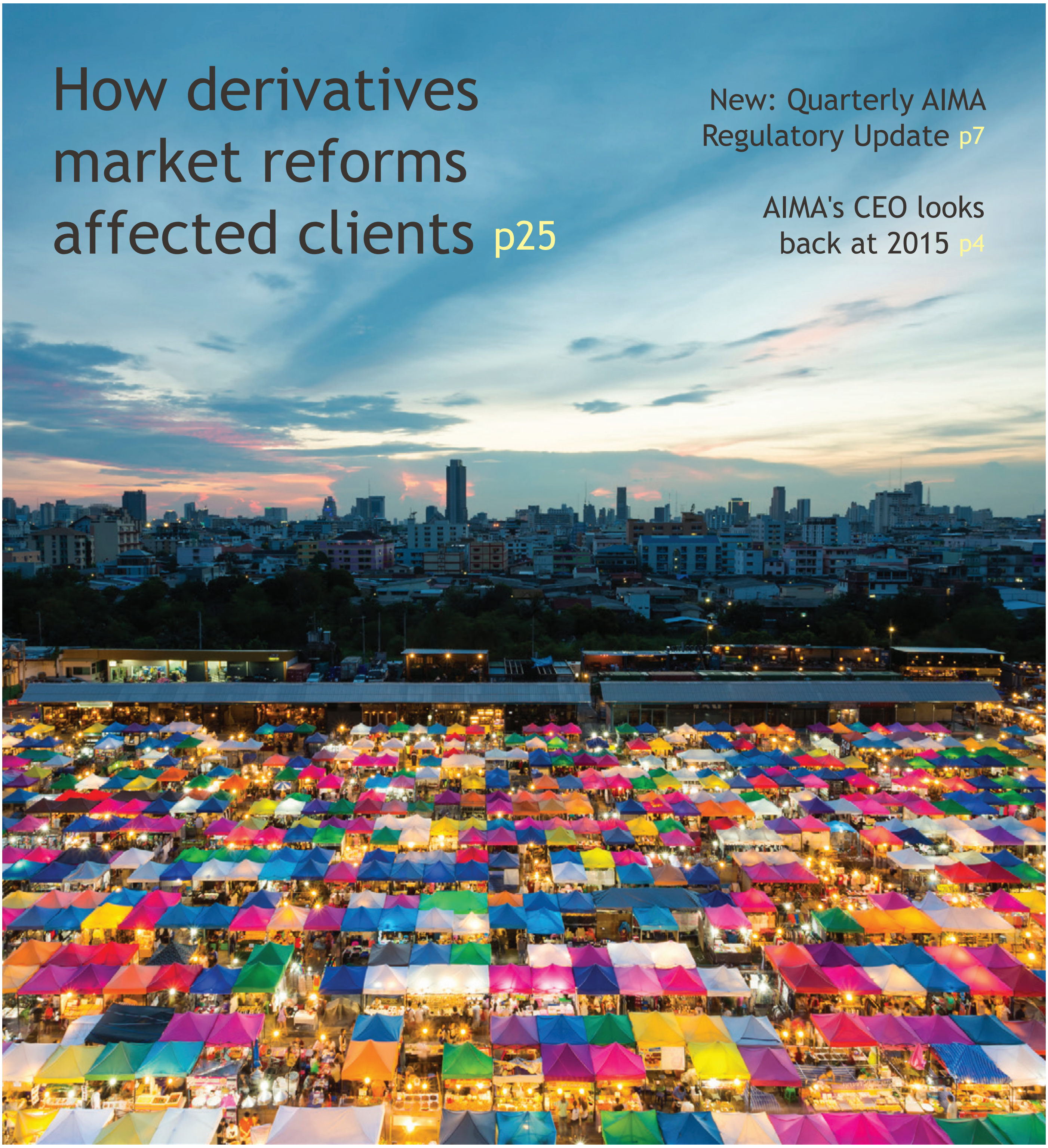
1990 | 2015 25 YEARS

The global forum for the alternative investment management industry

aima Alternative Investment Management Association

AIMA Journal



Contents

Another busy and rewarding year for AIMA

By Jack Inglis, CEO, AIMA

It is customary at this time of the year to look back on the last 12 months. I want to reflect firstly on AIMA's year before making some broader comments about the state of the global hedge fund industry as we enter the New Year.

AIMA's Global Review of the Year for 2015, which is being distributed to AIMA members, provides a very comprehensive round-up of our activities worldwide this year. I won't repeat them all here but would like to pull out some highlights:

- <u>Policy and regulation</u>: Our proactive and constructive engagement with policymakers and regulators across the full suite of legislation impacting our industry globally continued to secure improvements to initial proposals this year, including those relating to remuneration in Europe, the global 'SIFI' issue, MiFID II, the IMR in Australia, cross-border derivatives rules in the US and securitisation across the EU.

- <u>Compliance and training</u>: We expanded our library of due diligence questionnaires and sound practice guidance for AIMA members this year, and increased the number of training programmes for hedge fund staff globally. Of particular note were our guides on cyber security, liquid alternatives and fund directors.

- <u>Conferences and webinars</u>: In 2015, we organised more than 200 conferences, seminars, webinars and hedge fund staff training sessions in the key financial hubs across EMEA, North America and Asia-Pacific. This is our highest ever number of events in a single year.

- <u>Member engagement</u>: Member engagement has never been greater, with more than 10% of our 10,000 member contacts now regularly participate in our committees and working groups, while our events drew a combined attendance of well over 11,000 delegates.

- <u>Record numbers</u>: By the end of the year, we had over 1,700 member companies in 57 countries – a net increase of 10.4% on 2014 and a new high for the association, coming at the end of our 25th anniversary year.

So it's been another busy and productive year for AIMA, but how has the global hedge fund industry fared? Without doubt, market conditions, particularly during Q3, have been difficult, and no one is saying this will be remembered as a vintage year for the entire sector, but there have been many good news stories. Indeed, AIMA research, based on the HedgeFund Intelligence database, shows that over two-thirds of reporting hedge funds were in positive territory for the year to the end of October, while the "average" hedge fund beat the main equities and bond indices over the same period. We aim to publish the year-end numbers in January.

The hedge fund universe offers investors such a diversity of alternative products and strategies today, it should be no surprise that there will be winners and losers in any given year. This year is no exception and while the media tends to focus on the negative performance of some individual funds there is plenty of evidence that 2015 was a very good year for investors in many other funds. The data suggests that investors remain, on the whole, convinced by the useful role that hedge funds can play in their portfolios. There were net inflows to funds during the first three quarters of the year, continuing the post-crisis trend. What I continue to hear from the investors I meet is that they allocate to hedge funds not only because of the potential for positive, low-risk returns but also as very effective means of preserving capital and accessing particular investment opportunities that may not be available to them otherwise. Investors' expectations on the whole continue to be met.

I anticipate another productive period for AIMA in 2016. Our pipeline for the first half of next year includes some significant projects, including new due diligence questionnaires, additions to our suite of Guides to Sound Practices, another substantial programme of events including the 'AIMA in Asia' conference in Hong Kong in January and the sixth Global Policy & Regulatory Forum in London in May, a major update to our website and investments in projects designed to enhance the reputation of the industry. Delivering value to our members remains my number-one priority, and I look forward to continuing our work on the industry's behalf in 2016.

Happy Holidays to all our members.

Our regulatory and tax submissions and summaries in Q4

Date	Authority	Description
17 December	EC	AIMA Update Note - MiFID2 state of play on dealing commissions
8 December	CFTC	AIMA Summary - Proposed Regulation AT
25 November	HMT	Submission – Amendments to the UCITS Directive (UCITS V)
20 November	ESMA	Summary – Final Draft RTS on MiFIDII/R for Algorithmic trading, HFT and DEA
20 November	EC	Summary – EU Regulation on transparency of Securities Financing Transactions and of reuse
12 November	CFTC	Submission – Aggregation of Positions – Supplemental Notice of Proposed Rulemaking
9 November	FCA	Submission - UCITS V implementation and other changes to the Handbook affecting investment funds
2 November	UST	Submission – Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers
1 November	MAS	Submission – Policy Consultation on Margin Requirements for Non-Centrally Cleared OTC Derivatives
30 October	SFC	Submission - Proposed Changes to the Securities and Futures (Financial Resources) Rules
30 October	CFTC	Submission – Amendments to Swap Data Recordkeeping and Reporting Requirements for Cleared Swaps
23 October	ESMA	Submission – Draft Guidelines on sound remuneration policies
16 October	MAS	Submission - Proposed Amendments to the Securities and Futures Act, Financial Advisers Act and Trust Companies Act
14 October	ESMA	Submission – Draft regulatory technical standards under the ELTIF Regulation
5 October	FCA	Submission - FCA's CP 15/27 (ELTIF Regulation)

AIMA Regulatory Update

An update from AIMA's Government and Regulatory Affairs Team

The AIMA Regulatory Update, previously delivered by email but now part of the AIMA Journal, strives to provide a succinct update to AIMA members on the current state of play on the most important files in the Government and Regulatory Affairs space. It is a one-stop-shop for members seeking to gain a quick overview of the main points of interest to the hedge fund industry while also providing links to a number of internal and external documents for those interested in greater detail. The issues treated in the update do not provide an exhaustive list of AIMA's work in the area and we encourage members to contact AIMA's Government and Regulatory Affairs team if they wish to be informed on the progress of work on issues which are not covered.

ASSET MANAGEMENT REGULATION

UCITS V

AIMA responded to the European Securities and Markets Authority's (ESMA's) consultation paper on setting out guidelines on sound remuneration policies under the fifth Undertakings for Collective Investments in Transferable Securities Directive (UCITS V) and the Alternative Investment Fund Managers Directive (AIFMD) commenting that, amongst other things, AIMA agrees with ESMA's approach to the application of the proportionality principle and encourages ESMA to retain the possibility for firms to neutralise certain provisions of the remuneration principles, on a case-by-case basis, where it is proportionate for them to do so.

AIMA has also responded to part I of the UK Financial Conduct Authority's (FCA) consultation paper (CP15/27), which proposed changes to the FCA Handbook in order to implement the UCITS V Directive. In AIMA's response, AIMA encouraged the FCA to be as flexible as is possible given the limited amount of time that is left before the legislation comes into force and the current level of uncertainty that remains. Amongst other things, AIMA commented that management companies should be given at least a three-month window from publication of the final UCITS V remuneration guidelines in their translated versions before having to apply the remuneration provisions of the UCITS V Directive in order to allow them time to comply with the requirements.

HM Treasury (HMT) has also published a consultation on amendments to the UCITS Directive to implement UCITS V. The consultation paper sets out the proposed changes to UK legislation that will need to be made in order to transpose UCITS V, which include changes in relation to depositaries, remuneration principles, and the national sanction regimes. Chapter 5 seeks views on a small number of other issues, including the requirements for reporting infringements of the UCITS Directive. The consultation closes on 17 December 2015.

- **AIMA contacts**: Jennifer Wood (jwood@aima.org) and Anna Berdinner (aberdinner@aima.org).

AIFMD

ESMA Advice and Opinion on the AIFMD passport

The Chair of ESMA, Steven Maijoor, delivered a speech to the Economic and Monetary Affairs Committee of the European Parliament in relation to ESMA's advice (the 'Advice') on the application of passport under the AIFMD to non-EU alternative investment fund managers (AIFMs) and alternative investment funds (AIFs) and ESMA's Opinion (the 'Opinion') on the functioning of

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the AIFMD EU passport and of the National Private Placement Regimes in which he identified a second group of non-EU countries to be assessed, namely Australia, Canada, Japan, the Cayman Islands, the Isle of Man and Bermuda. These countries were selected using the same criteria as for the first set of advice. He also noted that ESMA is continuing assessments of Hong Kong, Singapore and the US with a view to reaching a definitive conclusion on whether to extend the passport to those countries. Mr. Maijoor also stated that ESMA "will focus on putting in place the extensive framework foreseen by the co-legislators in case the passport is indeed extended to one or more non-EU countries." AIMA has produced a summary of the Advice and the Opinion and has been continuing to engage with the competent authorities in various jurisdictions as well as ESMA in relation to the progress of the extension of the passport.

- **AIMA contacts**: Jennifer Wood (jwood@aima.org) and Anna Berdinner (aberdinner@aima.org)

Securitisation

As part of its Capital Markets Union ('CMU') initiative, the European Commission (Commission) published a proposal for a Securitisation Regulation that will apply to all securitisations and include due diligence, risk retention and transparency rules together with the criteria for simple, transparent and standardised ('STS') securitisations. The Commission also issued a proposal to amend the Capital Requirements Regulation ('CRR'), to make the capital treatment of securitisations for banks and investment firms more risk-sensitive and able to reflect properly the specific features of STS securitisations. AIMA is drafting a position paper to address the points of these regulations which most affect the hedge fund industry.

