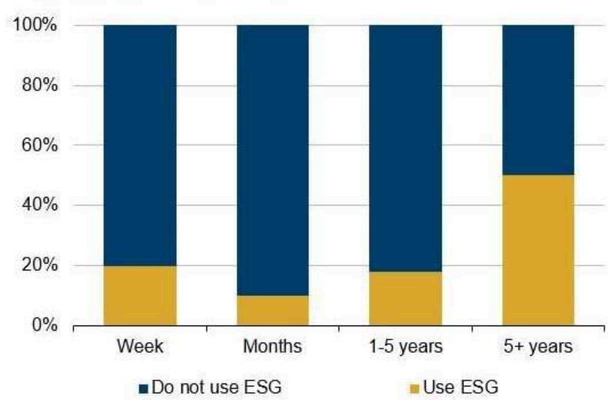
One main reason why we believe discretionary hedge funds could do better than long-only strategies at implementing RI is because of discretionary hedge funds' ability to go short the companies that are on the losing end of SRI or ESG factors.

2. Credit Opportunities

Governance is one of the most important factors to evaluate when investing in credit securities. Bondholders are looking to be repaid in full, and poor governance can easily jeopardize a company's financial health, precipitating a rapid decline in the market price of the bonds and potentially impacting the final maturity and recovery value of the notes. Governance is also notoriously hard to score on an absolute basis or to model into traditional forward-looking credit metrics. At Man GLG, we tend to use a red-flag system where bond issuers that are flagged with poor governance are avoided.

3. Activism

Discretionary hedge funds can be very active investors, which could result in positive outcomes if corporate engagement is done in a correct manner. In our experience, we have found that companies may be willing to have an open dialogue about where they need to improve on their ESG, SRI and/or sustainability metrics. It is, however, important to emphasize the importance of a fund's investment time-horizon: a fund with a 5-year investment period, for example, may have more success when it comes to active management than a fund with a 3-month investment period. Indeed, it is widely acknowledged that ESG factors play a larger part in company analysis over longer time periods (Figure 2).



Source: 2017 Institutional Factor Survey. Bank of America Merrill Lynch US Equity and US Quant Strategy.

Figure 2: Hedge Funds Use More ESG Analysis if Investing Over a Longer Time Period

The challenges of implementing RI at discretionary hedge funds

However, RI at discretionary hedge funds is certainly not without its challenges.

1. Grey Areas

There are certainly grey areas when it comes to RI: Different funds many have different criteria as to what constitutes a good SRI, ESG or sustainable company. Additionally, how should a portfolio manager invest if a company is strong on 'E', but poor on 'S'? There is also the age-old debate about divestment versus engagement.

2. The Lack of Data

ESG data have matured over the last decade, and we are entering a phase where the data have both a long-enough history and broad-enough coverage to make it interesting to quantitative investment firms. However, ESG data are qualitative, discretionary and unregulated. Indeed, the ESG data we obtained by vendors typically have a short history and is often retroactively collected. This is an area in which Man Group is applying its skillset – to improve the collection and analysis of ESG data. We believe that by spending the time to understand the nuances of each vendor's methodology and properly handling their data quirks can potentially lead to a unique, alpha-generating dataset.

Implementing RI in practice

So, how can hedge funds implement RI in practice? We believe the first and most important step is education: Portfolio managers need to own and embrace RI. To do that, education is required so that portfolio managers build an understanding of what clients expect and what it means to effectively integrate RI into the decision-making. Indeed, RI doesn't have to be about 'greening' a portfolio, but rather weighing your portfolio toward companies that are proactively doing something about their sustainability issues.

Once portfolio managers understand the importance of RI, the next step is how to do the research on the companies. As mentioned earlier, a lack of data is definitely a challenge in implementing RI. However, this is improving: from sell-side integrating ESG factors into research to the aforementioned third-party service providers that rate companies based on how sustainable they are. Hence, portfolio managers do have a breadth of tools available to them when conducting research and analysis as it pertains to sustainability.

After decisions are made on which securities should be included in the portfolio – either as longs or shorts – discretionary portfolio managers have the ability to actively engage with corporate management to assess firm governance and potentially drive change. While corporate engagement is already a key part of the process of many discretionary portfolio managers, we believe portfolio managers should embrace active stewardship such as proxy voting. Larger hedge-fund firms tend to either have their own in-house stewardship teams or outsource this function.

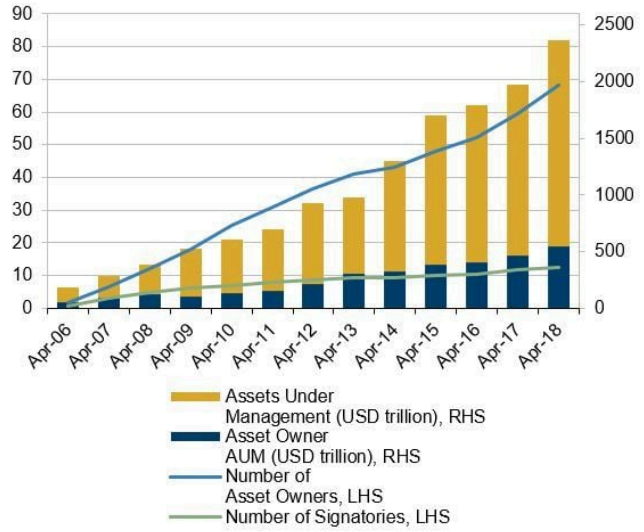
In assessing stewardship activities at Man Group, we took a hard look at where our strengths and weaknesses lay and found that there was an over-reliance on service providers. This forced us to ask how we could make better decisions in proxy voting, especially as it related to RI. As a result, Man Group is in the process of developing an in-house stewardship team. The aim is that while we had previously been quite reactive when it came to stewardship, having an in-house team will help allow us to become more proactive.

Last but not least, quantifying responsible investment is key. Portfolio managers should be able to provide visibility on RI dynamics across portfolios. This could be as specific as metrics on carbon footprints across a fund's portfolio, or as broad as exclusion lists.

What should asset owners look out for?

We believe the first thing asset owners should look out for is whether the hedge-fund firm is a signatory to the UN PRI. This is being increasingly expected from hedge-fund firms, as illustrated by the growth of signatories in Figure 3.

Once a firm has demonstrated a high-level commitment to RI, it may be worth digging a little deeper. RI at discretionary hedge funds can range from ESG analysis tacked on as an overlay to fundamental analysis, to ESG analysis being embedded into the fundamental analysis. If an asset owner is really passionate about RI, we believe it should take the time to really understand



Source: AIMA, as of April 2018.[6]

Figure 3: Growth in UN PRI Signatories

the discretionary hedge fund's culture: portfolio managers must be able to demonstrate their commitment to sustainability, and be able to explain how they incorporate RI into their portfolio construction clearly.

One thing assets owners should bear in mind here is greenwashing, or the act of appearing to be 'greener' than the reality. It would be worth really doing the due diligence to determine whether RI is just a box-ticking exercise, or whether RI is really embedded in the fund's culture.

We stress the 'fund' versus 'firm' here – It is quite difficult at firms with many funds to have a 'one-size-fits-all' approach. While there may be an overriding theme at a firm, different funds' approaches may vary depending on the needs and interests of that fund's clients, managers and strategy.

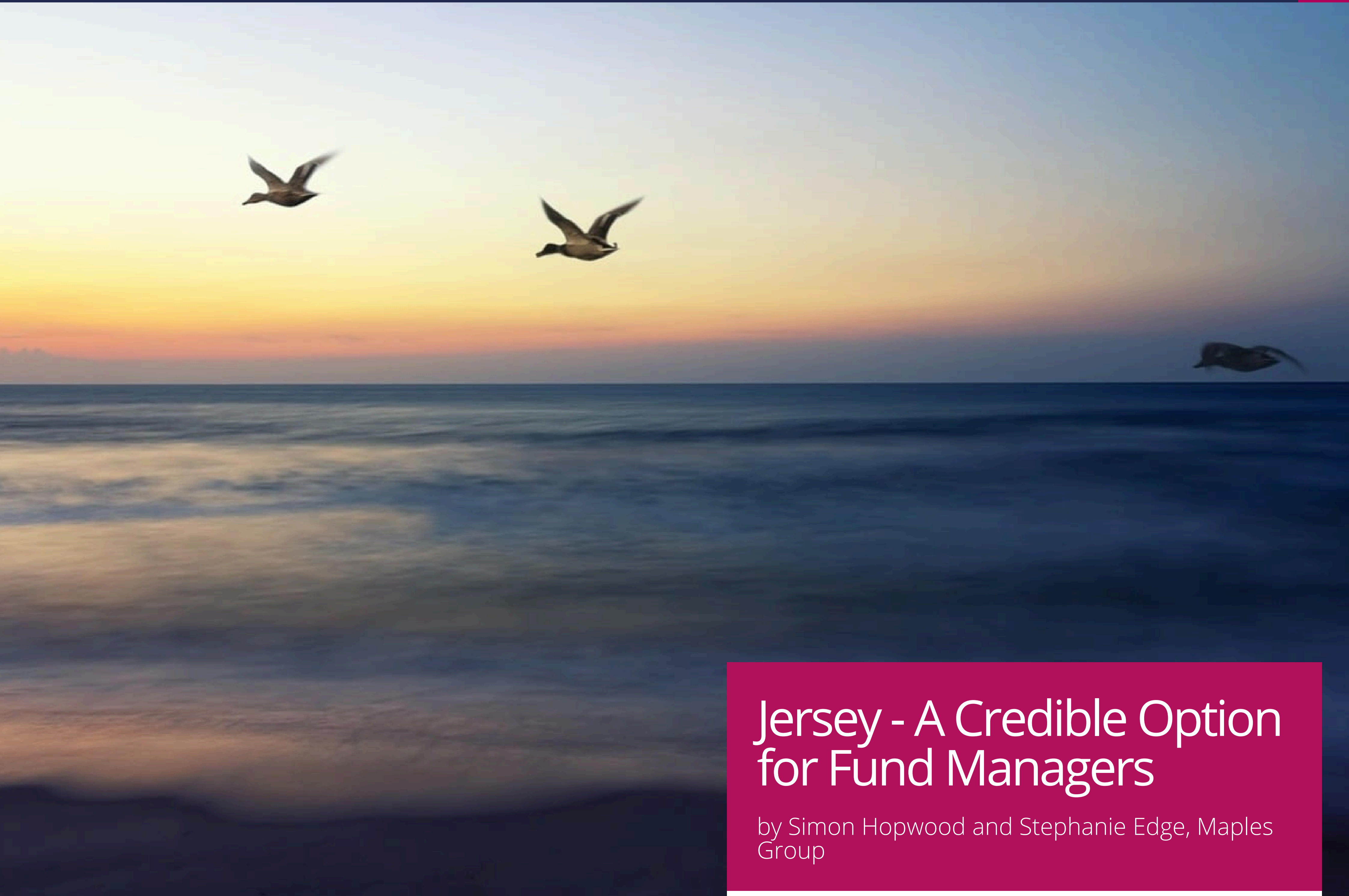
For example, Man Group has implemented a new RI Fund Framework, designed to establish a baseline requirement of ESG standards, and to provide credibility, clarity and consistency in Man Group's approach to RI across its range of funds. There will be three categories into which all funds will fall: the base standard; a standard for funds with a further level of RI integration; and a standard for RI-dedicated funds. Under this framework, Man Group has formalised its mandatory, firm-wide exclusion policy on ownership of positions in companies that participate in controversial arms and munitions across all of its funds. In addition, Man Group is also introducing an RI Exclusions List, designating sectors that will be excluded from Man Group's RI-integrated or RI-dedicated funds.