- **AIMA contacts**: Jennifer Wood (jwood@aima.org) and Anna Berdinner (aberdinner@aima.org)

Remuneration

The Commission has launched a public consultation on the impacts of the maximum remuneration ratio under the Capital Requirements Directive (CRD IV) and the overall efficiency of CRD IV remuneration rules. The aim of the consultation is to collect stakeholder feedback on the possible impact of the Maximum Ratio Rule (paragraph (b) of Article 161(2) of CRD IV) on: (i) competitiveness; (ii) financial stability; and (iii) staff in non-EEA countries. Additionally, the consultation seeks input more broadly on the overall impact on the remuneration provisions of the CRD IV and the CRR. The consultation will run until 14 January 2016. The consultation also refers to work carried out by the external contractor with whom the Commission services are working (the institute for financial services (iff)). If you are affected by CRD III, CRD IV, AIFMD or UCITS remuneration provisions and interested in taking part in this work, please contact Anna Berdinner or Jennifer Wood.

- **AIMA contacts**: Jennifer Wood (jwood@aima.org) and Anna Berdinner (aberdinner@aima.org)

ELTIF

AIMA responded to ESMA's consultation on draft regulatory technical standards (RTS) under the ELTIF Regulation on European Long-term Investment Funds (ELTIFs), arguing that, in order to make the ELTIF more attractive to prospective investors and to broaden the ELTIF manager's ability to provide risk adjusted returns on the ELTIF, the RTS should allow the use of derivatives for hedging purposes but otherwise impose no further restrictions on the type of risks which can be hedged.

- **AIMA contacts**: Jennifer Wood (jwood@aima.org) and Anna Berdinner (aberdinner@aima.org)

Form CPO-PQR and Form CTA-PR

The U.S. Commodity Futures Trading Commission (CFTC) has published a document setting out responses to Frequently Asked Questions Regarding Commission Form CPO-PQR and CTA-PR. The document sets out 53 FAQs on Form CPO-PQR and 12 FAQs on Form CTA-PR, which include some of the Q&As that AIMA, along with the Investment Adviser Association (IAA) and the Investment Company Institute (ICI) submitted to the CFTC last year.

- **AIMA contacts**: Jennifer Wood (jwood@aima.org)

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and Anna Berdinner (aberdinner@aima.org)

Proposed AML Rules for Registered Investment Advisers

AIMA submitted a response to the Financial Crimes Enforcement Network's (FinCEN) proposed rule regarding anti-money laundering (AML) programme and suspicious activity report filing requirements for investment advisers registered with the Securities and Exchange Commission (RIAs). In the response AIMA suggested that the proposed rule should be limited to investment advisers who are U.S.-domiciled or not already subject to adequate AML rules in their own jurisdiction. AIMA commented that to the extent that is not possible, the requirements under the proposal should apply only to the extent of the RIA's conduct and transactions involving U.S. persons and/or U.S. domiciled financial institutions where the non-U.S. registered investment adviser is subject to adequate AML rules in its home jurisdiction.

- **AIMA contacts**: Jennifer Wood (jwood@aima.org) and Anna Berdinner (aberdinner@aima.org)

Shadow Banking

The Financial Stability Board (FSB) has published three reports on transforming shadow banking into resilient market-based finance. The reports are: (i) a progress report entitled Transforming Shadow Banking into Resilient Market-based Finance, which sets out actions taken to implement the FSB's strategy to address financial stability concerns associated with shadow banking over the past year as well as next steps; (ii) a Global Shadow Banking Monitoring Report 2015, which presents the results of the FSB's fifth annual monitoring exercise to assess global trends and risks of the shadow banking system, reflecting data as of end-2014; and (iii) a Regulatory framework for haircuts on non-centrally cleared securities financing transactions, which finalises policy recommendations in the framework for haircuts on certain non-centrally cleared securities financing transactions to apply numerical haircut floors to non-bank-to-non-bank transactions and update the implementation dates of these recommendations.

- **AIMA contacts**: Jennifer Wood (jwood@aima.org) and Anna Berdinner (aberdinner@aima.org)

MARKETS REGULATION

Capital Markets Union

September saw the publication by the European Commission of an Action Plan to deliver its flagship Capital Markets Union project. The CMU initiative has stated objectives to: develop a more diversified financial system to complement bank financing with deep and developed capital markets; unlock currently frozen capital around Europe and put it to work for the economy, giving greater choices for both savers and businesses; and establish a genuine single cross-border capital market in the EU. The intended policy actions to meet these objectives include: legislative measures on high quality securitisation; the implementation of the Regulation on European Long-Term Investment Funds (ELTIF); a review of the Prospectus Directive; additional credit information on SMEs; and rules on private placement of securities. A key additional aspect of the project is a Call for Evidence on the EU Regulatory Framework. The Call for Evidence is driven by the Commission's desire to understand the combined impact of the rules that have been put in place post-crisis, particularly where those rules are having unintended consequences. The Commission has signalled that it is open to changing rules where there is strong evidence that regulation is adversely impacting the ability of the economy to grow and finance itself. AIMA is developing a response.

- **AIMA contact**: Adam Jacobs (ajacobs@aima.org) or Oliver Robinson (orobinson@aima.org)

MiFID2/MiFIR

The MiFID2/MiFIR application date now looks set to be pushed back until January 2018, providing welcome additional time for industry to implement the new rules. The delay has been championed to a large extent by the European Securities and Markets Authority (ESMA), reflecting concerns on the part of regulators that they themselves have too little time to design the necessary systems to supervise the new rules. To give effect to a delay, the European Commission will have to propose a new piece of legislation, which will be subject to approval by the European Parliament and Council. The Parliament has accepted that this is necessary, but continues to push for swift adoption by the Commission

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of secondary rules. In this context, our key area of interest is the issue of the use of dealing commissions to pay for investment research. Looking ahead to 2016, AIMA is launching a MiFID2 implementation project, which will comprise various strands of work on the topics that matter most to our members. As well as developing guidance material, we will also provide an open discussion forum for members to exchange perspectives, whilst engaging closely with ESMA to solicit guidance on areas of uncertainty.

- **AIMA contact**: Adam Jacobs (ajacobs@aima.org) or Oliver Robinson (orobinson@aima.org)

EMIR

On 1 December, the European Commission published its first Delegated Regulation with regard to RTS on the EMIR clearing obligation. The RTS mandates clearing of certain interest rate products denominated in G4 currencies as follows: (i) basis and fixed-to-floating swaps denominated in EUR, GBP, JPY and USD; and, (ii) FRAs and overnight index swaps denominated in EUR, GBP and USD. The Regulation enters into force on 21 December 2015 and the clearing start-dates for each category of entity are as follows: Category 1 entities (CMs) 21 June 2016; Category 2 entities (non-CM FCs and AIFs meeting the relevant threshold) 21 December 2016; Category 3 entities (all other FCs and AIFs) 21 June 2017; and, Category 4 entities (NFC+s) 21 December 2018. Frontloading will be required for contracts that will have a minimum remaining maturity of six months on the relevant clearing start date and that were entered into on or after: 21 February 2016 for Category 1 entities; and, 21 May 2016 for Category 2 entities.

- **AIMA contact**: Adam Jacobs (ajacobs@aima.org) or Oliver Robinson (orobinson@aima.org)

ISDA resolution stay protocol

In November ISDA launched the ISDA 2015 Universal Resolution Stay Protocol, also publishing related FAQs. The ISDA 2015 Universal Protocol enables parties to amend the terms of their Protocol Covered Agreements to contractually recognize the cross-border application of special resolution regimes applicable to certain financial companies and support the resolution of certain financial companies under the United States Bankruptcy Code. While the ISDA 2015 Universal Protocol is open to any entity to voluntarily adhere, it was not developed with the expectation of being used by broader market participants, including buy-side institutions, as a means of complying with regulations applicable to their dealer counterparties. The ISDA 2015 Universal Protocol is universal in that an institution that adheres to the ISDA 2015 Universal Protocol is agreeing to "opt in to" and be bound by stays applicable to all other Adhering Parties to the ISDA 2015 Universal Protocol and with respect to all Identified Regimes and Protocol-eligible Regimes, even if not required by regulation to do so. ISDA continues its work to develop a Jurisdictional Modular Protocol to facilitate compliance with the specific regulatory or legislative requirements and it is expected that buy-side institutions generally could comply with such regulations and legislation through the forthcoming ISDA Jurisdictional Modular Protocol rather than the ISDA 2015 Universal Protocol.

- **AIMA contact**: Adam Jacobs (ajacobs@aima.org) or Oliver Robinson (orobinson@aima.org)

CFTC position limits aggregation proposals

In November, AIMA responded to the CFTC's supplemental notice of proposed rulemaking on the aggregation of positions for the purposes of position limits for commodity contracts. In our response, we detailed our concerns regarding the ultimate market impact of position limits, and noted the absence of compelling evidence in support of the establishment of broad, ex ante position limits. We explained our view that the extension of the regime to "economically equivalent" OTC positions will, in particular, be difficult to administer, and encouraged the CFTC to provide the necessary guidance on the calculation of economically equivalent OTC positions such that market participants can develop automated systems to monitor their positions as far as possible. We also addressed the specific issues raised in the context of the Proposed Rule, highlighting our view that the independent account controller exemption and owned entity exemption could usefully be modified to allow entities to share an execution desk and thereby avoid any risk of cross-trading. Disaggregation relief would still be premised on ensuring that the original trading decisions of the entities involved were made separately.

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- **AIMA contact:** Adam Jacobs (ajacobs@aima.org) or Oliver Robinson (orobinson@aima.org)

SEC Regulation of NMS Stock ATSs

The Securities and Exchange Commission (SEC) announced in November that it had voted to propose enhanced operational transparency and regulatory oversight of alternative trading systems (ATS) trading stocks listed on any national securities exchange, including 'dark pools'. The intention behind the proposals – which would amend Regulation ATS - is to enhance investor and market participant information about the workings of ATSs. The proposals include for the provision of information via a new 'Form ATS-N' on the trading of ATS operators and their affiliates on each ATS, the types of orders and market data used on each ATS, as well as each ATS's execution and priority procedures. Such Form ATS-N disclosures would be publicly available on the SEC's website. Once published in the Federal Register, industry will have 60 days in which to respond to the proposed amendments.

- **AIMA contact:** Adam Jacobs (ajacobs@aima.org) or Oliver Robinson (orobinson@aima.org)

CFTC Regulation AT proposals

The CFTC has voted unanimously to approve a new suite of proposed rules for the regulation of algorithmic trading on U.S. DCMs – Regulation AT. In addition to proposing a definition of 'Algorithmic Trading', Regulation AT would introduce risk control, development, testing, monitoring, reporting, recordkeeping and other requirements for: (a) market participants using algorithmic trading systems – defined as 'AT Persons'; (b) clearing member FCMs; and (c) DCMs executing AT Person orders – including self-trade controls. It would also require the registration of certain prop traders that undertake algorithmic trading through DEA not currently registered with the CFTC. Finally, proposed Regulation AT contains provisions on market-maker and trading incentive programs, the role of Registered Futures Associations (RFAs) and transparency into the functioning of DCM matching engines. Despite a very broad definition of 'Algorithmic Trading', the CFTC has sought to provide a significant degree of flexibility for market participants to implement and calibrate controls most relevant to their businesses, in line with responses to the CFTC Concept Release consultation back in 2013. RFAs are proposed to be relied upon to promulgate further rules as necessary to account for particular activities and ongoing development of market practices. A noteworthy concern for AIMA members is the Regulation AT proposal for each AT Person to maintain its own 'source code repository' to act as an audit trail of a firm's algorithms. An AIMA Summary is available here. Once published in the Federal Register, industry will have 90 days in which to respond. AIMA will be submitting a response.

AIMA contact: Adam Jacobs (ajacobs@aima.org) or Oliver Robinson (orobinson@aima.org)

EU rules on benchmarks

The EU legislative institutions have reached an agreement on the Level 1 text for the EU Regulation on indices used as benchmarks in financial instruments and financial contracts. The Regulation, first proposed in 2013 in response to the LIBOR rigging scandals, is intended to place particular requirements on the administrators of any EU benchmark or any third-country benchmark used by a supervised entity in the EU. The rules, including requirements for the use of transaction data, is intended to complement the extension of market abuse rules under MAR which, once in effect next July, will introduce specific offences in relation to benchmark manipulation. The rules on the administration of benchmarks will distinguish between three categories of benchmark: (i) non-significant; (ii) significant; and (iii) critical. The most onerous rules, including mandatory contribution by supervised entities, are reserved for critical benchmarks. A reduced set of rules is also provided for benchmarks based on regulated data. The treatment of third-country benchmarks was a particularly contentious issue during the regulatory development process, however, third-country administrated benchmarks will be allowed to continue to be used in the EU through the recognition and endorsement regimes contained within the Regulation.

AIMA contact: Adam Jacobs (ajacobs@aima.org) or Oliver Robinson (orobinson@aima.org)

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CFTC Proposals for Cleared Swap Reporting

In November, AIMA and MFA submitted a joint response to the CFTC's proposed rulemaking on Amendments to Swap Data Recordkeeping and Reporting Requirements for Cleared Swaps. Among other things, the letter recommended that: (i) the CFTC should eliminate alpha swap reporting for swaps that are executed with the intention to be cleared, in order to reduce the complexity of the CFTC's swaps reporting regime; and (ii) the CFTC's amendments establish registered derivatives clearing organizations (DCOs) as the reporting party for cleared swaps transactions.

AIMA contact: Adam Jacobs (ajacobs@aima.org) or Oliver Robinson (orobinson@aima.org)

MAR implementation

The FCA has published a consultation on its policy proposals for handbook changes to implement the Markets Abuse Regulation (MAR) (CP15/35: Policy proposals and Handbook changes related to the implementation of the Market Abuse Regulation). The Consultation notes that the Treasury is currently preparing secondary legislation to repeal or modify existing UK domestic law where it conflicts with MAR, as well as to cover new MAR obligations not currently dealt with by the domestic regime. In particular, it is proposed that the Handbook will provide guidance on and signposts to MAR where appropriate, with any Handbook requirements equivalent to MAR being deleted. The Consultation also invites comments on two specific issues: (i) the step change in regulation from a Directive to a Regulation; and (ii) options for implementation provided by MAR for delaying disclosure of inside information and persons discharging managerial responsibility. The deadline for comments is 4 February 2016.

- **AIMA contact**: Adam Jacobs (ajacobs@aima.org) or Oliver Robinson (orobinson@aima.org)

FCA consultation on delayed disclosure of inside information

The FCA published its consultation CP 15/38 on Provisions to delay disclosure of inside information within the FCA's Disclosure and Transparency Rules which seeks to address recent developments following the Ian Hannam v FCA [2014] decision of the Upper Tribunal around the disclosure of inside information by issuers with securities admitted to trading on a regulated market. The FCA have decided to review the Disclosure & Transparency Rules (DTRs) on when an issuer can legitimately delay such disclosure of inside information, proposing to clarify that issuers may have a legitimate reason to delay disclosure in circumstances other than the non-exhaustive examples listed in the DTRs. It is intended that this will align the rules more closely with MAR and MAD's policy intention. The CP poses a single question: Q1: Do you agree that making the proposed change to DTR2.5.5G, without issuing further guidance relating to 'legitimate interest', supports a properly functioning disclosure regime? The deadline for comments is 20 February 2016.

- **AIMA contact**: Adam Jacobs (ajacobs@aima.org) or Oliver Robinson (orobinson@aima.org)

EU rules on Securities Financing Transactions

The EU legislative institutions have adopted the Level 1 text of the Regulation on transparency of securities financing transactions and of reuse (SFTR). The text now falls to the European Commission for publication in the Official Journal of the European Union. The SFTR will introduce a two-sided, T+1 reporting obligation to a registered trade repository applying to all EU established counterparties and EU branches of third country counterparties that enter repo/reverse repo, securities and commodities lending, buy/sell back and margin financing transactions. There are also additional rules for pre-contractual and periodic investor disclosures by fund managers and requirements for the right to and exercise of reuse of collateral by all counterparties. The SFTR also introduces amendments of the EMIR definition of an 'OTC derivative' to provide an alternative mechanism for the Commission to deem third-country trading venues equivalent to EU regulated markets. An AIMA summary is available here.

- **AIMA contact**: Adam Jacobs (ajacobs@aima.org) or Oliver Robinson (orobinson@aima.org)

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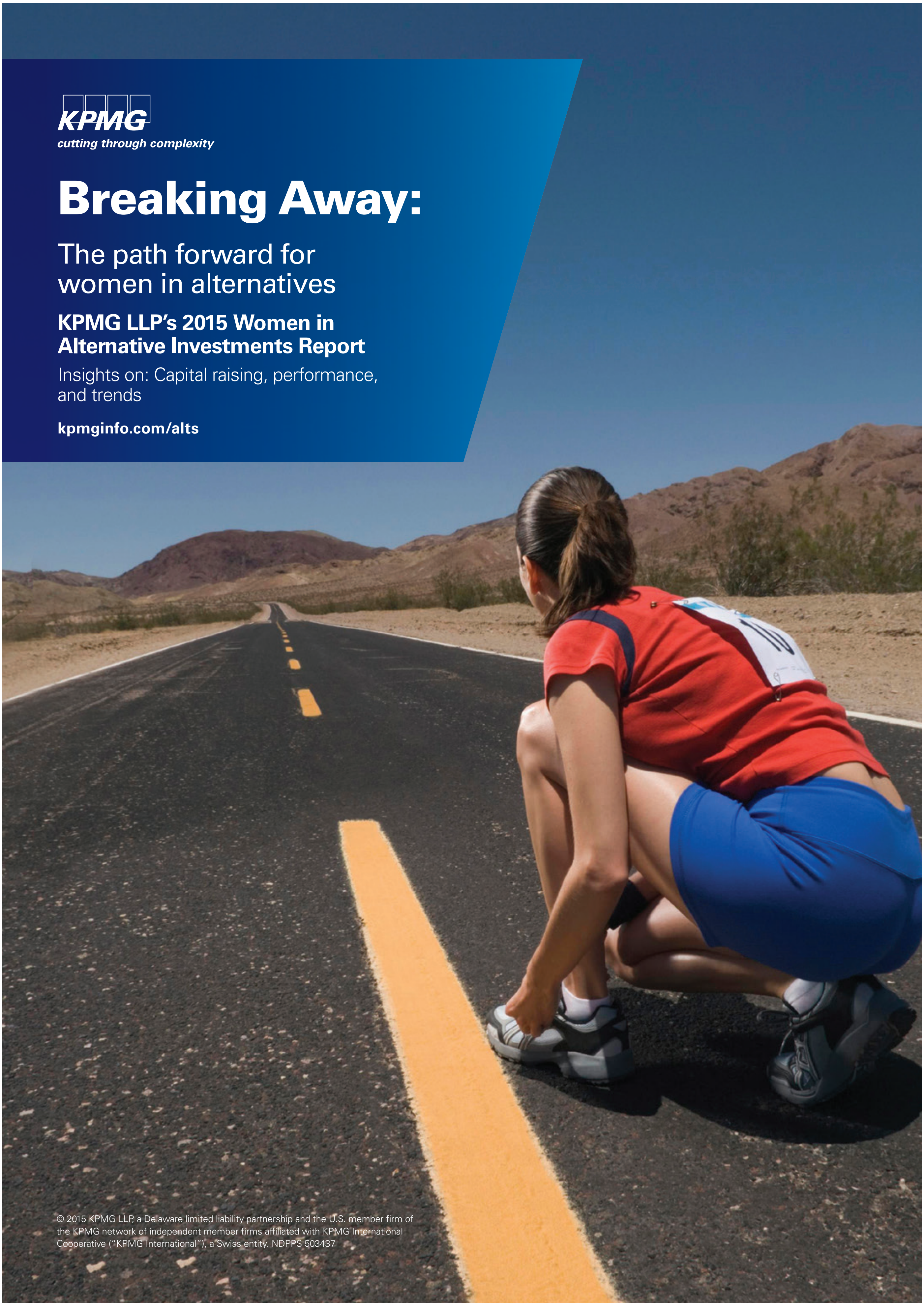

KPMG
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Breaking Away:

The path forward for women in alternatives

KPMG LLP's 2015 Women in Alternative Investments Report

Insights on: Capital raising, performance, and trends

kpmginfo.com/alts

TAX AFFAIRS

India Minimum Alternate Tax (MAT)

The MAT is imposed where a company's tax liability does not exceed a minimum percentage of its profits as computed in accordance with the Indian Companies Acts. Recently Indian tax authorities have contended that the MAT should apply to foreign companies (with or without a permanent establishment in India) which have profits derived from Indian sources. Measures included in the last Finance Bill did not address the issue clearly, and in response to the uncertainty a Committee, headed by Justice A P Shah, was set up to look into the question, particularly the position of Foreign Institutional Investors and Foreign Portfolio Investors (FIIs/FPIs). The Government accepted the Shah Committee report that the MAT was not applicable to FIIs and FPIs. Additionally, the Central Board of Direct Taxes (CBDT) published a press release confirming that the MAT does not apply to foreign companies having no place of business or permanent establishment (PE) in India. The Income-tax Act is to be amended accordingly.

- **AIMA contact**: Paul Hale (phale@aima.org) or Enrique Clemente (eclemente@aima.org)

EU - Corporate Tax Transparency/CCCTB

The EU Council has approved the Directive on automatic exchange of information on tax rulings. Key points in the compromise text are: (i) a clearer definition of advance cross-border rulings and advance pricing arrangements; (ii) a statement on appropriate use of information so that *"The provision of information should not lead to the disclosure of a commercial, industrial or professional secret or of a commercial process, or disclosure of information which would be contrary to public policy"*; (iii) retrospective application limited to rulings given within five years before the effective date of the directive (1 January 2017) and then remaining valid; (iv) exclusion of rulings involving third countries from mandatory automatic exchange where treaty provisions apply to limit disclosure; and (v) the role that the European Commission will have in analysing the information provided to tax authorities. Important implementing issues remain, and the provisions in relation to confidentiality and data protection need to be further developed. The EU Commission has published a consultation to help identify the key measures for inclusion in the relaunch of the proposal for a CCCTB, as part of the implementation of the Commission's Action Plan for Fair and Efficient Corporate Taxation which was presented in June 2015. AIMA intends to respond to the consultation as the special nature of collective investment schemes needs to be taken into consideration when designing the proposed framework.

- **AIMA contact**: Paul Hale (phale@aima.org) or Enrique Clemente (eclemente@aima.org)

Financial Transaction Tax (FTT)

FTT has not seen any significant progress in 2015. There was some discussion of the proposals for the FTT at the last ECOFIN of 2015, which was reported to have led to some political agreement, but it is not clear that a consensus will be found on the details of the FTT. The ECP Member States, now reduced to ten as Estonia has withdrawn from the group, will not meet their self-imposed deadline for application of the FTT as from January 2016, to the point that meeting a January 2017 deadline is also unlikely. The ECP Member States disagree on core aspects of the FTT and differences remain in satisfying the different needs of small and large participating jurisdictions. The UK has signalled that it would contest any FTT if it is in a form which the UK believes would damage the UK's interests.

- **AIMA contact**: Paul Hale (phale@aima.org) or Enrique Clemente (eclemente@aima.org)

Base Erosion and Profit Shifting (BEPS)

The OECD released the 2015 Base Erosion and Profit Shifting (BEPS) deliverables which form a comprehensive set of changes to the international basis of corporate taxation. The proposed framework operates as a combination of minimum standards, reinforced international principles and best practices, and includes these areas: (i) the interaction between different domestic tax rules (such as controlled foreign company regimes, hybrid mismatch arrangements); (ii) the substance of international tax provisions and model tax conventions (anti-avoidance provisions to prevent treaty abuse, changes in the definition of a

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permanent establishment, transfer pricing principles); and (iii) transparency and certainty of MNE tax liabilities (country-by-country reporting).

Action 6 – Prevent the granting of treaty benefits in inappropriate circumstances (treaty abuse)

Additional work remains to be done in various areas, in particular in the context of treaty abuse (Action 6 – final report) where the ability to access tax treaties may be restricted as the draft limitation on benefits (LOB) clause has limited protection for regulated collective investment vehicles (CIVs) and does not offer a carve out for non-CIVs such as alternative funds. Although the final report now seems to acknowledge the general principle of tax neutrality, the treatment of non-CIVs is to be developed further by the OECD. AIMA intends to continue to put the case of non-CIVs to the OECD and to respond to concerns expressed by the OECD that non-CIVs are used by investors that are not themselves entitled to treaty benefits and that investors may defer recognition of income through non-CIVs.

In a development that may be relevant to the ability of EU member states to adopt a LOB in their tax treaties rather than a more general principal purpose test, an infringement decision published on 19 November 2015 by the European Commission asked that the Netherlands amend its double tax treaty with Japan to revise the LOB clause on the grounds that this acts to restrict EU fundamental freedoms. The Commission believes that a Member State concluding a treaty with a third country cannot agree better treatment for companies held by shareholders resident in its own territory than for comparable companies held by shareholders who are resident elsewhere in the EU/EEA. The Commission's action puts in doubt whether Member States may agree to the inclusion of an LOB clause in their tax treaties and whether LOB clauses in existing treaties are valid. AIMA is seeking further information from the Commission.

Action 4 - UK HMT consultation document

HM Treasury has published a consultation on tax deductibility of interest expense for companies. This consultation follows the OECD report on Action 4, which provides recommendations for a best practice approach to the design of rules to prevent base erosion through the use of interest deductions. The OECD report recommends the combination of a fixed ratio rule (under which a company may deduct net interest expense up to a net EBITDA ratio between 10%-30%) and a group ratio rule as general principles together with other targeted provisions (such as specific rules for the banking and insurance sectors). The UK Government confirms that it wishes to address BEPS abuses involving interest expense in order to reduce unfair outcomes and imbalances in the tax system but it also wishes to ensure the UK tax system remains competitive and attracts and retains business investment in the UK. AIMA is considering whether to respond to this consultation document (the deadline for responses is 14 January 2016).