Conclusion

As RI becomes increasingly important to asset owners, governments and society in general, discretionary portfolio managers need to own and embrace ESG integration. At Man Group, our approach is to develop a 'toolkit' for portfolio managers to make it as easy as possible for them to integrate RI in to their existing process. After all, the long-term sustainability of the hedge-fund business requires forward-thinking environmental practices. The sooner we embrace it, the better.

Footnotes

1. https://www.unpri.org/Uploads/u/j/z/Fidu...
2. http://europa.eu/rapid/press-release_IP-...
3. https://www.unpri.org/pri/what-are-the-p...
4. AIMA and CAIS collected 80 survey responses from hedge fund firms representing approximately $550 billion in total assets under management. Survey responses were collected from December 2017 to February 2018, and the results were published in June 2018.
5. From Niche to Mainstream: Responsible Investment and Hedge Funds.
6. https://www.aima.org/article/esg-integra...



Jersey - A Credible Option for Fund Managers

by Simon Hopwood and Stephanie Edge, Maples Group

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Introduction

Despite the current challenges facing the financial services industry, the Jersey funds industry remains resilient with a positive future outlook, presenting fund managers with an alternative jurisdiction to establish a manager or investment manager, or to domicile a fund.

Jersey's total funds business is up 13.8% year on year, with regulated fund's net assets standing at £301.7 billion.[1] Alternative investment funds ("AIF") represent over 81.3% of all Jersey funds, with hedge representing 18.3%.[2] The number of Jersey-based fund promoters has nearly doubled in the last five years.[3] There has also been a 14% annual increase in fund managers seeking authorisation in Jersey to market their funds within the EU.[4]

This article focuses on why Jersey remains attractive for fund managers, particularly hedge fund managers, by touching on some of the key factors that make Jersey a credible option.

Jersey as an IFC

Jersey is a highly-regarded international financial centre and known as a leading jurisdiction for AIFs. Jersey is politically and economically stable with its own government, but not part of the UK or the EU.

Having a modern and sophisticated legal system, Jersey is also internationally recognised as well-regulated jurisdiction, complying with international standards set by the IMF, OECD, IOSC, ESMA and FATF.

As a regulator, The Jersey Financial Services Commission ("JFSC") is both pragmatic and approachable, welcoming applications from new fund managers. There are a wide range of flexible entities and innovative fund products with fast-track authorisation procedures, suiting most promoters, without compromising investor protection.

With a simple tax system offering tax neutrality for funds and 0% corporate tax for fund managers, as well as low personal income tax rates and no capital or inheritance taxes, Jersey is fiscally attractive and offers economic substance.

Jersey has an extensive infrastructure to support its funds industry with high quality professionals providing tax, legal, accounting, administration and depositary services.

Conveniently located within the European time zone, Jersey has excellent travel connections to and from the UK and Europe and offers a good lifestyle and culture on a scenic island.

Jersey Manager

In recent years, the number of fund managers setting up a new manager or investment manager in Jersey ("manager") has greatly increased particularly for hedge fund managers and PE start-ups. The approach to presence and substance has varied.

Some fund managers set up a 'full presence' manager with substance, securing premises and staff, as well as key persons relocating to Jersey. Most partnered with a regulated administrator to act as a 'manager of a managed entity' ("MoME"), who manage the manager in Jersey, providing presence, substance and appropriately experienced directors. Others used a hybrid of these two approaches.

The key drivers depend on the fund manager, its strategy and the promoter's personal circumstances. Some examples include locating outside the EU; reducing costs of regulatory compliance; a lighter touch regulatory environment; delegating discretionary management from a third party AIF manager ("AIFM"); and tax neutrality suiting promoters who reside in different locations.

Regulation

Generally, a manager carrying on investment business (dealing in investments, discretionary investment management and giving investment advice) ("IB") or fund services business (acting as a manager, investment manager of or investment adviser to a public fund) ("FSB") in or from within Jersey, must be licensed under the Financial Services (Jersey) Law 1998 ("FS Law"), unless an exemption applies.

If a fund (Jersey or non-Jersey domiciled) is established as a Jersey private fund ("JPF"), which complies with the Jersey Private Fund Guide ("JPF Guide"), its manager will be exempt from the IB and FSB licensing requirements.

Where a manager is FSB licensed, it will be exempt from the IB licensing requirements. License applications are made to the JFSC, with timescales ranging from 30 working days for a 'full presence' manager to 14 working days for a MoME manager.

For Jersey's economic substance requirements, a manager must show it is managed, conducts core income generating activities and it has adequate staff, premises and expenditure for its business, in Jersey. A manager must maintain appropriate records and comply with filing requirements.

A 'full presence' manager must apply to the Populations Office of the States of Jersey for a business licence before starting its business in Jersey, normally processed within 10 working days. The license may be issued with conditions, particularly in relation to staff.

EU Market Access

While not subject to Alternative Investment Fund Managers EU Directive ("AIFMD"), Jersey implemented its own 'opt-in' AIFMD regime for funds and their managers wishing to be located outside the EU, with the ability to access the EU.

Jersey offers AIFMD compliant fund products, as well as an effective route for funds or their managers to access EU investors through the National Private Placement Regime ("NPPR"), without the additional costs and burden of full AIFMD compliance. Conversely, Jersey managers wishing to market to investors outside the EU, will not be subject to the requirements of AIFMD.

Since the introduction of the AIFMD regime, fund managers now have the following options: (1) market in the EU under the NPPR, (2) use their own AIF manager ("AIFM") outside the EU, (3) use a non-AIFM outside the EU, (4) use a third party EU AIFM or (5) use a third party non-EU AIFM.

Referring to those options, a Jersey-based FSB licenced manager may market a private or public fund in the EU under the NPPR. A Jersey-based manager, which is not FSB licensed, wishing to market a JPF in the EU under the NPPR, must be licensed for AIF services business under the FS Law.

Jersey is in a strong position providing a route for fund managers to market to investors outside the EU or selectively in the EU. This will continue to be the case post-Brexit.

Latest Products for Managers

Jersey, in recognition of it being a leading funds jurisdiction, is aware that in order to maintain this status it needs to be proactive and innovative by offering efficient solutions to attract and maintain fund managers based in Jersey.

Firstly, Jersey introduced the Qualifying Segregated Managed Account ("QSMA") regime aimed at hedge fund managers. A hedge fund manager, who is FSB licensed, can establish and manage QSMAs and will be exempt from the IB licensing requirements and, for an EU-based investor, outside the scope of AIFMD.

A QSMA investor must sign a prescribed form investment warning. In addition, the hedge fund manager can only implement hedge fund strategies used by one or more funds in respect of which it is appointed.

The introduction of the QSMA regime demonstrates Jersey's pro-activeness in light of the increased number of Jersey-based hedge fund managers, who now benefit from a simplified and favourable regulatory and tax environment, in order to attract more hedge fund managers.

Secondly, the JFSC launched the JPF in April 2017, with the release of the JPF Guide, detailing the JPF's eligibility criteria. The JPF has simplified Jersey's private funds space by replacing various historic fund classifications with one Jersey private fund product for 50 or fewer investors.

As a result, the JPF is a more streamlined and flexible regime, with a light regulatory touch for certain professional or eligible investors (including those investing at least £250,000 (or equivalent)), who acknowledge an investment warning.

A fast-track 48-hour authorisation process applies to JPFs, which now features an online application facility. A Jersey designated service provider must confirm in the application that the JPF meets, and on an annual basis that it continues to meet, the eligibility criteria.

The JPF is essentially an investment fund pooling capital raised by it and invests on the basis of risk spreading. It can be structured as open or closed-ended, Jersey or non-Jersey domiciled and using any type of vehicle. In addition, there is no need for the promoter to be approved by the JFSC nor an auditor appointed.

The high volume uptake of the JPF product is indicative of Jersey's innovative approach to supporting institutional and professional investors. With its speed, ease and versatility attractive to a range of funds, the success of this product is set to continue.

Finally to note, while most new managers are formed as Jersey companies, fund managers may now consider using the Jersey LLP, which has separate legal personality. This is an attractive and flexible option following the introduction of the new Limited Liability Partnership Law in August 2018.