- **AIMA contact**: Paul Hale (phale@aima.org) or Enrique Clemente (eclemente@aima.org)

Automatic Exchange of Information (AEOI)

The OECD's Common Reporting Standard (CRS) will go live in few weeks. The first CRS deadline is 1 January 2016, from when financial institutions (FIs) established in participating jurisdictions must implement due diligence procedures when a new account is opened. The evolution from FATCA to the broader automatic exchange of information under CRS will be challenging, and AIMA will continue to take up members' concerns with the OECD, the EU Commission and tax authorities, while encouraging sound practices in the industry.

- **AIMA contact**: Paul Hale (phale@aima.org) or Enrique Clemente (eclemente@aima.org)

UK Summer Finance Bill

The Summer Finance Bill received the Royal Assent on 18 November 2015 (as the Finance (No. 2) Act 2015), just ahead of the Autumn Statement on 25 November 2015. Of interest to the fund management industry are various changes introduced by the Government to the carried interest and disguised investment management fees legislation in the Act (here). These changes clarify its operation, including (i) the circumstances in which an amount in respect of carried interest or disguised investment management fees arising to another person can be treated as income of the fund manager and (ii) the operation of reliefs for double taxation and allowable losses.

continued ▸

- **AIMA contact**: Paul Hale (phale@aima.org) or Enrique Clemente (eclemente@aima.org)

UK Autumn Statement

The Autumn Statement delivered on 25 November 2015 included few tax measures alongside the spending review for the next parliament. There was a brief announcement on taxation of asset managers' performance based rewards, which concerns the outcome of the consultation held by HMRC following the July Budget in which AIMA and other fund management industry bodies took part. The purpose of the consultation was to establish a clearer method of determining the nature for tax purposes of amounts received as carried interest. Draft legislation was published on 9 December 2015. The measure restricts full capital gains tax treatment in respect of managers' receipts of carried interest to funds with an average investment holding period of at least four years. Most hedge fund management businesses in the UK receive performance fees which are taxed as income, and will not be affected by the measure.

The Government will also consult on and enact measures intended to implement aspects of the BEPS project, including hybrid instruments and interest relief for corporate taxpayers.

- **AIMA contact**: Paul Hale (phale@aima.org) or Enrique Clemente (eclemente@aima.org)

FATCA

The Internal Revenue Service (IRS) and the US Treasury issued notice 2015-66 announcing their intention to extend FATCA transitional rules for gross proceeds, foreign passthru payments, limited branches and limited FFIs, and sponsored entities. The grandfathered obligation rule with respect to collateral will be modified to reduce compliance burdens. Where a partner jurisdiction has entered into a Model 1 IGA, or has committed to do so, but has not yet completed domestic legal or administrative processes to enable it to exchange information relating to 2014 by 30 September 2015, FFIs resident in the jurisdiction will be regarded as compliant if the jurisdiction commits to providing the information by 30 September 2016.

Of particular interest is the extension of the date for when withholding on gross proceeds and foreign passthru payments will begin after December 31, 2018.

US Tax

The IRS released temporary and final regulations governing withholding under section 871(m). Section 871(m) was introduced in March 2010, in response to concerns that non-US persons were able to avoid US withholding tax (WHT) on dividends through the use of equity swaps (generally a 30% WHT applies to dividends paid by a US corporation to a non-US person, subject to a rate reduction by a treaty). In response to representations received on the 2013 draft regulations, the final regulations have increased the “delta” (“ratio of the change in the fair market value of a contract to a ‘small change’ in the fair market value of the number of shares of the underlying security referenced in the contract”) threshold from 0.7 to 0.8, and provide that this would be measured only at issuance. The effect of these changes is understood to be that most convertible bonds should now fall outside of the scope of the WHT which in turn may in some instances remove a potential imposition of WHT as a result of section 305(c) deeming a dividend equivalent to arise on certain adjustments to the terms of convertible bonds. The IRS is expected to address the section 305(c) issue separately. It seems that transactions “issued” on or before 31 December 2015 are grandfathered from the Final Regulations, which would address concerns over possible WHT liabilities for prior years, and that the Final Regulations will apply to payments made on or after 1 January 2018 for transactions issued in 2016, and to payments made on or after 1 January 2017 for transactions issued after that date. The IRS and US Treasury have requested comments and have scheduled a public hearing (15 January 2016). Further clarifications of the operation of the regulations are expected.

The House of Representatives and the Senate have passed the Bipartisan Budget Act 2015. This includes revenue raising measures, but also significant changes to the Internal Revenue Service (IRS) partnership audit processes and adjustments which will be relevant to alternative investment funds and management entities which are partnerships which file US tax returns.

- **AIMA contact**: Paul Hale (phale@aima.org) or Enrique Clemente (eclemente@aima.org) alfi association of the luxembourg fund industry

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AIMA hosts UK Parliamentary reception

AIMA's Jack Inglis (left) and Henry Kenner of Arrowgrass Capital Partners (right) with Mark Garnier MP, a member of the UK Treasury Select Committee

Britain's General Election may have been six months ago, but it is often during the critical first months of a new parliament when policy ideas begin to take shape and key alliances are formed. This is why AIMA has been stepping up its engagement with policymakers in the UK in recent weeks and months. Capping this recent effort, on 25 November 2015, we hosted a reception in the Palace of Westminster, where members of both Houses of Parliament gathered alongside many of our members from the UK hedge fund sector to hear about the contribution that hedge funds are making to the UK economy.

The event, sponsored by the CME Group, featured a distinguished set of speakers comprising Chris Skidmore MP (Conservative), the Parliamentary Private Secretary to the Chancellor of the Exchequer; Iain Wright MP (Labour), the Chair of the Business, Innovation and Skills Select Committee; Michelle McGregor-Smith, the CEO of BA Pension Investment Management; and Henry Kenner, the CEO of Arrowgrass Capital Partners.Among the points that were raised during the event –

- The hedge fund sector in the UK comprises around 500 businesses and employs around 40,000 highly skilled people, who pay corporation and income taxes worth over £4 billion to the UK public purse.

- While much hedge fund activity may seem complex and esoteric, it all links back, whether directly or indirectly, to the real economy.

- Hedge funds provide liquidity in the derivatives markets that is vital for other users. Without interest rate derivatives trading by macro hedge funds, banks and other lenders would find it more difficult or risky to offer fixed-rate mortgages to their customers. Without commodity derivatives trading by hedge funds, airlines would find it more difficult to control the costs related to their fuel consumption. Without credit derivatives trading by hedge funds, banks may have to liquidate wholesale portfolios of SME loans and restrict finance to an already cash-starved sector.

- Hedge funds are increasingly lending directly to businesses, filling a void left by bank retrenchment.

- Many hedge funds are also extremely active and engaged shareholders – they drive improvements in the share price, operating performance and governance of the companies in which they invest.

Date confirmed for 'AIMA in Asia 2016' conference

AIMA in Asia 2016, our flagship full-day event for the Asia-Pacific region, will be held on 21 January 2016 at the Hong Kong Convention and Exhibition Centre. The conference will be opened by Professor KC Chan, Secretary for Financial Services and the Treasury, FSTB. It will feature sessions on the following topics:

- Regulatory and Fiscal Themes anticipated for 2016;
- Media, Communications and Reputation Management;
- Managing CSAs and Conflicts of Interest;
- Corporate Governance Reform in APAC Capital Markets;
- Conducting Investment Due Diligence in APAC Jurisdictions;
- China's Asset Management Industry: Opportunities and Internationalisation.

AIMA in Asia is proud to be part of HK's International Financial Week; and our event directly follows the 'Asian Financial Forum' (AFF) which regularly attracts more than 2,000 delegates. Our inaugural AIMA in Asia, held earlier this year, brought together nearly 300 policy and regulatory figures, hedge fund managers and other Asia-Pacific thought leaders. If you would like further details of the event, either as a potential sponsor or attendee, please contact Heide Blunt.

Forthcoming AIMA events

Hong Kong - AIMA in Asia 2016
Date: 21 January 2016
Venue: Hong Kong Convention and Exhibition Centre, 1 Expo Drive, Wanchai, Hong Kong

Hong Kong - Networking Drinks
Date: 21 January 2016
Venue: Ramas Oyster and Grill, Wanchai, Hong Kong

Canada – AIMA Canada Ontario Ski Day 2016
Date: 4 February 2016
Venue: Osler Bluff, Collingwood

Canada - AIMA Canada Quebec Ski Day 2016
Date: 15 February 2016
Venue: Bromont Ski Resort, Bromont

Australia - Capital Raising in the United States: Solicitation Advice for Australian Fund Managers
Date: 16 February 2016
Venue: Henry Davis York, 44 Martin Place, Sydney

Australia - Regulatory Update
Date: 16 February 2016
Venue: Henry Davis York, 44 Martin Place, Sydney

AIMA Global Policy and Regulatory Forum 2016
Date: 18 May 2016
Venue: Lancaster Hotel, Lancaster Terrace, London

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AIMA Global Policy & Regulatory Forum 2016

SAVE THE DATE
18 MAY 2016

VENUE
Lancaster Hotel
Lancaster Terrace
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TIME
09:00 - 17:00

Please join us for AIMA's 2016 Global Policy and Regulatory Forum, which will take place in London. Providing you with a greater understanding of the key policy themes that will impact the evolution of the industry in coming years, the event will feature senior regulators sharing personal insight, as well as a focus on key financial services legislative updates, and peer networking opportunities.

AIMA members / Regulators	Non-members 'early bird' rate	Non-members standard rate
Free	£500 + VAT (until 24th March)	£750 + VAT (after 24th March)

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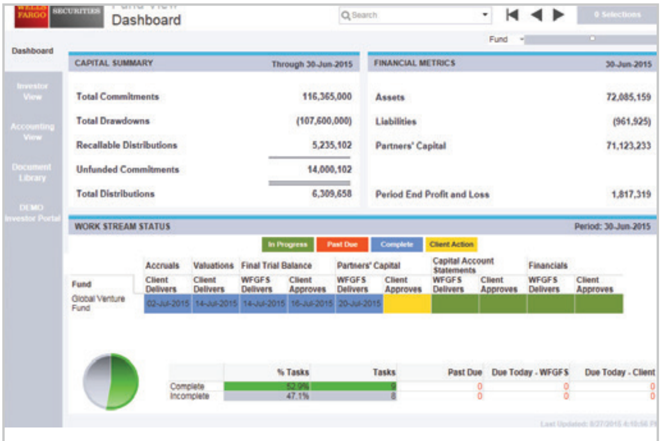

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- **Accounting View:** activities related to NAV calculation and financial statement processing
- **Investor View:** subscription/redemption and capital call/distribution, KYC/AML, and investor accounting and servicing activities

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For more information contact

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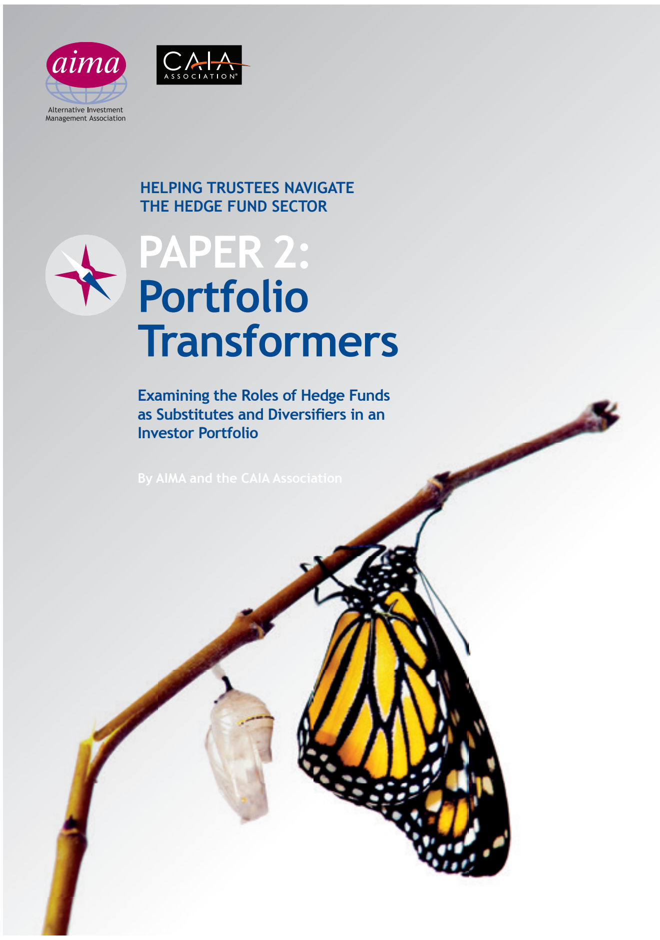
New paper for pension trustees by AIMA & CAIA Association



Hedge fund diversification and the particular benefits that hedge funds offer is highlighted in a new paper for pension trustees and other fiduciaries by AIMA and the CAIA Association that we published in November.

The paper, titled 'Portfolio Transformers: Examining the Role of Hedge Funds as Substitutes and Diversifiers in an Investor Portfolio', details the specific qualities that different types of hedge funds offer to institutional investors. The research is based on a "cluster" analysis of the risk and return characteristics of the main hedge fund investment strategies.