Summary

In light of current challenges facing the financial services industry, Jersey has a bright outlook for managers. Its reputation as a stable IFC combined with seamless market access and its drive to be proactive, makes it a credible option for hedge fund managers.

Footnotes

1 Source: Based on statistics published by Jersey Finance Association as at 30 September 2018.
2 Source: Based on statistics published by Jersey Finance Association as at 30 September 2018.
3 Source: Monterey Insight Jersey Funds Reports and Jersey Finance Association.
4 Source: The Jersey Financial Services Commission and Jersey Finance Association.

Senior Managers and Certification Regime

by Nicholas Colston, Simmons & Simmons

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The FCA's Senior Managers and Certification Regime (SMCR) is a regulatory initiative designed to strengthen market integrity and reduce harm to consumers by making individuals more accountable for their conduct and competence.

SMCR came into force for banks in 2016 and is now being extended to include all FCA solo-regulated firms, including asset managers, from 9 December 2019. SMCR will replace the existing UK Approved Persons Regime and is intended to play a pivotal part in changing the culture within financial services in the UK.

In this article, we summarise the key changes under SMCR and suggest some of the practical steps which firms will need to take during 2019 to ensure compliance.

A proportionate application of the rules

Helpfully, the SMCR regime is designed so that its application is based on grounds of proportionality. There are different requirements for different firms based on the size and nature of the firm. The FCA has identified three categories of firms: Limited, Core and Enhanced. Most alternative fund managers will be Core firms, but it will be necessary to take legal advice to confirm your firm status.

The remainder of this article assumes that firms fall into the "Core" category.

Three new regimes which regulate staff at investment managers

SMCR is replacing the Approved Persons Regime, consisting of three main elements:

(i) a Senior Managers Regime which approves Senior Managers under designated functions;
(ii) a Certification Regime for employees whose roles make it possible for them to cause significant harm; and
(iii) a set of Conduct Rules for most other employees within a firm.

Senior Management Functions

Senior Managers must be formally assigned responsibility for areas of the firm's business which will be documented in a personal Statement of Responsibility, including certain "prescribed responsibilities" which are mandated by the FCA. This may be very different to the current governance structure for some organisations.

If a firm breaches an FCA requirement, the Senior Manager responsible for that area could be held personally accountable if they did not take reasonable steps to prevent or stop the breach from occurring. Individual Senior Managers are likely to be conscious of their personal duty of responsibility.

Given these new rules, it is important to understand which people will be caught as Senior Managers under the new regime. There are six Senior Management Functions (SMFs) which are relevant to Core firms: Chief Executive, Executive Director, Partner, Chair, Compliance Officer and Money Laundering Reporting Officer (MLRO).

The governing functions will depend on the firm's set up (e.g. whether it is a limited company or a partnership); however, every firm will be required to have individuals appointed as Compliance Officer and MLRO. The rules permit an individual to perform more than one SMF at the same time and for multiple entities under the same Group. This can be a good way to streamline the implementation process.

For fund managers which are set up as LLPs, the fact that an individual is a Partner of a firm and is currently approved as CF4, does not mean they will automatically be performing a SMF. The definition of the Partner function under SMCR now includes a carve out for Partners without management influence.

Junior Partners may not always have substantial involvement in the management of the partnership and would not necessarily fall automatically within the SMCR definition of a Partner. However, for tax purposes, under the salaried member rules, to ensure that Junior Partners are not treated as "employees", firms are typically structured such that Junior Partners do have influence over the affairs of the business. This means that partnerships will need to consider a balancing act between their HMRC position and the roles performed by Junior Partners in deciding whether it is appropriate to identify Junior Partners as SMFs under the SMCR.

Corporate members of an LLP can also be caught within the definition of a Senior Manager, and may need approval to be a SMF, particularly if the corporate member is a vehicle for exercising management control over the UK firm.

The Certification Regime

The Certification Regime will apply to individuals whose roles make it possible for them to cause significant harm to the firm or its customers. In practice, this is likely to include all existing approved persons who are not Senior Managers (e.g. front office staff performing the current CF30 customer function).

Firms will be obliged to assess and certify the fitness and propriety of their "certification regime staff" and FCA approval will no longer be required. This will require additional due diligence, an annual certification process and a new regime for regulatory references, which will increase the onus on firms to satisfy themselves about the history of their new hires.

Again, it will be important for firms to properly identify their certification staff. SMCR prescribes certain functions which it expects to be certified functions. These include client dealing functions (such as portfolio managers, traders, and advisers), material risk takers, and algo traders.

There is a further complexity for LLPs, that many Partners may not be employees (which has a specific meaning here) and so not technically subject to the Certification Regime.

The Conduct Rules

The Conduct Rules set standards of good personal conduct, against which the FCA can hold individuals accountable. There are two tiers of conduct rules:
(1) the first tier of Conduct Rules which apply to all individual staff, other than ancillary staff; and
(2) the second tier of Conduct Rules which only apply to Senior Managers.

Firms will be expected to train staff on the new Conduct rules and will be required to notify the FCA where disciplinary action is taken against an individual for breach of a Conduct rule.

SMCR implementation projects

Many UK investment managers are treating Q1 2019 as the appropriate time to kick-off implementation projects. If you have not already done so, you should set-up an internal working group, and appoint external advisors such as legal counsel.

Your project plan will need to include scoping steps to identify who is internally caught by the three new elements to the new regime, including: drafting new documentation (including statements of responsibility, updates to employee handbooks), updating HR and recruitment processes (including background checks, references, and annual review processes) and delivering appropriate internal training.

Simmons & Simmons is widely advising clients across the asset management industry on SMCR, including offering clients a Toolkit of template documents, internal training and scoping documentation. We would be happy to further discuss our products and how we can help your firm with your SMCR implementation: http://www.elexica.com/en/resources/micr...

Credit Funds – The Growth of an Asset Class

by Nicolas Grenie, SS&C Technologies

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Fund managers diversify their strategies to reduce risk and to deliver new and reliable sources of returns for end clients. As more institutional and alternative asset managers acknowledge the difficulties presented by today's market conditions, such as continued low interest rates and increased volatility, some are making the transition into new asset classes.

Many managers are actively moving to private debt and direct lending, issuing loans to underfunded small-to-medium-sized enterprises (SMEs) that are excluded from traditional bank financing.

This deviation from conventional investment brings both opportunities and challenges. These new investment avenues may offer reasonable returns and have tacit regulatory endorsement, but for firms who have historically made their clients' profits through traditional asset and derivative investments, the swing to such complex debt products cannot be made without major adjustment to their processes. In this paper, we will explore why a growing number of leading fund managers are engaging expert third-party loan service providers to reduce operational risk and improve agility and time to market.

Why the change in course?

For several years, active managers have struggled to outperform benchmarks, with one in three large cap managers failing to beat the S&P 500 in 2016.[1] While performance improved the following year, it remained relatively low with just 43 percent outperforming passive peers.[2] Although volatility helped active firms in 2018, they are still facing pressure from relatively less expensive passive managers, some of whom have even launched zero-fee products.[3] This is forcing active managers to scope out new strategies beyond conventional stock-picking.

Similarly, hedge fund performance following the financial crisis has yet to reach its pre-2008 zenith, and while 2017 was the industry's best year return-wise since 2013,[4] the results in 2018 appear to be more mixed.[5] This is partly because assets in the $3.23 trillion industry[6] have ballooned and managers who were once able to pinpoint interesting investment opportunities are now being crowded out of those trades.

Returns are falling, and benchmark targets are not being met. Firms are working hard to cultivate existing clients and win new mandates, often through generous fee discounting. Despite this, hedge funds – just as traditional long-only managers – face competition from lower-cost smart beta, index trackers and hedge fund replicator strategies (i.e. products that track hedge funds). This is forcing firms to seek out new sources of alpha.

For the $2.83 trillion private equity industry, performance – which has consistently exceeded that of public markets and other asset classes – is currently not a problem. Client satisfaction in private equity is phenomenally high, with 93 percent of investors telling data provider Preqin that returns in 2017 had met or exceeded their expectations. More than half said they would grow their allocations in the asset class in the long term.[7]

The principal dilemma facing the private equity market is the risk of overheating[8] fuelled by sizeable deal multiples, large leverage ratios and extraordinarily high dry powder volumes.[9] With too many private equity firms chasing after too few deals,[10] buyouts are routinely concluding at double-digit multiples of EBITDA, valuations which many feel cannot be propped up indefinitely. Conscious of this, more private equity firms are edging away from buyouts and are investing in different asset classes.

Fund managers embrace loan origination

Loan origination and direct lending to SMEs is a growing strategy across the asset management industry. $56.7 billion was raised in 2017, more than double the amount in 2016,[11] bringing total assets under management (AUM) to almost $1 trillion.[12] While returns have dropped recently,[13] internal rate of return (IRR) is still hovering between five and 10 percent as the average margins on loans stands at around 600bps to 1500bps.[14]

Performance advantages are not the only driver of increased flows into loan origination products. Low rates have made banks reluctant to provide loans, and regulators – both intentionally and unintentionally – have had a material impact. Basel III assigns SME loans a higher risk rating, forcing banks to hold more capital on their balance sheets when providing financing to such companies. This has led to a deprivation of bank financing which has prompted SMEs to explore other funding channels, and asset managers have proven to be willing backers.

Local regulators in markets such as France and Italy have also been supportive of measures aimed at loosening SME dependency on bank financing by easing limitations that had previously prevented or heavily restricted non-banks from participating in direct lending activities.[15] In addition, pan-EU initiatives such as the European Long-Term Investment Fund (ELTIF) have played a positive role, creating an augmented regulatory structure for asset managers authorized under AIFMD to originate loans across the EU.[16]

Building the internal infrastructure

The purchase and/or issuance of loans requires asset managers to rethink their operations and middle-office processes. It demands significant investment in technology systems and the appointment of experienced personnel who have a deep understanding of credit and borrower risk. As alternative and traditional asset managers embrace these new strategies and debt instruments, they are fast realizing their existing processes, which have served them well so far, are in need of an urgent overhaul.