The paper says that some of the most experienced investors in alternative investments no longer see hedge funds as a standalone allocation but rather as substitutes for investments in equities and bonds or as investments that bring particular diversification benefits.

It is the second in a series of reports that AIMA and the CAIA Association are producing for trustees and other fiduciaries, an audience traditionally under-served by educational material about hedge funds and other alternative investments. The first paper in the series, titled 'The Way Ahead: Helping Trustees Navigate the Hedge Fund Sector', set out hedge funds' core value proposition while objectively discussing some of the challenges that investors face when considering a hedge fund allocation. For more information about the papers and our investor education efforts, contact Tom Kehoe.

News in brief

AIMA/PwC publish survey on distribution trends

Around half of hedge fund firms intend to launch a new hedge fund by the end of next year and most are reporting rising assets, according to a global survey by PwC and AIMA, released in December. The report, 'Distribution Disrupted – A Spotlight On Alternatives', assesses the impact of regulatory reforms and changed investor behaviour on hedge fund distribution models and capital-raising efforts. For our press release, click here.

AIMA survey on alignment of interest

AIMA is asking manager members to complete its Alignment of Interest survey, which seeks to highlight how hedge funds are matching their interests to those of their investors. To complete the survey on the AIMA website, click here. For more information, contact Tom Kehoe.

Ex-hedge fund general counsel Kher Sheng Lee joins AIMA

Kher Sheng Lee joined AIMA recently from Azentus Capital, where he held the position of General Counsel. He has taken up the position of AIMA's Managing Director, Global Deputy Head of Government Affairs and Head of APAC Government Affairs.

Derivatives clearing: why have clients lost the right to claim for their losses?

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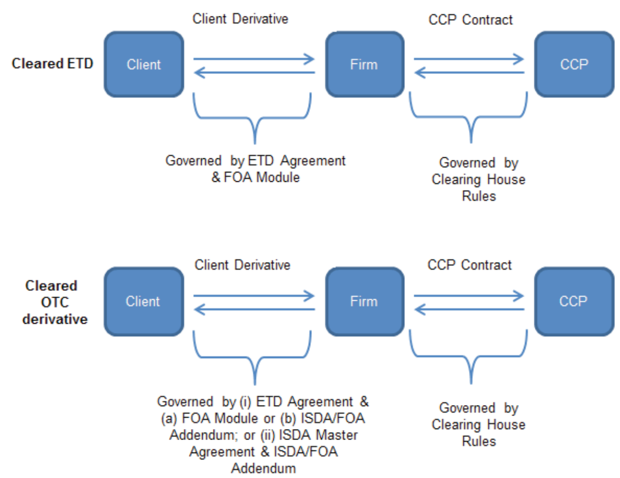
MACFARLANES

By Robert Daniell, Senior Counsel, Macfarlanes LLP

The standard documents in use for OTC and exchange-traded derivatives central clearing in Europe oblige clients to surrender their standard contractual right to claim for compensation should their clearing member default. If following a clearing member default a client's derivatives are terminated by the central counterparty clearing house (CCP), then instead of being able to claim for the cost of being put in the position that the client would have been in had the clearing member not defaulted, the client is obliged to accept a CCP valuation that does not take the client's circumstances into account. This creates a significant risk of unrecoverable losses for clients, a result that is not needed for the proper functioning of the derivatives market, and which may add to the inevitable market stress should a major derivatives clearing member default. This situation should be remedied by restoring within the industry standard documents the client's right to claim for its full losses.

Background

In response to the requirements imposed by the European Market Infrastructure Regulation[1] (EMIR) with regard to the trading and clearing of derivatives, Europe-based clearing members and their derivatives clients are re-documenting their relationships. In this they have been assisted by two industry standard English law documents published in 2013, the FOA Clearing Module[2] (the "Module") published by FIA Europe (published under FIA Europe's prior name, the Futures and Options Association), which deals with clearing exchange-traded derivatives (ETDs) and OTC derivatives; and the ISDA/FOA Client Cleared OTC Derivatives Addendum[3] (the "Addendum") as jointly published by the International Swaps and Derivatives Association and FIA Europe, which covers clearing of OTC derivatives, but not ETDs. The clearing documents were published after a lengthy drafting process involving market participants.



The clearing documents cover the relationship between the clearing member and its client under "principal to principal" clearing relationships where the clearing member acts as an intermediary between two derivatives: a cleared derivative (the "CCP Contract") with a CCP; and a second, economically equivalent, derivative with the clearing member's client (the "Client Derivative"). The clearing documents are supplementary to the existing agreements used for ETD and OTC derivatives. The relationship is shown in the diagram below:

Central clearing of standardised derivatives was a commitment contained in the 2009 G-20 Leaders Statement at the Pittsburgh Summit, with the objective of reducing systemic risk in derivatives markets.

1 Regulation (EU) 648/2012

2 The Module is available for subscribers to FIA Europe Documentation Library on www.foa.co.uk, and FIA Europe has confirmed to Macfarlanes that the Module is typically made available to non-subscribers on direct application to the Legal Documentation team at FIA Europe.

3 The Client Cleared OTC Derivatives Addendum is available on http://www.isda.org/publications/isda-clearedswap.aspx .

continued ▸

Central clearing of derivatives creates a number of benefits, notably the possibility that, if a clearing member defaults, its clients can potentially transfer the cleared derivatives and associated collateral held at a CCP to an undefaulted clearing member (a process known as "porting"). If a major financial institution defaults and porting is successful, the significant credit losses that its derivative clients could otherwise incur on termination of derivatives may be avoided. This note focuses only on the consequences if porting fails, which would lead to the CCP having to terminate the derivatives associated with the defaulted clearing member's clients. If this occurs, the clearing documents needlessly create a risk of unrecoverable loss for clients.

The problem caused by clients not having the right to claim for their full losses

The clearing documents provide that if a clearing member defaults and its clients' cleared derivatives are terminated rather than porting to a new clearing member, when determining the amount that must be paid between the clearing member and a client for the terminated Client Derivative, the same value must be used as that which the CCP imposes on the clearing member for the CCP Contract[4]. This use of the CCP valuation creates a risk of significant unrecoverable losses for clients if the porting process doesn't succeed.

To give an example of how the concern arises (using Lehman Brothers to stand in for the client's counterparty):

- Suppose a client enters into a single derivative with Lehman Brothers under a standard ISDA master agreement, and the derivative is not centrally cleared. The derivative is acting as a hedge for the client. Lehman Brothers defaults at a time when the derivative has a mark-to-market value close to zero. The derivative terminates. The client replicates the derivative with another dealer as it needs to replace the hedge. The other dealer charges $10 to replicate the derivative. The client is out of pocket $10. The client claims $10 from the Lehman Brothers insolvency using the normal ISDA master agreement closeout mechanism.
- Now suppose that the derivative with Lehman Brothers is cleared through a CCP with Lehman Brothers as clearing member, and Lehman Brothers and its client are using the new clearing documents[5]. Lehman Brothers defaults and the derivative is terminated rather than porting to a new clearing member. As before, the client replicates the derivative with another dealer, and pays the dealer $10 to do so. Separately, the CCP runs an auction among undefaulted clearing members to enter into a derivative with the CCP to replace the terminated CCP Contract equivalent to the Client Derivative[6]. The winning auction bidder requires $25 to enter into the replacement derivative with the CCP, which the CCP must pay. Under the clearing house rules the insolvent Lehman Brothers must pay the CCP $25 for the terminated CCP Contract. Under the clearing documents' terms, the client must now pay Lehman Brothers $25 for the terminated Client Derivative. The client is now out of pocket $35, with no opportunity to recover from the insolvency estate.

The odd result of using the new clearing documents' terms for valuing terminated cleared derivatives is that Lehman Brothers is effectively insulated from the losses that its own default causes. Lehman Brothers has escaped liability for the $10 of losses it caused the client, and can pass on to the client the $25 loss that Lehman Brothers' default caused the CCP. Not only is this result not required by EMIR, it appears to run counter to the G-20 objective of reducing systemic

4 The relevant clauses that provide for the use of the CCP termination levels are clause 5.2.2(c) of the Module, and clause 8(b)(ii)(2) of the Addendum.

5 Lehman Brothers may be party to a number of derivatives with a client that were originally agreed by the client with a third party executing broker, but then cleared by Lehman Brothers such that the client no longer faces the executing broker. This is a common feature of central clearing with CCPs, but also occurs with derivatives that are not centrally cleared - particularly where the party in the position of Lehman Brothers is acting as prime broker, interposing itself as intermediary between the client and the executing broker, and acting as principal counterparty to both. The principles described in this article apply equally whether the executing broker for the derivative was a third party or the party in the position of Lehman Brothers in the examples above.

6 A default auction among undefaulted clearing members is a common means of dealing with the CCP's exposures under the CCP Contracts of a defaulted clearing member. For example, a default auction is provided for in Chapter 11 of Eurex Clearing AG's Procedures Manual, and in LCH Clearnet Limited's Default Rules.

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risk in derivatives markets. It is contrary to normal contractual principles for claims for breach of contract and to the ordinary measure of creditor claims under bankruptcy law.

Answering the arguments put forward that clients should not have the right to recover losses

Various reasons have been put forward for the valuation approach adopted in the clearing documents. Considering them in an article may appear like attacking straw men, but it is better to address them here rather than leave arguments that are commonly put forward unanswered.

A number of dealers and other commentators argue that a firm clearing derivatives needs greater protections than a party to a bilateral derivative, as a clearing member acts as a service provider intermediary in facilitating access to the CCP. As a service provider they draw an analogy to a broker acting as a “riskless principal” in securities markets, where the intermediary broker acts as principal to trades with a buyer and a seller, and the market price is the same on both principal trades. However, it is not the case that a riskless principal in securities markets is insulated from losses in the way that the clearing documents provide. If an executing broker that was acting as a riskless principal in the OTC securities market were to default in the period between trade date and settlement date of the securities, it would face a claim from the intended buyer of those securities for the difference between settlement price and the price at which the buyer could buy elsewhere; and at the same time the broker would face a claim from the intended seller for the difference between settlement price and the price at which the seller could sell elsewhere. When trading OTC securities, there is no equivalent of the clearing documents’ requirement that a defaulting clearing member face the same price on both sides of the cleared derivative.

Some dealers have voiced a concern that being liable for a client’s losses acts as an undue disincentive to act as a clearing member. This concern is unjustified, as a service provider should not be incentivised to provide a service by a clause that on insolvency effectively provides for a transfer of wealth from its derivatives clients to its insolvency estate (the $25 payment in the example above), to subsequently be transferred from the insolvency estate to the service provider’s other creditors - and conversely a service provider should not be discouraged from offering a service if its insolvency estate remains liable for the consequences of the service provider’s fundamental breach of contract. Using the CCP’s valuation on default of a clearing member subtracts value from the relationship between a clearing member and its clients, as it creates risks of unrecoverable loss for clients with no corresponding benefit to the clearing member.

For ETDs, if the clearing documents are not used, the typical master agreement used by clearing members gives clients no express rights should the clearing member default. Some dealers have argued that there is no reason for clients to object to the valuation term in the clearing documents, since it is no worse than under those existing ETD agreements. One imperfect agreement should not be a justification to agree to another, but more importantly the argument put forward by those dealers is incorrect. Given the silence in the typical ETD agreement as to what occurs should a clearing member default, normal English law principles apply in determining the rights of the client. A clearing member’s default and non-performance of its obligations would amount to a repudiatory breach of contract. The general rule under common law is that the measure of loss that a party can claim for breach of contract is the value that the contract would have had to that party had the breaching party performed, which can include the cost of entering into new transactions to replicate the terminated contract. In the circumstances of a clearing member default leading to client derivatives being terminated where the ETD agreement is silent on the treatment of the client claim, it would be open to the client to claim for the replacement cost of the derivatives as a measure of the cost to the client of putting itself in the same position as if the clearing member had performed.

Eurex Clearing AG, a major CCP, does require that clients which elect to use Eurex’s Individual Clearing Model for an individual segregated account must use the Eurex termination values if derivatives fail to port on a clearing member default[7]. However, this is a rule that only applies to this account type at Eurex. The clearing documents apply this approach of using CCP termination values to all other account types at all CCPs, without the rules of the CCPs requiring this.
The clearing documents’ use of the CCP termination

7 Imposed by the Clearing Conditions of Eurex in Chapter I, Part 3, Subpart C, Number 2.1.2(7).

continued ▶

levels may have been due to the reasonable concern that a clearing member cannot be seen to guarantee a CCP by giving a greater return to clients than the clearing member gets from the CCP, as this could lead to the CCP Contracts ceasing to be zero-risk weighted for regulatory capital under Article 306 of the EU Capital Requirements Regulation (CRR)[8]. However, Article 306 concerns losses caused by a CCP default, and not a clearing member agreeing to pay a client's losses caused by the clearing member's default.

Potential for systemic harm

More broadly, the obligation on a client to make an excessive payment to the insolvent clearing member has a needless negative impact on the financial system. In the example above, the $25 that the client has to pay the insolvent Lehman Brothers is cash that will not reappear until the bankruptcy estate makes a distribution in years to come. A major clearing member default would likely see the financial system in crisis, and in those circumstances the further loss of liquidity caused by excessive payments to the insolvency estate risks adding to the stress.