Research conducted by the Alternative Credit Council (ACC), an AIMA-affiliated offshoot and global body representing the interests of private credit and direct lending managers, found 45 percent of respondents involved in the loans space said regulatory and client reporting was their biggest challenge.[17] In many cases, the regulators themselves are not ready for the asset class, and some expert loan service providers like SS&C are working alongside regulators to educate them and ensure meaningful and applicable regulation transpires. Asset managers that are not in this position may later be caught off guard as regulation ramps up.

Another 45 percent of managers said in the ACC study that limitations in their existing technology made it difficult to accurately track loans,[18] a problem which creates significant investment and operational risks. These assets also have complex settlement processes which require a deep understanding of the industry.

As volumes grow, legacy technologies will struggle with the complexity of this new asset class. Given the pace at which technology is advancing, building an internal system capable of mastering administration, valuation and reporting of loans in-house is expensive and notoriously difficult to future-proof. Many fund managers simply do not have the time to wait for such development work to take place. Furthermore, at a time when regulatory compliance costs and client reporting requests are consuming firms' resources, managing loan administration internally is arguably an unnecessary add-on.

This realization is prompting more fund managers to offload some or all of their loan administration activities to third parties, although the overall rates of outsourcing remain low, at least when benchmarked against other fund subsets such as hedge funds. The ACC study, for example, found 48 percent of managers outsourced loan administration while only 30 percent contracted out their regulatory reporting to third-party vendors.[19]

As the cost and complexity of performing middle- and back-office functions becomes increasingly apparent, managers will look to service providers for support with their loan administration. By outsourcing day-to-day activities and administration, firms can direct resources and capital to revenue-generating processes.

Footnotes

1 CNBC (April 12, 2017) Bad times for asset managers: Almost none have beaten the market over the past 15 years
2 Mercer Capital (2018) Value Focus: Asset Management Industry
3 Financial Times (August 2, 2018) Asset manager shares dive after no-fee fund launch
4 Financial Times (January 9, 2018) Hedge funds produce best returns in four years
5 Opalesque (November 2018) https://www.opalesque.com/671570/Perform...
6 Hedge Fund Research (July 19, 2018) Hedge fund assets eclipse record level for eighth consecutive quarter despite mixed capital flows
7 Preqin (2018) 2018 Private equity and venture

capital Report
8 PE News (June 4, 2018) Half of investors think the buyout market is overheating - Coller
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11 Financial Times (March 6, 2018) Fund houses pile into direct lending as banks retreat
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15 Kramer Levin (April 2, 2018) Direct lending in the EU: Regulations on loan origination create high return opportunities for asset managers
16 Kramer Levin (April 2, 2018) Direct lending in the EU: Regulations on loan origination create high return opportunities for asset managers
17 ACC – Enhancing the loan administration function
18 ACC – Enhancing the loan administration function
19 ACC – Enhancing the loan administration function

Be Prepared: New US IRS Partnership Representative Rule Deadline is Approaching

by Scott Davidoff, DMS Governance and David Stauber, Pepper Hamilton LLP

 

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Overview of the New Partnership Tax Audit Regime

A new federal audit regime for partnerships and other entities classified as partnerships for tax purposes (the "New Audit Rules") are in effect for audits of partnership tax years beginning on or after January 1, 2018. The New Audit Rules are a dramatic departure from the prior rules, known as the "TEFRA rules." Under the TEFRA rules, the IRS was required to allocate any partnership audit adjustments among the partners in the year subject to audit, and assess and collect any underpayment of tax at the partner level. Audits under the TEFRA rules required substantial IRS resources, causing audits of large partnerships, with hundreds, or even thousands, of partners extremely difficult and time-consuming for the IRS. The New Audit Rules change course and allow the IRS to impose any underpayment directly against the partnership. The burden of allocating the adjustments or underpayment among the partners therefore is shifted to the partnership. With the potential for increased efficiency conducting partnership audits under the New Audit Rules, it is anticipated that the IRS will more vigorously pursue large partnership audits.

Because the "imputed underpayment" is assessed directly on the partnership under the New Audit Rules, the partners in the year of the assessment bear the economic burden of the underpayment. This result may be inequitable if the ownership interests of one or more partners in the "reviewed year" differ from their interests in the partnership in the year the audit concludes and the assessment is paid. As an alternative to the partnership bearing the imputed underpayment in the year the audit concludes, the partnership can elect to push the audit adjustments out to the persons who were partners in the reviewed year (the so-called "**Push-out Election**"). When the Push-out Election is made, each reviewed year partner is required to include its share of the audit adjustments in its current year tax return and pay any resulting increase in tax.

Significantly, the New Audit Rules also replace the designation of a tax matters partner under the prior TEFRA rules with the designation of a "partnership representative." Unlike the tax matters partner, the partnership representative need not be a partner in the partnership. Moreover, the New Audit Rules grant the partnership representative broader authority to act on behalf of, and bind, the partnership and its partners than the tax matters partner. Accordingly, the other partners may seek restrictions in the partnership agreement on the partnership representative's ability to make decisions binding on the partners as part of the audit process.

To qualify as a partnership representative, the person designated must have a substantial presence in the United States. If the partnership representative is an entity, the partnership representative must appoint an individual, known as the designated individual, through whom it will act for all purposes under the New Audit Rules. The partnership representative has the sole authority to act on behalf of the partnership, and legally bind the partnership, with respect to federal examinations and audits. No contractual arrangement, including any partnership agreement or state law document, can limit or alter this authority. In addition, other than the partnership representative, no partner or other person may participate in any examination or other proceeding with the IRS.

Drafting/Amending the Partnership Agreement to Account for the New Audit Rules and to Address Potential Conflicts of Interests

A critical issue among the parties to an investment fund is how much authority to vest in the partnership representative, and whether to give the other partners a role in the partnership representative's decision-making process. Particularly if the partnership representative is a partner with effective control of the partnership or management responsibility for day-to-day operations (such as the general partner in a hedge fund or private equity fund), this partner may seek an unfettered right to make decisions with respect to partnership examinations and audits at its sole discretion. In response, investors may request notice of the initiation of a partnership examination or audit, and the right to be kept reasonably informed with respect to these matters by the partnership representative, because these rights are not guaranteed under the New Audit Rules. In addition, the investors may seek the right to consult with the partnership representative on key decisions, determinations and elections related to an examination or audit, and may even ask for a prohibition on certain actions by the partnership representative without the investors' consent. On the other hand, broad consent rights could cause a deadlock among partners, which could delay the orderly administration of a partnership audit or even cause the partnership representative to miss a deadline imposed by the New Audit Rules or the IRS. An alternative approach is to put these key decisions, determinations and elections in the hands of the partnership's board or other governing body, although this may not necessarily eliminate the risk of deadlock or delay.

Another provision of the partnership agreement that is often heavily negotiated is the provision governing the Push-Out Election. As discussed, the Push-Out Election permits audit adjustments to be allocated to the partners in the year under review as an alternative to the current year partners bearing the resulting assessment. The fund sponsor will typically prefer to have full control over the decision to make the election, if not a binding mandate in the partnership agreement to make the election in all instances, rather than being required to seek the consent of, and potentially negotiate with, the investors.

Practical Aspects of Designating a Partnership Representative

A failure to designate (or an ineffective designation of) a Partnership Representative allows the IRS to designate the Partnership Representative in certain circumstances. For example, if the designated partnership representative fails to satisfy the substantial presence requirement, or if the IRS receives multiple revocations of a partnership representative designation within a 90-day period, the IRS will notify the partnership and the most recent partnership representative of the ineffective designation. The partnership will then have 30 days to appoint a successor partnership representative, after which time the the IRS will designate a partnership representative on behalf of the partnership. An IRS designation is irrevocable without the express written consent of the IRS.

In the event of an IRS audit, designating an outside firm as the partnership representative to represent the partnership's interests may prove crucial to good governance. The IRS's core strategy is the centralization of an intermediary function in the form of a partnership representative to interact in real time with the IRS during business hours in the United States. To the extent that a third-party firm is utilized, the partnership representative (or the designated individual if applicable) should be reliable to exercise sound business judgement as substantial powers are vested in the partnership representative. The establishment of partnership representative policies and procedures around IRS communications, information document requests (IDRs), and decisions that impact the tax election treatment of the partnership, should be enshrined in fund documents and a service agreement with an outside firm.

It will be fairly obvious that the "substantial presence" requirement discussed above will necessitate immediate action from foreign investment managers with US partnership entities. The need for action may be less obvious to US-based managers who are familiar with the recently replaced tax matters partner rules and who may assume no significant distinction between the two roles. However, the broad grant of authority to the partnership representative results in a significant potential for conflict, and immediate action should be taken to address this inherent conflict of interests.

An employee of the investment manager may rightfully be wary, and would be well-advised to seek advice from outside counsel, before agreeing to serve as the partnership representative. To illustrate, if a partnership audit determines that one partner should have been allocated more income (or fewer deductions) than was actually allocated to that partner in the partnership's tax return, under the old TEFRA rules the audit adjustment would be a wash and could be handled through internal accounting maneuvering. However, under the new audit rules an adjustment to the distributive shares of the partners would be ignored in an adjustment that imposes the imputed underpayment on the partnership, and not on specific partners. To address the misallocation, therefore, the partners may need to agree to file amended returns to account for the imputed underpayment, which some partners may take issue with. As such, a disinterested third-party partnership representative firm may well be in a better position to provide the arms-length comfort partners are seeking.

In this sense, a third-party service firm may be a valued addition to an investment fund's roster of trusted service providers. Speaking with current accountants and attorneys can ease the task of finding a suitable partnership representative firm. Understanding the partnership representative's role and responsibilities is critical to ensuring proper alignment amongst the service being sought and provided. Practical considerations to ask a third-party Partnership Representative firm include:

- Does your firm currently provide regulatory compliance services? In the US? Globally?
- Will the Partnership Representative maintain a substantial presence in the US?
- Does the Partnership Representative (Designated Individual if applicable) have the requisite knowledge and understanding to act as liaison between the IRS and the partnership?
- Does the Partnership Representative service agreement set for forth the limitations and obligations of the Partnership Representative?
- Is the Partnership Representative required to give prompt notice of audits, audit progress updates and assessments to the General Partner?
- Does the Service Agreement specify that any substantive communications between the IRS and partnership that are required to be acted upon, are done so only with the written consent of the General Partner? Examples include settling an audit or extending the statute of limitations
- In the event of an IRS audit, will the Partnership Representative consult regularly with the General Partner and Advisors concerning the Partnership's audit and to the extent applicable, any subsequent audit litigation strategy?
- Under what circumstances will the Partnership Representative be indemnified by the partnership?
- As per the IRS' Partnership Representative resignation notification requirements, will the Partnership Representative provide at least a 90-day notice before resigning?

The key take-aways are that **Partnership beware**: non-US managers, particularly those that do not have a physical presence in the US, need to appoint a Partnership Representative on the partnership's 1065 tax form by the filing date. Non-compliance with the new audit law may place the partnership in the unenviable position of ceding that decision to the IRS. In addition, all investment managers should review and amend their fund documents to protect current investors from incurring costs relating to an audit not under their purview.

Venture Capital for Everyone?

by George Salapa, Bardicredit

READ ON

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Good ideas tend to stick. When Rockefellers persuaded their friends to spray some of their wealth on young and hopeful startup-ists in the 1960s, they began what we now know as Venture Capital(-ism). Ever since then, VCs have been a domain of ultra-rich, super-successful ex-founders and large corporations with deep, deep pockets.

Since then, venture capital has had a profound impact on the world. Some exceptional businesses have been created that have managed to disrupt entire industries, and surpass the size of smaller European countries. Many VCs have grown to a 'corporate-like' complexity and become well-recognized brands. Some of them have become somewhat dehumanized - an army of analysts reporting to a remote invisible panel of partners sitting atop.

There are several issues that challenge the model of big-brand VCs. Venture capital is not bottom-up investing. Good accounting, a great projection model and a detailed go-to-market strategy often say little about the startup's growth potential. It is hard to measure vision, energy, soul, excitement. In some respects, VC is everything but bottom-up investing. It is about understanding the Zeitgeist, and making bets on the potential of people with not much more than a slide deck.

A study by CB Insights looking at top 100 US Venture Capitalists found that neither the years of experience nor whether they had founded a successful company in the past matter. Indeed, many of the highest ranked VCs came from a regular job. Ex-entrepreneurs are also not necessarily good VCs - they may have a tendency to be forceful in the boardroom.

Indeed that same study found that one common denominator of all super-successful VCs is their deal flow. To put it bluntly, the more deals that they can 'afford' to look at and turn down, the more likely they are to stumble upon the next Facebook.

...and neither the quality, nor the size of the deal flow necessarily coincide with the VC's wealth or seniority. In fact, Venture Capitalists that are able to draw a community of followers and supporters may have a clear advantage. Pocket Sun and

Elizabeth Galbut, the twenty-something year old founding partners of SoGal Ventures attained a celebrity-like status precisely because of what they are: girl millennials starting a VC fund. Championed by media, they have gained a community of supporters, who also point them to interesting deals.

Traditional VCs may also be prone to suboptimal decision-making. Since they are limited by time (they have to make exits and return money to their investors within 7-10 years), VCs have a tendency to push companies too hard. For years the VC model has been to throw cash at businesses, and then some more, but also expect them to grow super-aggressively, faster than anyone else; certainly much faster than their competitors.

Others suggest that Venture Capital has turned into a game of statistics. The urgency to deliver double-digit returns means that VCs like to shoot for the stars. A naturally high rate of failure among startups is driving VCs to make up for the loss by searching for absolute moonshots. Put simply: a 100B+ company with a 1% chance of success is more appealing than a 200M company with a 10% chance of success.

All this casts a very bad light on VCs, degrading the model of Venture Capital(ism) to a cold, soulless apparatus.

Many if not all of these inefficiencies could be solved with tokenization. Security tokenization is shaping up to be one of the most disruptive trends in finance. At its core, it is about 'cutting' real assets into regulated intelligent securities ('tokens') tradable in a pre-programmed way on blockchain.

Tokenization could be transformative for alternative investment funds: VCs, private equity and hedge funds. A tokenized fund would be offered to investors as a security that they can resell as soon as a year later (in U.S., for example in acc. with SEC's Rule 144). And it will be intelligent, so that it will know who & where can trade it, or how it should distribute returns.

There are, of course, the obvious practical advantages. A pre-programmed security with rules encoded within, will remove tons of paperwork and the need for middlemen. And being on blockchain, it can be traded instantly, globally and 24x7x365.

But, there are several other much more significant positive externalities that tokenization can bring to the funds industry. Removing the lock-up would open this space to a much larger audience of investors because they would not have their money 'locked' in the fund for many years; they could simply sell their token when they want to. Indeed, the age-old problem of Venture Capital (and the entire alternative investment funds industry, actually) is that the high minimum sign-up cheque and the 7-10 years lock-up restricts the access to invest to only a small group of investors.

Tokenized funds will also be tradable. Liquidity removes the urgency to achieve exits and return money within a certain period of time — investors can simply sell their stake in the fund if they want to. This gives the VC fund freedom to be transparent about its investments; it also allows it to let its portfolio companies grow at a more natural pace, arguably building sustainable businesses for the long-term, not moonshots with a sacrificed moral core.

The lack of liquidity in the alternative funds industry in general (not just VCs) is somewhat puzzling because there is a clear need for it. The massive growth of the secondary market for alternative funds in recent years (Preqin: USD2B in 2002 -rising to approx. USD46B in 2016), a market which was more or less nonexistent a few years back, has been in no small part due to increased confidence in the process thanks to ease and legal clarity with more advisors and secondary market funds focused on this space.

However, perhaps the most profound improvement that tokenization can bring to the funds industry relates to the process of fundraising, which can open the industry to emerging independent fund managers. For decades, the act of giving money was a project in itself for investors - a paperwork-heavy process with no easy in-and-out. This may have been fine until now when the sector was dominated by large funds closed to anyone but a few super-rich individuals and large institutional investors. This is changing.

The past few years have seen the emergence of independent fund managers. This is for several reasons. The instantaneous access to knowledge brought about by internet has erased the information gap between institutions and individuals. It is this proliferation of knowledge that allowed Luca Lin, Christina Qi and Jonathan Wang to start a hedge fund from their dorm room. Numbers collected by PREQIN show that emerging managers can have far superior performance.

There has also been a growth of funds run by influencers - investors that people can identify with and that they like to support. SoGal Ventures that we have mentioned before are a prime example of this trend. And if indeed the bar to enter the funds industry has been removed from below, then why should it remain closed top-down. Why couldn't the middle class also invest in a VC?

Well, with tokenization it will be able to do just that. The expectation is that tokenization will change the investing into a one-click process. When a potential investor comes to the website of a tokenized fund, he/she will undergo a number of onboarding steps, including KYC and AML checks, but also whitelisting in relation to his/her investor status (retail, professional investor).

Tokenization UBER-izes the fundraising process by removing the institutional apparatus that are presently needed to connect managers and investors. It puts emerging talent on the same level as established veterans. Imagine that the access to alternative funds investment is as simple as lending on a P2P platform.

A number of 'paperwork-heavy' functions currently performed by middlemen can be automated away thanks to the use of smart contracts. To put it simply, ultimately the process will no longer involve an issuer, lawyer, authority, investor, but merely issuer-investor.

The profoundness of the technological advantage that tokenization can bring hasn't gone unnoticed. Several tokenized funds have emerged, each of which has been domiciled in one of the exotic jurisdictions recognized for their flexible regulation. This was necessary because there was no legal framework to regulate the new technology.

But, since then, the countries that are perhaps most recognized for wealth management - Switzerland, Liechtenstein and Luxembourg - have embraced the new technology and began forming the necessary rules. They are on a path to pass their own versions of a ‘Blockchain act’ that will recognize representation and transfer of securities on blockchain without intermediaries.

Thanks to the progressive, if strict procedures in these countries, it is possible to tokenize a fund and attain legal certainty even now in a regulated manner compliant with the incoming framework. Progress favors the first-movers.

The "Asset-Income Gap" - The Greatest Financial Challenge Retirees Face Today

by Srin Sridharan and Ryan Marr, Waypoint Investment Partners

 

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Introduction

The status quo for retirees and those approaching retirement is no longer sustainable. There is a growing strain on the balance sheet of Canadian households, pushing them to find new sources of income to achieve their desired lifestyle upon retirement. In parallel, we are experiencing a difficult investment landscape – peak market valuations and a challenging yield environment.

Households need to better understand the link between their assets and expenditures, so they can determine what their investment income needs will be upon retirement. Traditional investment portfolios are unlikely to suffice and retirees will need to unearth unique sources of investment income going forward. While this needs to be the focus of investors, the asset management industry is focused elsewhere.

We strongly believe that these issues are the most significant financial challenges Canadian families face today.

An analysis of household assets, income and spending patterns suggests families will struggle to maintain their lifestyle upon retirement; we believe this is the <u>greatest financial challenge that Canadian families face today</u>

The majority of Canadians' household assets are linked to the value of their house. Their "liquid assets" – assets they could readily access for income - accounted for just 40% of their total household assets, while nearly half of their assets were tied to real estate (Figure 1).