The potential for loss for clients between the price at which clearing members accept the risk of replacing terminated CCP Contracts through the CCP default auction process and the price at which a client is able to re-hedge the terminated Client Derivative should not be understated. The notional size of Lehman Brothers' derivatives book has been estimated as being approximately $35 trillion at the time of default[9]. A CCP that needs undefaulted clearing members to take the market risk of a significant percentage of a large defaulted clearing member's cleared derivatives in a time of system-wide distress would likely receive poor offers for replacement derivatives. Similarly a client seeking to re-establish a derivatives hedge immediately following its clearing member defaulting would face poor offers from dealers.

Conclusion

There are strong arguments in favour of restoring a client's normal contractual position of having the right to claim for its losses under the industry clearing documents. Restoring these rights would not involve clearing members suffering harm. Further, restoring these rights would be an improvement to the functioning of the financial system in the testing times of a clearing member default. FIA Europe and ISDA should engage market participants in a review of the clearing documents in this regard, one that would most appropriately lead to a restoration of the normal contractual right to claim for losses. In the interim, users of the clearing documents should seek to incorporate the client's contractual right to claim for losses on a negotiated bilateral basis.

robert.daniell@macfarlanes.com
www.macfarlanes.com

8 Regulation (EU) No 575/2013. Article 306.1(c) of CRR provides that "where an institution is acting as a financial intermediary between a client and a CCP and the terms of the CCP-related transaction stipulate that the institution is not obligated to reimburse the client for any losses suffered due to changes in the value of that transaction in the event that the CCP defaults, the exposure value of the transaction with the CCP that corresponds to that CCP-related transaction is equal to zero. "

9 Kimberley Summe, Misconceptions about Lehman Brothers' Bankruptcy and the Role Derivatives Played, 64 Stanford Law Review Online 16 (28 November 2011).

Gearing up for MiFID II

AIMA SPONSORING PARTNER

Bloomberg

By Harald Collet, Global Business Manager, Bloomberg Vault

The clock is now ticking for Europe's investment managers to get their operational systems in place in order to be compliant with new regulations including the Market Abuse Directive and Regulation (MAD/MAR) and the Markets in Financial Instruments Directive II (MiFID II). While the implementation deadline of MiFID II may get pushed back from the initial January 2017 date, MAD/MAR becomes applicable in July 2016 and firms also have to implement record-keeping and market abuse prevention programmes under Dodd-Frank and global market conduct mandates.

Record-keeping of communications, voice recording and trade reconstruction are among the fundamental objectives of these regulations, and in particular of MiFID II. They will change the way an investment manager works, making them more accountable than ever before. While my experience has been that many companies in Europe have been faster to begin formulating strategic solutions to the various reporting obligations than firms in the US, much remains to be done as the record-keeping rules up to this point haven't been as prescriptive in Europe as in the US.

In a recent survey which was conducted at a Bloomberg event, only 7% of attendees said their firm was ready to meet the record-keeping requirements. Nearly 50% of respondents said that their firms are only now in the process of formulating a plan and would not be ready to implement by January 2017, a deadline which might now be pushed back. Records, including voice recordings of telephone conversations, will now have to be immediately available, stored in an accessible and searchable way and organised by both transaction and counterparty. Now it will be a question of whether you can retrieve the data in the way examinations require, rather than just of how it is stored.

Fund management firms will need to keep records of any conversation – email, chats, voice, documents and files - that relate to or are intended to result in a transaction, regardless of whether that transaction is made. Most record-keeping efforts currently underway only apply to trader calls.

One way to think of it - consider record-keeping as the underlying fabric tying businesses together. Besides trade reporting obligations, you can also use the system for market abuse monitoring and prevention by identifying behaviours and communication patterns. Managers will have to have a system for MAR in place that shows they are performing effective monitoring. For the industry overall, there should be an expectation you can report on exceptions and you have a documented process in place for such cases. The pre-trade workflow is the hardest to recreate and will require logging a deluge of communications, documents and meeting notes leading up to the trade.

Fund managers will also need to be efficient as they undertake record-keeping surrounding the best execution requirements. Investigating and documenting your best execution process will demand a new process be put in place.

The information that will need to be given to the investment client is increasing considerably. Managers have to provide clients with the top five execution venues per asset class and a summary of the analysis and conclusions of the monitoring that was undertaken and execution achieved. As such, fund managers need to think about how they are going to resource all the technological aspects for meeting these requirements – which parts can be done in-house and which can be outsourced? While the obligations seem overwhelming, it is important to recognise that the compliance analytics that will be generated can be used to gain business insights on trading performance, client coverage and sentiment analysis, for example. Some managers look at the best execution requirements from a transaction cost analytics perspective to evaluate the particular performances of their traders, for example. From a trader's point of view, the vast quantity of information available pre-trade will enable them to make better decisions.

There are also efficiencies to be gained from having a combined reporting solution not only for MiFID II and MAR, but also for the European Market Infrastructure Regulation and Securities Financing Transactions Regulation, when that comes into force.

hcollet@bloomberg.net
www.bloomberg.com

MiFID II fallout: unbundling the research payments dilemma for fund managers

By Jack Pollina, Managing Director, Head of Global Commission Management and Hedge Fund Business Development, ITG

In September 2015, the European Securities and Markets Authority (ESMA) finally announced its long-awaited capital market reforms. With 1,500 pages to wade through and 28 new rules to digest, it's fair to say that fund managers have plenty on their plates. While many will be thankful for the level of granular detail regarding who needs to report on what to whom and when, the question of exactly how research will be paid for still remains.

It's a question that's likely to hang in the air for a while yet. Although expected in November, the latest chapter in the lengthening story is that the delegated acts probably won't appear from ESMA until at least February 2016 and perhaps even March, with rumours that the European Commission may send some of the rules back to the regulator.

Until then, much uncertainty surrounds how exactly fund managers go about paying for research. But one thing we know for sure is that investment managers must set their research budgets in advance either through Commission Sharing Arrangements (CSAs) or – in the event that the EC decides that managers have to pay for research separately – via a Research Payment Account (RPA).

There is currently a lack of clarity stemming from national regulators' differing interpretations of ESMA's take on CSAs, which enable fund managers to access research and execution from separate providers while paying for both through dealing commissions. Back in February, the UK's FCA argued that CSAs are linked to transacted volumes and therefore not allowed, as ESMA states that research costs should not be linked to the volume or value of execution services. Yet, other European regulators have argued CSAs will still be valid, and at the moment it looks as though the French are making headway with their push to convince the Commission to allow portfolio managers to keep using them. In any case, fund managers cannot afford to wait for the final results: there are fundamental questions that need addressing today.

The most pressing of these is exactly how fund managers will be affected. Regardless of whether CSAs survive, fund size is an important factor. If the cost of research goes up, smaller investment managers may be disadvantaged given the relative impact any increased expense would have on a small firm. Then there is the administrative burden of setting a research budget – deciding how much money to set aside will be challenging. However, larger players may find it easier as their budgets likely have more capacity to absorb any extra research costs.

As if this wasn't enough to think about, MiFID II now encompasses all asset classes, so confusion also remains over how firms should allocate research payments. For example, can an investment manager who consumes research for currency and bonds share the cost with an equity-focused colleague? If so, how should they allocate the cost? Additionally, fund managers will have to contend with extra expenses if research is unbundled as VAT costs will be piled on top.

One might think that once research has been allocated and costs factored in, fund managers would be all set, but there are other points to consider. Since trading desks will gain greater discretion over which execution brokers to trade through, the quality of algorithmic and electronic trading will become even more important.

It may take time for these changes to filter through, but time is still very much of the essence for fund managers. Both ESMA and the Commission have made a case for delaying the January 2017 implementation date, but for now it remains hardcoded in the regulatory texts, and we don't yet know whether any delay will be wholesale or take a phased-in approach. The challenge for trading desks is to reevaluate the tools available to them now to ensure they achieve best execution.

So what immediate steps should fund managers take to prepare for this new and highly complex environment? Well, unbundling broker relationships to gain transparency and differentiate between execution

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and research is a good place to start. CSAs can certainly help with this. CSAs are designed to get the best research and execution from separate providers, without incurring additional costs or administration. Fund managers can also compare past research budgets with future expectations, as well as assess whether portfolio managers are consuming all the research they currently receive. We also believe that tools that allow fund level reporting will become increasingly important.

It would be unwise for fund managers to break from CSAs now, as we await the European Commission's final decision. As far as long term strategy, much will depend on whether the rules are implemented as a regulation or directive. If a regulation, they must be implemented uniformly across Europe, while a directive provides more flexibility to local policymakers and regulators in how they interpret and apply the rules. Regardless of the outcome, fund managers who are already tackling the key questions will be best positioned to demonstrate full transparency to clients.

jack.pollina@itg.com
www.itg.com

Would you like to write for the AIMA Journal in 2016?

The next edition of the *AIMA Journal*, the global forum for the alternative investment management industry, will be released at the end of March.

If you are an AIMA member and would like to contribute to this edition, please contact Dominic Tonner by the end of January at dtonner@aima.org.

Only AIMA members may write for the AIMA Journal. If your firm is not currently a member and you would like to learn more about the benefits of joining, please contact Fiona Treble at ftreble@aima.org.

AIFMD passport and Cayman Islands funds

AIMA SPONSORING PARTNER

MAPLES

By Harjit Kaur, Partner, Maples and Calder

The announcement by the Chair of the European Securities and Markets Authority (ESMA), Steven Maijoor, in October 2015[1] that the Cayman Islands would be included in the second wave of jurisdictions to be assessed for the AIFMD passport is welcome news for managers of alternative investment funds, given the prevalence of the Cayman Islands as a jurisdiction for offshore hedge funds.

Third country passport – current state of play

In July 2015, ESMA issued an opinion and advice ("July Opinion") to the European Parliament, Council and Commission (EC) on the application of the AIFMD passport and whether it should be extended to non-EU jurisdictions.

As ESMA has taken a "country-by country" approach, the July Opinion included an assessment of six jurisdictions, with a positive recommendation to two of those (with a third subject to certain conditions). ESMA deferred its decision in respect of the other three jurisdictions assessed, being Hong Kong, Singapore and the US.

In its July Opinion, ESMA also recommended the deferral of the extension of the AIFMD passport to non-EU jurisdictions until a larger number of jurisdictions had been assessed by it. The EC appears to have indicated its agreement with this approach[2] and ESMA's opinion and advice on the second wave of jurisdictions ("Second Opinion") is expected in the first half of 2016. The Second Opinion is also expected to include ESMA's definitive conclusion on whether the AIFMD passport should be extended to Hong Kong, Singapore and the US.

Cayman Islands well placed for extension

The Cayman Islands is well placed to receive a favourable assessment from ESMA as part of the Second Opinion. Cayman Islands funds already satisfy the minimum requirements prescribed by the AIFMD in order to be marketed to the EU member states under the passport: the Cayman Islands has an extensive network of tax information exchange agreements in place with the various EU member states, and the Cayman Islands regulator, the Cayman Islands Monetary Authority, is a party to the requisite cooperation agreements with its counterparts in almost all of the EU member states.

Another element of ESMA's assessment of each non-EU jurisdiction is a review of its regulatory regime. The Cayman Islands has been developing an AIFMD compliant opt-in regime which will enable Cayman funds and managers to take full advantage of the AIFMD once the passport is extended to the Cayman Islands. In August, the necessary amendment laws required to implement the new opt-in regime were passed, and the relevant supporting regulations which will set out the detail (but which are expected to mirror the requirements of the AIFMD) are expected imminently. This, together with the fact that the Cayman Islands affords reciprocity of access for EU funds and managers to investors in the Cayman Islands, makes it very likely that it will receive a positive recommendation from ESMA.

The status quo and position with respect to NPPRs

Pending ESMA's assessment of a larger number of jurisdictions and the EC's subsequent decision on whether to extend the AIFMD passport to non-EU jurisdictions, the status quo remains. That is, Cayman funds, like all non-EU funds, may continue to be marketed into EU member states under the existing national private placement regimes (NPPRs).

Should the AIFMD passport be extended to non-EU jurisdictions, both the passport and the NPPRs are expected to function in parallel for at least three years, following which there would be another assessment by ESMA and the EC as to whether the NPPRs should cease to exist. Representatives of both ESMA and the

1 At the Economic and Monetary Affairs Committee ("ECON") session held on 13 October 2015.

2 At the ECON session held on 13 October 2015.

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EC[3] have indicated that the extension of the AIFMD passport to non-EU jurisdictions will not result in the automatic withdrawal of the NPPRs at the end of the three-year period, particularly in view of the fact that the assessment in respect of the AIFMD passport extension is being undertaken on a country-by-country basis. Managers content to market their Cayman funds into the EU under the existing NPPRs are expected to be able, therefore, to continue doing so for at least the next few years.