Upon retirement, a household might have to decide between the following "alternatives":

- Sell their real estate assets to create more cash or rely on real estate for rental income.
- Reduce their standard of living / expenditures.
- Attempt to find investors who can deliver excess returns to increase the value of their investments.
- Work longer to increase employment income.

Source: Statistics Canada, CANSIM 205-0004 2016 Assets, Waypoint Investment

Figure 1: Distribution of Canadian Household Assets

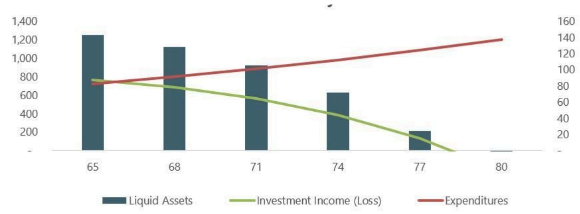
None of these "alternatives" seem ideal.

Planning for retirement usually involves a few steps:

1. You determine the value of the liquid assets you will have upon retirement.
2. Determine the monthly / yearly expenditures you make to allow for your desired lifestyle.
3. You set expectations for the investment income your investments should be able to generate.
4. You use these to determine how long your liquid assets will last and see if one of the 4 "alternatives" are necessary.

We found it very informative to apply these four steps to the average Canadian household in general.

Statistics Canada produces detailed reports on Households assets, debts, liquid investments and spending patterns, allowing us to build a model for Canadian households on average:



Source: Statistics Canada, CANSIM 205-0002, 205-0004, 203-0026, Waypoint Investment Partners Analysis
Graphical representation uses 7% as a target compounding rate

Figure 2: Under the status quo, households' liquid assets would last 10-15 years

Under the status quo, Canadian households would only have sufficient liquid assets to maintain their current lifestyle for ~13 years – making it unlikely that these liquid assets will be sufficient to last their entire retirement.

If we adjust this model slightly to incorporate one to two years of negative investment performance, this equation becomes even harder to maintain. Shortly after you retire, a "market downturn" (a 15-20% market correction) would cause those liquid assets to last four years less.

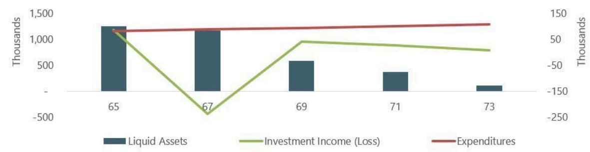


Figure 3: A significant market downturn could imply liquid assets would last ~8 years

Canadian households will need to consider how to generate additional income or liquid assets if they seek to maintain their standard of living.

Despite acknowledging this retirement challenge, we believe many pockets of the asset management industry are focused elsewhere - the majority of investment options are not built around income requirements that allow customers to maintain their lifestyle

We believe certain industry behaviors have created a lack of trust in the asset management industry...

- A confusing "buffet" of investment options that don't directly approach your lifestyle needs.
- Unwarranted fees, incentive structures build around "what to sell you" vs. "what you need".
- Confusing financial jargon and false promises

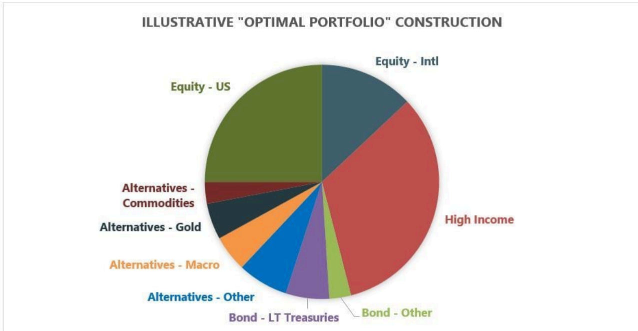
to “beat the market”.

...creating a huge flow of funds into passive investing & ETF strategies. However, this presents a number of potential risks.

- “Bubble-like” characteristics; equities trading less on fundamentals or the value of the underlying securities the indices hold.
- Investors are mistakenly connecting low cost of ownership to value in the underlying securities.

Traditional portfolio construction principles (the “balanced” portfolio) fund managers often employ were designed to have a mix of Fixed Income and Equities depending on their clients’ age and preferences.

As these portfolios no longer provided clients with the income they need, many fund managers often use a broader range of financial products and attempt to incorporate them into their offerings to clients. The “pie” of a client’s assets tend to look more complex with several new products, assets classes and asset mixes. In the illustration below, there are several bond, equity and alternative assets classes built around a “high income” product.



Such portfolios do not get to the heart of the asset-income gap that we spoke to earlier.

We believe the long-term outlook for traditional “balanced” portfolios with traditional stock and fixed income securities are historically low. To achieve the income / yield requirements that have been achieved in the past (which retirees still need) investors will have to use unique portfolio strategies, alternative sources of income, and an expanded palette of asset classes to achieve this target.

How can one achieve an acceptable return under the following constraints & parameters?

1. Your assets need to remain liquid so that you can draw on them for income.
   These assets need to be invested, but they still must be liquid enough for you to regularly draw from – it is replacing your employment income. This biases you to liquid asset classes.

2. You want to invest with prudence and conservativism; avoid a market downturn and avoid losses early in your retirement years.
   As long term investors, we largely ignore short term market fluctuations, but as we highlighted earlier, for those who are retiring / in retirement, avoiding those large losses during retirement years becomes critical.

3. The need for liquidity & conservatism biases you towards reliable yield, income, dividends & cash-on-cash returns.

4. We have been in an all-time low interest rate environment since 2008 – making it a challenge to generate steady yield and income from your investments.

5. In parallel, equities have been at peak valuations. The returns investors earned in the previous 10 years may not be achievable over the next 10 years.
   History suggests that valuations and prices have to revert / normalize at some point. It would be prudent to assume that investing in equities today will not provide you the same returns they did in the past.

6. The outlook for traditional portfolios suggests investors need to identify unique strategies, investments and assets classes to deliver this target return.
   Projected economist and institutional outlooks for traditional US, Canadian equity & bond markets are at historical lows.
   Sources : Sources: Newfound Research – Portfolios in Wonderland, Shiller Data Library, RBC Global Investment Outlook 2017 (used for data), JP Morgan Capital Markets Assumptions (used for data), Waypoint Investment Partners Analysis.

What does the solution look like?

To deal with these parameters, one should develop a clear "retirement equation" that links investment returns, expenditures, and liquid assets. While developing a retirement equation seems daunting, it is a powerful tool to understand your financial situation – and it needn't be overly complicated.

Illustrative: An ideal build of household wealth and eventual usage of that wealth upon retirement.

This illustration is meant to depict that "ideal scenario" we referenced earlier. This illustration implies that:

- During your working years, you saved a large enough portion of your employment income (after taxes and your household expenditures) to make regular contributions to your investments and you invested that at a long term growth rate of ~7% (hopefully better!) over time. You built your wealth during these working years.
- You retired with the right mix of (i) sufficient liquid assets (ii) expenditures within your means and (iii) continues to find ways to generate investment income of ~7%.
- Because you had the right mix of these elements, you don't have to worry about your asset base depleting during retirement, you didn't have to sell property, work longer etc. and you still had a large asset base well into retirement.
- Your equation must factor in nuances around taxation, investment accounts (RRSPs, LIRAs, TFSAs etc), how to project what expenditures will look like over time etc.

In Conclusion

While the idea of mapping your assets, expenditures, income and finding an appropriate investment strategy amongst a buffet of options can feel daunting – it doesn't have to be. All of the analysis presented in this document can be easily done - as we did for our families - by (i) clearly identifying the right data points for your household – similar to the ones outlined in this document (ii) ensuring that heading into what appears to be the later stages of the economic cycle, you have a clear **plan** and **strategy** that generates the income and protection you need in your retirement equation.

The Treasury Technology Imperative

by Paul Busby, ENSO

READ ON

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Introduction

Specialist treasury technology has been the domain of the world's largest hedge funds and asset managers in the past, allowing them a competitive edge in reporting, analysis and optimizing work flow management and cost savings. Today, sophisticated treasury technology capabilities are accessible to the full spectrum of institutional investors, from two-person boutique organizations through to the world's largest asset managers.

As investor demands increase, and the operating and regulatory environment becomes more challenging, the right treasury solutions provide institutional investors with scalability and flexibility to manage change and growth.

Outsourced software-as-a-service (SaaS) technology helps hedge funds and asset managers to harness data more effectively, deliver mission-critical analytics and create a streamlined, automated and controlled work flow to reduce costs, manage risks, and increase efficiency.

Challenges and opportunities

Technology Transformation: The transformation over the past decade in the way that people use and interact with technology, is driving a step change in investors' expectations of their fund managers. No longer is periodic, static reporting enough, investors expect to be able to interact with their fund managers' far more interactively with far greater transparency and granularity of information.

Return Targets: As the period of low interest rates extends, and the trend for passive strategies continues, investors are looking to their investment managers to generate alpha and enhance their service offering, including exploring a wider range of asset classes. This in turn places greater demands on their investment manager for reporting, analysis and work flow capabilities.

Data Management: It is not only the way that information is delivered that is changing but also how it is generated. The use of enhanced data extraction, collation, normalization analysis and reporting tools is becoming more prevalent in financial services to reduce manual processing, enable complex work flows, increase scalability and improve the quality of insights and decision-making. Outsourced data services offer considerable potential to harness data and apply business logic in new ways. As these techniques become part of leading outsourced treasury solutions, fund managers are likely to gain rapid competitive advantage over those that lack the technology framework and business culture to do so.

Industry Professionalization: Developments in both investor expectations and the sophistication and scalability of analysis and work flow techniques are taking place in conjunction with an overall professionalization of the fund management industry.

Hedge funds and asset managers are developing greater sophistication in their middle and back office functions, with a greater focus on skills in quantitative math and computer science. It therefore becomes essential to relieve the operational burden of manual, spreadsheet or legacy technology-based treasury processes, allowing skilled professionals to focus on the tasks for which they offer the greatest value, and providing the tools they need to support their analysis and decision-making.

Data, decision-making and insights

Although all hedge funds and asset manager operate in an environment of challenge, change and growing regulatory and investor demand, treasury functions are at different stages of centralization and professionalization. As a result, fund managers need the access to a platform that can be scaled and flexed as their requirements change without the need to divert resources into major implementation and change management projects.

Outsourced, SaaS-based treasury solutions from a trusted provider enables treasurers to harness data, make informed decisions and act on insights across the full spectrum of their activities, including:

Harness Data

Collect, collate, standardise and track data from different sources create a rich, harmonised data set for reporting and analytics.

<u>Portfolio finance</u>

- Track all securities lending activities post settlement.
- Create a central repository of all securities finance information.
- Access re-rate tracking, community benchmarking and analytics.
- Track financing alpha post-execution.
- Best execution financing.
- Facilitate the stock locate process across multiple regions and brokers.

<u>Counterparty risk management</u>

- Provide a central point of consolidation for all counterparty information.
- Integrate internal counterparty analysis with credit rating agency data, stock and credit default swap (CDS) for counterparty oversight and investor reporting.

<u>Cash & Collateral management</u>

- Consolidate reporting on cash balances across currencies.

- Provide cash projections based on different settlement ladders.

Make Informed Decisions
Use data to model asset allocation scenarios, provide 'what if' analysis and optimize asset allocation:

Portfolio Finance

- Highlight opportunities to long lend, and optimize inventory.
- Daily inventory optimization – To reduce capital footprint, financing and securities lending costs.
- Stream prime broker inventory axes and identify opportunities.
- Allocate costs to portfolio manager/ strategy/ fund automatically.
- Perform wallet targeting and tracking.

Cash & Collateral Management

- Replicate prime broker financing rules to reconcile and identify cost reduction opportunities.
- Highlight inefficiencies within a portfolio to reduce cost or risk.
- Consolidate all margin statements to identify and analyze capital drivers.

Counterparty Risk Management

- Assess internal and external balance sheet impact by individual prime broker, including calculating ROA to drive decisions and assess prime broker allocation methodology.

Balance Sheet & Wallet Optimization

- Calculate and report on counterparty exposure and net asset value (NAV) at different entity levels, including limit utilization and breach notifications.
- Manage broker consumption and compute, manage and track execution and financing wallets to complete broker assessment reports (e.g. RTS 28 Article 2) and meet MiFID II requirements.

Act on Insights
Enhance transaction work flow through connectivity and messaging tools; manage cash and positions more effectively; track savings.

- Execute transactions directly from the on-screen position through online dealing platform integration.
- Integrate seamlessly with SWIFT for payments, balance & transaction reporting and automatic investment of surplus cash.
- Automate passive FX hedging.
- Calculate effective capital usage and margin replication.
- Attribute financing costs.
- Optimize cash flow.

Solutions in practice

While the value of specialist treasury solutions can be compelling in both qualitative and quantitative terms, there remain a number of barriers to adoption.

In some cases, there is a lack of understanding or confidence in selecting from the options available. In others, lack of budget or senior management buy-in can pose obstacles. Very often, particularly amongst hedge funds and asset managers that have not adopted treasury technology so far, the issue is not technological but cultural.

Asset management has always been, and remains a people-oriented industry. As a result, some still hold on to existing practices, which typically include manual, spreadsheet or legacy technology-based processes. However, the reality is that better processes, reporting, connectivity and compliance is crucial to efficiency, quality of decision-making and investor confidence. The right treasury solutions therefore
contribute positively to relationships rather than detracting from them, freeing up resources to concentrate on higher value-added activities and client relationships.

In the past, some fund managers opted to build proprietary treasury solutions inhouse but these were typically complex and expensive to develop and maintain which is no longer sustainable or desirable. On one hand, the upfront and ongoing costs of developing and maintaining systems to meet evolving technology, security, regulatory and functional requirements is prohibitive. On the other, the quality, depth, scalability and affordability of third-party solutions now vastly exceeds what a fund manager could create independently.

Acquiring third-party technology that needs to be installed on-premise also poses challenges, however. In particular, adoption requires a significant initial and ongoing investment in both financial and human resources that is difficult to justify for all but the very largest fund managers.

However, by accessing outsourced, SaaS-based treasury solutions, fund managers can enjoy best-in-class data, analytics and work flow capabilities without the burden of technology hosting, implementation and maintenance. Instead, they can focus on delivering excellence in their core business, boosting investor confidence and satisfaction, strengthening connectivity and creating economies of scale. An important benefit that is often overlooked is the ability to ensure business continuity. This is an important consideration for institutional investors, but it is more difficult to provide reassurance when using on-premise systems.

There are, however, crucial considerations when choosing outsourced treasury solutions.

- **Vendor Credibility:** Does the vendor have a proven track record of working with similar fund managers, together with the financial stability and combination of technical and industry expertise to continue investing in solutions and services?
- **Solution Scalability:** While solution providers deliver varying depth and breadth of functionality, fund managers need to be able to adopt the elements of the solution they need upfront and then scale their use as their needs expand and become more complex.
- **Security:** Protecting financial assets and data is the most important element of every treasurer’s role. With cyberattack and external fraud on the increase, treasurers play a vital role in the fund manager’s wider security strategy. The right treasury solution is an essential element in this strategy. Few hedge funds and asset managers can dedicate the specialist resources required to provide and maintain best-in-class security for treasury solutions managed in-house, or to secure

mission-critical interfaces, such as for payments. By outsourcing to a specialist vendor with dedicated resources and a proactive investment strategy in security, risk of cyberattack and fraud is reduced, while giving investors greater confidence.

- **Value Add:** Any technology project needs to have demonstrable value to the fund manager and ultimately to its investors. A crucial way of measuring this is financing alpha, a combination of quantifiable savings and revenue uplift. Fund managers need to satisfy themselves that their chosen treasury solution has a track record of delivering financing alpha to its clients through efficiency savings, improved risk management and enhanced returns through better-informed decision-making.

Conclusion

Treasurers of hedge funds and asset managers are committed to protecting, reporting on, analyzing and optimizing assets. The right treasury solutions contribute substantially to achieving these ambitions. Investors' due diligence demands are driving fund managers to implement operational best practices, including optimizing technology, infrastructure, and streamline operations. Becoming part of the ENSO community helps fund managers to identify and implement industry best practices by accessing a platform that has been designed, developed and refined collaboratively with clients.

The power of these solutions extends beyond operational efficiency, they also drive smarter decisions. Backed with intuitive, meaningful reporting and operational cost savings, fund managers can improve investor relationships and confidence. Crucially, they also enhance performance. As ENSO's analysis, and the experience of its customers demonstrates, outsourced, SaaS-based treasury solutions can contribute directly to hedge funds' and asset managers' ability to generate financing alpha and ultimately improve competitiveness and enhance the investor experience. Few fund managers, of any size, can afford to ignore this opportunity.

AIMA

5 Steps Hedge Funds Should Take to Stay on Top of CCPA Compliance

by Alex Scheinman, ACA Aponix

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According to the US Department of Commerce, California is the world's fifth-largest economy. So it is no surprise that California often takes the lead in paving the way for new legislation affecting not only civilians, but the business community in the US. With the recent wave of data breaches and misuses of data bringing data privacy to the forefront of the corporate agenda, in 2018, California passed the California Consumer Privacy Act (CCPA) to grant California residents increased control over their personal data, set to go into effect on January 1, 2020.

Under the CCPA, consumers will be able to find out what personal information of theirs has been collected, request that firms delete their data and opt out of having their information sold. Firms face hefty fines for non-compliance. The fine per civil violation is $2,500 to $7,500 for each violated data record, with the fine of $7,500 reserved for intentional acts of CCPA non-conformity. Further, if a data breach occurs, under the CCPA, the implicated firm could be held accountable for lawsuits.

When one hears about a regulation aimed at consumer data privacy, hedge fund compliance may not be the first thing that comes to mind. But hedge funds that put CCPA compliance on the backburner will find themselves scrambling to map out their affected data and comply ahead of the deadline for a variety of reasons.

Does GLBA override CCPA?

The first question that hedge funds might be asking themselves regarding compliance with the California Consumer Privacy Act is whether or not their data falls into scope. The question is one that has certainly been top of mind to the business community, lobbying to attain greater clarity on the regulation ahead of the law going into effect.

Following an amendment in September 2018, it was decided that GLBA-regulated data, which most core financial services data falls under, is indeed exempt. But hedge funds must be mindful that much of their data may not be considered 'core' by regulators.

The uptick in usage of alternative data by hedge funds has been a huge topic of industry discussion in recent years as hedge funds look to differentiate their investment strategies from traditional asset managers, facing increased competition from other managers offering multi-asset strategies. Statistics show that hedge fund spend on alternative data is skyrocketing. According to a recent report from Greenwich Associates, hedge funds are spending roughly $900,000 per year on alternative-data sources, and that amount is forecasted to hit $1 billion by 2020.