Practical considerations for managers of Cayman funds

Prior to passport extension

As ESMA's Second Opinion is not expected until mid-2016, and given that a decision on the third country passport will only be made after ESMA has assessed a larger number of jurisdictions, it is likely to be some time before the passport becomes available to non-EU jurisdictions. In the intervening period, managers of Cayman funds can continue to market their funds into the EU under the NPPRs.

Managers who wish to avail of the passport during this period will need to be based in the EU and would need to establish an EU fund (since only EU managers of EU funds are currently able to apply for a passport under the AIFMD). Becoming authorised as an alternative investment fund manager (AIFM) poses certain challenges, particularly for managers that are not already based in the EU, such as US managers. In particular, such managers would first need to establish a presence in a member state of the EU and deal with the challenges involved, including identifying office space and recruiting staff with the requisite skills. Becoming authorised as an AIFM also means that such managers would need to comply with all of the requirements of the AIFMD, which poses a significant compliance burden. In these situations, utilising the services of a third party service provider providing AIFM solutions (sometimes referred to as the "host AIFM") can be an attractive proposition.

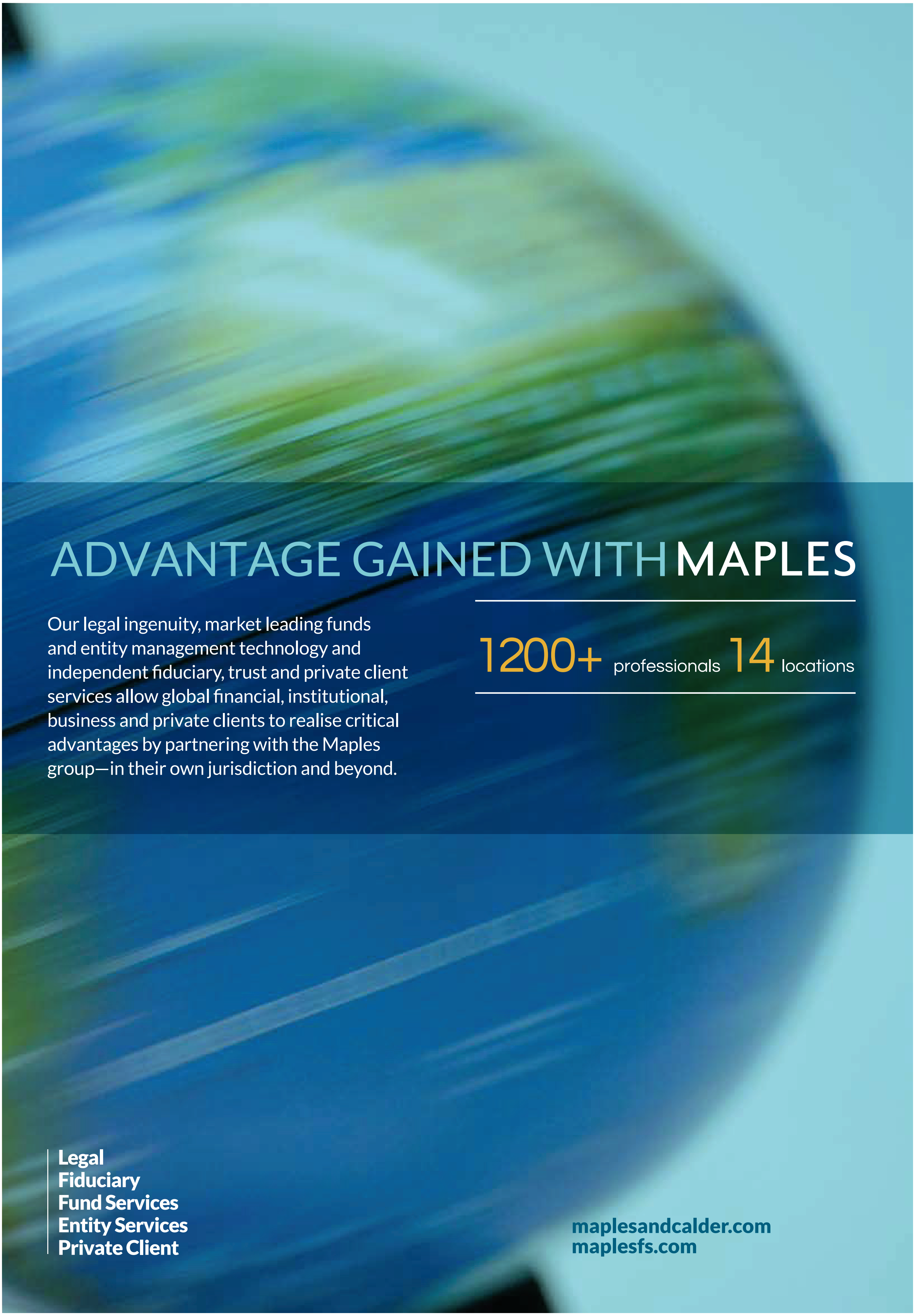
Following passport extension

Once the AIFMD passport is extended to non-EU jurisdictions, existing EU managers that are already authorised as AIFMs will have the option to market their Cayman funds into the EU using the passport, although such managers would need to comply with all of the requirements of the AIFMD. In practice, this should be fairly straightforward and should only require compliance with the additional requirement to appoint a depositary in respect of such Cayman funds. This is because EU managers are currently required to comply with all of the requirements of the AIFMD other than the requirement to appointment a depositary in accordance with Article 21 of the AIFMD (provided one or more entities are appointed to perform the "depositary-lite" functions set out in Article 21(7)-21(9) of the AIFMD) in order to market Cayman funds into the EU under the NPPRs.

In respect of non-EU managers, provided the passport is also extended to the jurisdiction in which the manager is based, then such managers would also have the option to apply for a passport in respect of their Cayman funds. However, such managers would need to become authorised as an AIFM in their "member state of reference" (determined in accordance with the AIFMD), which can pose a significant regulatory and compliance burden. Non-EU managers based in jurisdictions to which the passport is not extended are unlikely to be able to apply for a passport. In both of these cases, utilising the services of a third party "host AIFM" may provide a neat solution.

harjit.kaur@maplesandcalder.com
www.maplesandcalder.com

3 At the ECON session held on 13 October 2015.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Implications of FinCEN's proposed rule implementing AML program and suspicious activity reporting requirements for non-US investment advisers

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CLIFFORD CHANCE

By Megan Gordon, Partner, Clifford Chance; Steven Gatti, Partner, Clifford Chance; and David Adams, Associate, Clifford Chance

On 25 August 2015, the Financial Crimes Enforcement Network (FinCEN) issued a notice of proposed rulemaking (the "Proposed Rule") which would require investment advisers that are registered (or required to be registered) with the US Securities and Exchange Commission (SEC) (hereinafter, RIAs) to establish an anti-money laundering (AML) program and file suspicious activity reports (SARs) in response to certain indications of illegal activity observed by the adviser.

The Proposed Rule would also bring RIAs within the definition of a 'financial institution' under the Bank Secrecy Act. This would require RIAs to, among other things, file Currency Transaction Reports (CTRs) for transactions over certain monetary thresholds, and maintain records regarding the transmittal of funds. FinCEN intends to delegate examination authority for compliance with the Proposed Rule to the SEC.

History of the Proposed Rule

FinCEN first proposed applying AML and related requirements to registered and unregistered investment advisers in 2002 and 2003. Heavy opposition resulted in neither proposal being finalised. FinCEN withdrew both proposals in October 2008, noting, among other things, that it needed to take a 'fresh look' at the proposals given the passage of time. FinCEN also stated in the withdrawal notice that most transactions related to an adviser's business flowed through financial institutions that already were required to comply with the AML, SAR, and CTR requirements.

Implications of the Proposed Rule for Non-US Investment Advisers

Under the Proposed Rule, AML, SAR, and CTR requirements would directly apply to most RIAs. The following types of investment advisers would be explicitly covered: (i) dually-registered investment advisers and advisers that are affiliated with or subsidiaries of entities already required to establish AML programs; (ii) investment advisers to registered investment companies; (iii) financial planners;(iv) pension consultants; (v) entities that provide only securities and/or research reports; and (vi) certain advisers to public or private real estate funds.

The AML, SAR, and CTR requirements would also apply to certain foreign RIAs. The broad scope of the Proposed Rule may create numerous regulatory issues for non-US advisers in other jurisdictions. For example:

- Non-US RIAs who are subject to AML, SAR, CTR, or similar requirements in non-US jurisdictions would have to comply with the US requirements too[1]. Such advisers will have to analyse their existing compliance programs, identify and address any gaps between their existing protocols and the Proposed Rule's requirements, and determine how to deal with any US requirements that directly conflict with the requirements in other jurisdictions.

- Non-US advisers would have to collect sufficient information from clients and prospective clients to conduct US-compliant AML reviews. This may require primary advisers and even sub-advisers to US- and non-US private funds to perform AML assessments of each investor in the funds they advise. Client information would have to be stored in the non-US adviser's books and records and be

1 The implications of such an environment will become particularly difficult if FinCEN decides to impose arduous customer identification program (CIP) requirements on non-US advisers similar to the CIP programs required of other US financial institutions. The Proposed Rule does not impose a CIP program requirement on RIAs, but FinCEN explicitly reserves the right to do so in the future.

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provided to FinCEN and the SEC upon request. This may create privacy or other local regulatory issues for non-US advisers in local jurisdictions.

- Non-US RIAs would have an affirmative obligation to report suspicious transactions: (i) that are conducted or attempted by, at, or through the adviser and involve or aggregate at least $5,000 in funds or other assets; and (ii) that the adviser knows, suspects, or has reason to suspect, involve the use of the investment adviser to facilitate criminal activity. SARs must provide detailed information about suspicious activity, which may include: (i) the full name, address, government identification number, and IP address of suspected perpetrators; (ii) the identities of victims; (iii) the type of business involved and any business address; (iv) the relationship of the suspect to the institution; and (v) a detailed description of the suspicious activity that prompted a filing. SARs must also be filed for a wide range of incidents including fraud, terrorist financing, money laundering, account takeovers, embezzlement, identity theft, excessive insurance, market manipulation, and insider trading. Thus, the SAR requirements are likely to raise privacy and other confidentiality concerns for non-US RIAs, their clients, and their investors.

The Proposed Rule's AML, SAR, and CTR requirements would not apply to non-US advisers that are exempt from SEC registration, including non-US advisers that qualify as 'Exempt Reporting Advisers' or 'ERAs'. ERAs include private fund advisers with a principal office and place of business outside the United States that manage less than US$150 million in assets from a place of business within the United States. The decision to exclude ERAs from the Proposed Rule will lessen its impact on many non-US advisers. That said, FinCEN reserves the right to extend AML, SAR, and CTR requirements to ERAs in the final rule or at a later date. Non-US ERAs should closely monitor the Proposed Rule's development - particularly if they are located near, or do business with clients in, jurisdictions deemed high risk by US authorities.

megan.gordon@cliffordchance.com
steven.gatti@cliffordchance.com
davidg.adams@cliffordchance.com
www.cliffordchance.com

Investment manager performance linked rewards: draft legislation

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Simmons & Simmons

By Martin Shah, Partner, Tax, Simmons & Simmons

The UK Government has released draft legislation to implement the Summer 2015 Budget proposals to restrict the capital gains tax treatment of carried interest and other performance linked rewards received by fund managers.

Following on from the surprise consultation released in July 2015 as part of the Summer Budget, a consultation response document and draft legislation released on 9 December 2015 as part of the draft Finance Bill 2016 confirms that new rules will considerably widen the imposition of income tax on performance linked rewards received by investment managers.

HMRC has been open in confirming the intention that any return received by an investment manager which is calculated by reference to the performance of the underlying investments over a given period, or the life, of the fund should as a starting point be taxed as income, however it is structured. It is no surprise, therefore, that the legislation in the draft Finance Bill clauses makes it clear that the exceptions to income tax treatment will apply very narrowly and only where a fund has a long term investment profile, excluding a significant number of funds, even where they are currently "investing" rather than "trading" for tax purposes.

Investment managers affected by the provisions, which will come into force from 6 April 2016, should carefully consider whether any changes to their structures are advisable as a result of these changes.

Background

Not content with the recent changes to the taxation of salaried members, mixed membership partnerships, disguised investment management fees (DIMF) and carried interest, the Summer Budget saw the release by HMRC of a consultation on the taxation of performance linked rewards.

The consultation arose from concerns on the part of HMRC that investment managers outside the private equity and venture capital spheres were widely using carried interest and other arrangements to derive performance linked rewards as a return from the fund. Provided that the underlying fund vehicle is investing rather than trading for tax purposes, the performance linked interest in these circumstances would give rise to capital receipts charged to capital gains tax rather than income tax, reducing the amount of tax paid. In addition, amounts could be received as lower taxed dividend income, or potentially in untaxed form. A particular concern noted in the consultation was where such arrangements replaced performance fees that were previously taxed as trading income.

The consultation proposed a specific tax regime for performance linked rewards payable to individuals performing investment management services (using the wide definition in the DIMF rules). The measures would only apply to those individuals, and would not affect the treatment of the fund or its investors, or indeed "genuine" co-investment by the individuals. The default position under such a regime would be that rewards would be charged to tax as income.