Indeed - the usage of alternative data by hedge funds may prove of significant interest to California state regulators, as they may not consider data sets often leveraged by hedge funds such as the below covered by GLBA, and thus, subject to CCPA compliance:

- Data from financial aggregators
- Credit card data
- Geospatial and location data
- Web scraping datasets
- Social media data
- App engagement data
- Ad spend data
- Point of sale data
- Shipping data from U.S. customs
- Data made available through APIs
- B2B data acquired from parties in the supply chain
- Location/foot traffic data from sensors and routers
- Satellite and drone data
- Pharmaceutical prescription data

Hedge funds must approach CCPA compliance strategically and with a firm goal of mapping which of their data falls in scope, which does not, where that data is located, and where it is being shared. Only once a data mapping exercise has been completed will hedge funds be able to create a compliance roadmap, following the below best practices:

- **Obtaining executive buy-in** — CCPA compliance is a broad effort that will affect many aspects of a hedge fund and will require significant staff hours and financial resources. In addition, failure to comply can have serious financial and reputational consequences. As a result, it is crucial to gain executive buy-in to facilitate the compliance process.
- **Understanding data collection policies and procedures** — It is essential to understand what a hedge fund's current policies and procedures are for collecting, storing, and selling data on California consumers. Firms should prepare data maps, inventories, and other records that clearly illustrate what data the business collects and sells, and where it is sold.
- **Performing a gap analysis** — Reviewing CCPA requirements closely and comparing them with data discovery findings. Performing a detailed delta assessment between the firm's status and where it needs to be for compliance.
- **Developing a compliance roadmap** — Developing a comprehensive compliance roadmap of necessary action steps based on the results of the gap analysis. Prioritizing tasks based on risk and level of effort.
- **Implementing the compliance roadmap** — Assigning leaders for the remediation effort, and delegating tasks to responsible parties. Following up on progress regularly. Developing all necessary updates and mechanisms (e.g.,

privacy policies, opt-out, opt-in, web updates, etc.). Testing and fixing all solutions as necessary. Updating due diligence policies regarding third-party vendors and vetting vendors for compliance as well. Including staff training as part of the overall compliance effort.

What's next for hedge funds and CCPA compliance?

In fall of 2019, the business community and the California Chamber of Commerce are expected to push for another round of amendments to narrow the present scope of the CCPA. It is expected that they will seek to narrow the definition of personal data, exempt personal data collected in the B2B channel and perhaps limit or eliminate the inclusion of personal data related to employees (e.g., dependents and beneficiaries). A move like that is one that hedge funds should keep a mindful eye on, as it would certainly impact compliance strategies.

All things considered, however, the California Consumer Privacy Act should serve as a wake-up call for hedge funds to put robust data privacy programs in place, and perhaps even to appoint dedicated data privacy executives, such as a Chief Privacy Officer to focus solely on data privacy compliance, looking beyond SEC requirements. And as there has been much discussion around the CCPA marking a move towards a federal data privacy regulation, similar bills in the US continue to take hold in states like Washington, Hawaii and New York. Prudent hedge funds, already making significant changes to how they run their business to maintain alpha in a world of constant change, must also change their mindsets on data privacy, placing it at the top of their priority lists in 2019.

The Future of Cryptocurrencies - Ready to Buy Amazon at $9?

by Cedric Jeanson, BitSpread

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You might think from recent press coverage of cryptocurrencies that everything is doom and gloom in the space. And of course, it is significant that a speculative bubble in cryptocurrencies formed and then burst. Bitcoin has declined in price by around 85% since its December 2017 peak. But underneath the volatile price movements, there are profound changes underway that will transform the space and ultimately have a major impact on the global economy.

At the forefront of these changes are stablecoins, cryptocurrencies which are pegged to the value of stable real-world assets such as the US dollar or Euro. They offer the advantages of cryptocurrencies, such as negligible fees and incredible speeds on global transactions compared to fiat currencies, without the volatility associated with free floating cryptocurrencies such as Bitcoin or Ether. Most importantly however, they are transferable on global decentralised blockchain networks, where transactions are both cryptographically secured and transparent.

Tether, the US dollar-backed stablecoin, is the most established in the space, but it now faces major competition from USD Coin (USDC), which was recently launched by the peer-to-peer payments company Circle and the leading crypto exchange, Coinbase. They say that the token is backed by actual US dollars in a traditional bank account, and demonstrated that by issuing an "attestation" report by the accounting firm Grant Thornton, showing that over $127m was held in a custody account to cover a similar amount of USDC in circulation.

Stablecoins like USDC will be transformative for e-commerce because there is no risk of instability, unlike traditional crypto currencies. They allow consumers to take advantage of blockchain technology for transactions, meaning swift global payments, negligible transaction fees, and transfers are 100% traceable. And it is much easier to use, transfer and store digital dollars in e-commerce applications than traditional bank-account based dollars.

The consequence will be that it is likely that stablecoins will be increasingly be used on e-commerce websites in global payments for goods and services, and will increasingly be adopted as a medium of exchange for goods and services internationally. We are not at that point yet, but proof of the growing use of stablecoins can be found in increasing issuance of these tokens, increasing listings on exchanges and increasing volumes of trade. This increasing prevalence of stablecoins and the rate of acceptance and adoption which that implies are a huge development.

The decentralised global networks through which these stablecoin transfers take place will, for the foreseeable future, most likely be the Bitcoin and Ethereum blockchains, given the fact that they provide existing, tried and tested infrastructure. The necessary work to validate transactions is performed by dedicated providers of such services, the miners. Those global blockchains will continue to evolve both in terms of capacity of the number of transactions and speed via software upgrades (so-called "soft or hard forks").

The native cryptocurrencies of these blockchains, Bitcoin and Ether, which serve as the medium of compensation for these services, will thus increase in value in line with the number of users. As such, Bitcoin and Ether will be become the "oil" of a global e-commerce economy and constitute a highly investable crypto asset class by institutions.

Finally, as dire as the current crypto market seems, a parallel can be drawn with the early stages of another disruptive industry, the internet. When the Dotcom bubble burst in 2001, Amazon's share price dropped by around 90% and by 6 April 2001 its shares could be bought at under $9. By September 2018 however, Amazon's shares were trading at $2,000, and the company is today one of the world's largest companies by market capitalisation.

The bursting of that speculative bubble, Dotcom 1.0, was with hindsight a process of creative destruction. It cleared away the first generation of Dotcom firms, such as Lycos, Altavista and Netscape, and helped to create the conditions for the rise of household names like Google, Facebook, Instagram and Spotify in the Dotcom 2.0 era which utilised the new technology to transform how we live.

We may be at a similar inflection point with cryptocurrencies. The speculative bubble of Crypto 1.0 may have burst, but Crypto 2.0 will be about the successful adoption of blockchain technology globally. In a decade, it is likely that a new generation of firms will have become household names in the space. To invest in these firms now is the equivalent of buying Amazon at $9. There may be no better time to get into the space.

With thanks

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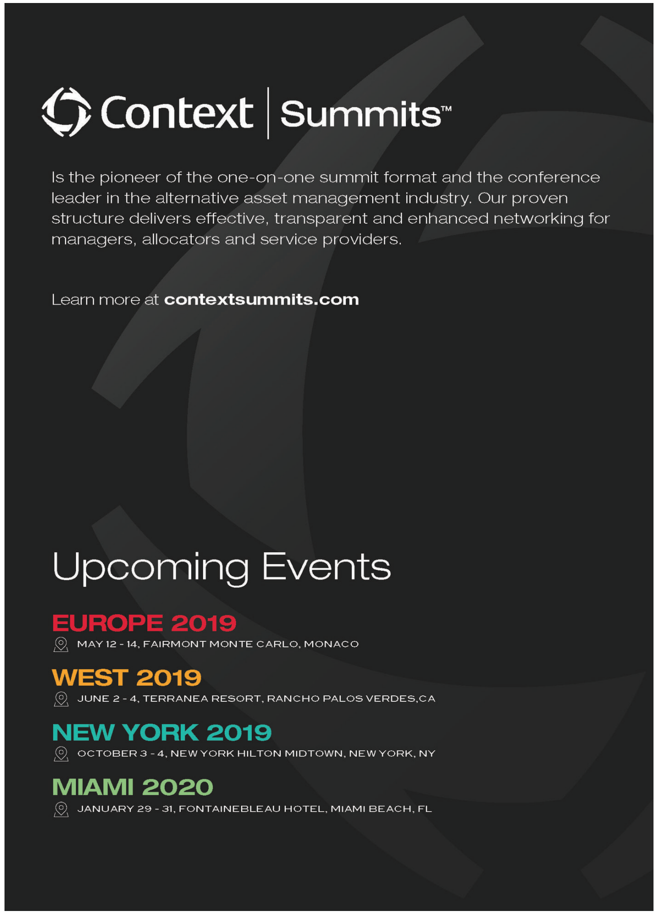

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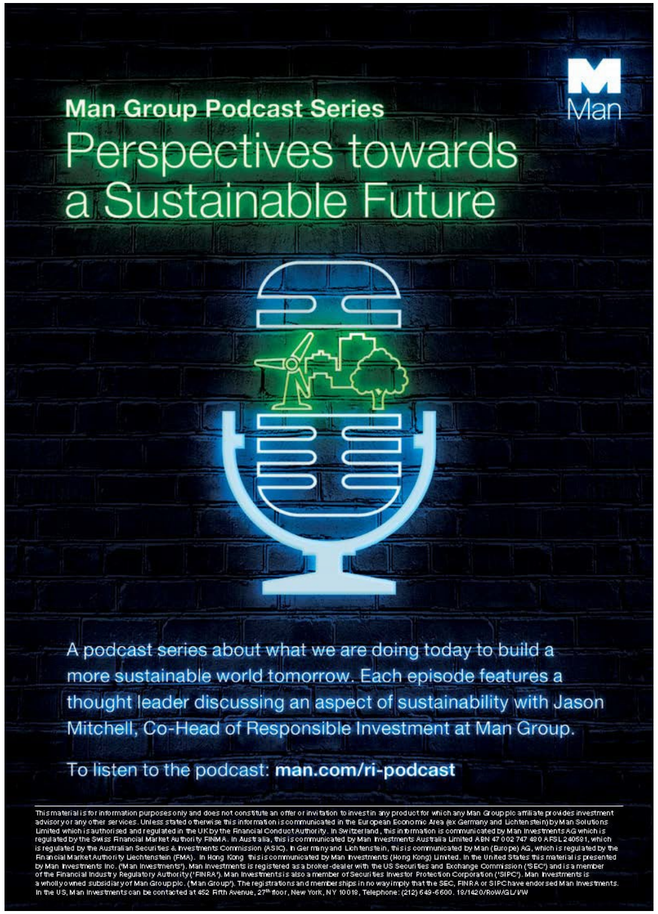

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