However, the consultation contained two proposals that sought to maintain the current capital gains treatment for "private equity carried interest". The first proposal was for a "white list" of activities that would be regarded as long-term investment activities. The second proposal instead focused on the average length of time for which a fund holds investments, with the proportion of the performance linked reward that would be taxed as a capital gain increasing in a series of 25% steps from 0% where the average holding period is less than six months to 100% where the period exceeds two years.

Draft legislation

Draft legislation, together with a consultation response document, has now been released to implement the new tax regime for performance linked rewards as part of the draft Finance Bill 2016, with a commencement date of 6 April 2016. As feared by many in the industry, the draft legislation providing for the exception to the imposition of income tax on performance linked rewards will be tightly defined and difficult to meet.

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The draft legislation confirms that the Government will adopt a version of “option 2”, providing an exception to the rules based on the length of time underlying investment are held, but in a much more onerous form. The Government has decided that the proposed holding periods set out in the consultation were too short and has considerably extended the holding periods required for the retention of capital gains tax treatment.

Under the new legislation, carried interest or other performance linked rewards received by investment managers that is not already taxed as trading or employment income will be subject to income tax treatment, unless it arises from assets held by a fund with an average holding period for its assets of at least three years. Where the holding period is more than three but less than four years, a sliding scale will determine the proportion of the return subject to income tax. Only if the average holding period is at least four years will capital gains tax treatment apply in full.

For these purposes, the average holding period will be based on the average holding period by the fund of investments held for the purposes of the scheme and by reference to which the carried interest is calculated. In turn, this is calculated on an investment by investment basis using the amount originally invested at the time the investment was made. The calculation is made at the time the carried interest arises. In this way, the legislation uses an average weighted holding period to determine the tax treatment of performance linked rewards such as carried interest.

In general, TCGA principles will be followed to identify whether and when a disposal of investments is made, including the reorganisation rules, but the share pooling rules will be disapplied and a “first in, first out” (FIFO) basis will be used. This means that each holding will be made up of the most recently acquired instruments, making it very difficult to meet the four year holding period where there is any turnover in shares. Indeed, a large sale even if made for sound investment principles will have a negative effect on the fund’s average holding period.

An exception is, however, made for an investment amounting to an increase in a controlling interest in a trading group, where the investment will be treated as made at the time the controlling interest was acquired. The BVCA has already indicated that it will be lobbying for more protection for the venture and growth capital sectors where minority stakes are the norm.

The consultation document does hold out the promise that HMRC will be “willing to discuss other situations where the provisions could be said to misrepresent the average holding period of a particular type of fund and to explore any unintended consequences”.

“In particular, the government understands that the investment model used by many venture capital funds may result in the above test producing a shorter average holding period and income tax treatment even where the fund is undertaking long-term investment activity. HMRC is keen to engage with industry representatives so as to ensure the average holding period test accurately reflects the activity undertaken by venture capital funds.”

For the purposes of determining the investments against which to measure the holding period, the legislation provides for intermediate holdings or holding structures to be disregarded. The definition of what amounts to an investment for these purposes is wide, but excludes cash awaiting investment or cash disposal proceeds that are to be distributed to investors as soon as reasonably practicable. Derivatives are included, although separate rules determine the value invested in a derivative. “Direct lending funds” are specifically excluded from capital gains tax treatment, unless additional strict conditions are met as to the composition of the fund’s loan portfolio.

This method of calculation would, of course, mean that for new funds the first performance linked rewards would prima facie be taxed as income as the holding period will be less than three years. However, the legislation allows conditional capital treatment to be applied from the outset where it is reasonable to suppose that the conditions for the exemption would be met at the relevant later time. This will, at least, allow funds which do have clear long-term investment objectives (such as real estate and some private equity funds) to obtain capital gains tax treatment from the outset.

Finally, the legislation includes the obligatory anti-avoidance provision which provides that any arrangements which have as a main purpose the reduction in the proportion of carried interest which is subject to income tax treatment are to be disregarded.

Comment

The draft legislation makes it clear that very few hedge funds or other funds, except for private equity, real estate or infrastructure funds, will be able to qualify

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for continued capital gains treatment on carried interest or other performance linked rewards.

Even where funds do have a long term holding strategy sufficient to fall within the exception to the legislation, it will be necessary to consider whether the possible advantages outweigh the costs of a more complex structure, more difficult compliance and the risk that investment decisions will remove the advantage anyway. There is, in addition, the risk that managers may find themselves in a position of conflict, between maximising their investors' returns and seeking capital gains tax treatment.

The draft provisions will now undergo a further period of consultation leading up to Royal Assent of the Finance Act 2016. It is at least welcome that the consultation response document shows that HMRC is open to further discussion on the detailed calculation of the average holding period.

martin.shah@simmons-simmons.com
www.simmons-simmons.com

The Senior Managers Regime: The need for greater accountability throughout financial services

By Jérôme de Lavenère Lussan, CEO, Laven Partners

Senior managers throughout the banking sector can be heard breathing a sigh of relief as the assumption of an individual's accountability will no longer to stem from a presumption of responsibility. The magnitude of this amendment to the proposed Senior Managers Regime silences many alarm-bells that have been attracting much media and industry speculation recently. Whilst the Treasury's announcement may have been welcomed by the banking sector's senior managers, who must abide by the new regime by March 2016, the rest of the financial services industry is jaw dropped. From 2018 the Senior Managers Regime is now proposed to be extended across the entire financial services industry thus ensuring a comprehensive and consistent approach across the business spectrum including hedge fund and private equity managers.

The Senior Managers Regime aims to combat the notorious 'bad behaviour' highlighted throughout the financial crises of 2008. Subsequent financial investigations revealed the lack of specific accountability for material failures. The UK Financial Conduct Authority (FCA) initially attempted to create a shift in behavioural culture through imposing fines unprecedented in size. However, these fines were paid through corporate institutions and little remedial action followed suit to discourage and prevent the offending behaviours being repeated. The announcement to extend the Senior Managers Regime across the financial services was foreseeable. The Bank of England noted in June 2015 that the rules were likely to be extended to cover asset managers and other financial institutions, however no precise details were alluded to at this point. The Senior Managers Regime will replace the Approved Persons Regime. The Approved Persons Regime is deemed weak and has been under attack in recent years for its acknowledged gaps and failures. It enabled firms to avoid taking appropriate responsibility over assessing the fitness and proprietary of their staff as well as allowing there to be cavities in the enforcement powers available to the regulator.

One of the most prominent instances of the Approved Persons Regime not being satisfactory was demonstrated through the investigation into Paul Flowers, former chairman of the Co-op bank. Here, Mr Flowers was appointed in an Approved Persons' role despite a lack of senior banking experience. A safeguard was raised to counter this experience defect in the form of two deputy chairmen with relevant expertise who acted alongside Mr Flowers. Nevertheless, the appointee led the bank to require a £1.5 billion rescue injection. The inadequacies of Mr Flowers, who had been appointed following a 90-minute interview with the regulator, have been exposed further throughout the media, including for illegal drug use, public indecency as well as confusing the bank's actual assets to be £3 billion rather than the actual figure of £47 billion. The flaws in the Appointed Persons Regime that allowed for such an appointment have been brought to the attention of the regulator and more detrimentally to the public. Consequently the Senior Managers Regime will replace the outdated and ineffective Appointed Persons Regime. This is much desired by the rule-abiding institutions to begin to regain the public's trust in the financial services of the UK.

Senior managers across the entire financial services that held appointed positions previously will be grandfathered by 2018 into their applicable roles within the Senior Managers Regime. Approved persons below senior management level will now be captured under the Certification Regime. Here the identified staff will not hold senior functions as prescribed by the FCA and PRA, but will have responsibilities that are capable of causing significant harm to the business. These persons will no longer be subject to prior approval, but rather their firm will be required to conduct fitness and proprietary assessments and maintain annual reviews to ensure the individual's ongoing suitability for their role. The banking sector (that are subject to both the Senior Management and Certification Regimes earlier than the rest of the industry) have been given until March 2017 to ensure that their existing staff have completed the certification process. The Senior Managers Regime and the Certification Regime methods of providing ongoing supervisory assurance are far more rigorous than the Appointed Persons Regime and will focus on continuing appropriateness.

The Senior Managers Regime has overhauled the accountability of senior members of staff. The regime assigns specific responsibilities to certain senior individuals in key positions throughout the

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firm's hierarchy. Once identified, an individual's responsibilities are functionally mapped out and documented through a statement of responsibilities. This statement alongside the functionality map will be used to determine accountability if a material failure does arise. It is deemed that these increased specifically identified accountability measures will ensure that greater care and oversight is given prior to any potentially detrimental risk-taking decisions being made. Not only does the Senior Managers Regime bring along the requirement to prescribe specific responsibility functions throughout the firm, but it also introduces greater consequences for failures that subsequently occur on the identified individual's watch. The regulator may impose civil penalties that may affect an individual's future within the financial profession. They may withdraw an individual's approval for holding a specific function or they may determine an outcome that causes the individual to suffer public censure. Further the regulator is empowered to impose criminal sanctions to penalise an individual's misconduct and their reckless mismanagement of a firm.

The introduction of criminal liability is undoubtedly the element of the Senior Managers Regime that has caused the most contention and debate to date. Until recently, a senior manager would have been under the presumption of guilt upon a business failure. This conflicted with the tradition under English law that one is innocent until proven guilty. Many senior managers felt uneasy being burdened with the presumption of responsibility and it was highlighted throughout the industry that many senior individuals would not want to take such roles. This could have prevented high-quality talent from participating in the management of the UK's banks. Consequential solutions were already emerging throughout the industry, work-arounds such as renaming or creating new roles that did not fall within the scope of the Senior Managers Regime were being mooted as alternative methods of gaining senior management type exposure without such individuals attracting the burdensome risks.

Recognising the impracticalities of imposing this presumption upon senior managers, the Treasury have recently removed the reverse burden of proof. Although the regulator has been seen to down-play this amendment to the regime ahead of it coming into effect for banks as of 7 March 2016, the banking sector have not been shy in demonstrating their approval and their great relief. The FCA has noted that the presumption of responsibility element to the regime has received such significant industry focus that 'it risked districting senior management within firms from implementing both the spirit and letter of the regime.'[1] Further, following the extension of the regime across the financial services industry, the reverse burden of proof would have been disproportionate to apply to all firms now captured under the regime, recognising that many small firms have less complex hierarchies than the large institutions that the regimes were initially prescribed to apply to.

Despite this reversal on the burden of proof, senior management will still be under the same stringent obligations to ensure that they have taken all reasonable steps to prevent a breach. Formulating that reasonable steps were taken will be based on multiple considerations including the size, scale and complexity of the firm, the individual circumstances including what knowledge the individual had or ought to have had, the individual's expertise and competence, what alternative steps could have been taken, as well as the individual's own prescribed responsibilities. In addition the suitability and appropriateness of any relevant delegations that were made will be scrutinised. Determining the above requirements will place heavy reliance on the quality of audit trails that are maintained to demonstrate that the relevant considerations and suitable due diligence took place.

Extending the Senior Managers Regime and the Certification Regime to apply equally to both banking professionals as it does to other financial professionals does have the effect of implementing a level playing field and creating one high standard of expectations for all to adhere to. However, there is much debate over the necessity of the extension of the regimes. Many non-banking professionals have been quick to point out in the wake of the financial crisis that it was large banking institutions that have been responsible for any identified misconduct, and that the other sectors have not demonstrated the propensity to act in a similar way. Conversely, if a high standard of behaviour is instilled across the entire financial industry, then it should make no difference to the institutions that have already been meeting such behaviour standards, if their actions are now required to meet such a prescription or otherwise. Introducing these regimes can be viewed as the initial steps in entrenching a culture of personal responsibility across the industry which in turn should help to rectify the current defect in consumer trust that the entire market continues to face.

jerome@lavenpartners.com
www.lavenpartners.com

1 Tracey McDermott, acting CE of the FCA

Moving centre stage: Alternative asset management in 2020

AIMA SPONSORING PARTNER

By Mike Greenstein, Global Alternative Asset Management Leader, PwC; and Barry Ness, Partner, PwC

Introduction[1]

Over the past several years, rapid developments in the global economic environment have pushed asset management to the forefront of social and economic change. An important part of this change -- the need for increased and sustainable long-term investment returns -- has propelled the alternative asset classes to centre stage. To help alternative asset managers plan for the future, PwC's Asset Management practice has considered the likely changes in the alternative asset management industry landscape over the coming years and identified six key business imperatives for alternative asset managers. We have then examined how managers can implement and prosper from each of these six imperatives.

The landscape in 2020

What factors are driving this evolution? First, regulation will continue to hinder banks: for alternatives, this furthers significant opportunities such as hires from banks and the opportunity to further step into the funding gap. As the world population ages, retirement and healthcare will become critical issues that asset management can solve. Capital preservation and alpha generation will be key. In addition, asset managers will dominate the capital raising required to support growing urbanisation and cross-border trade: growing asset classes in infrastructure and real estate play into alternatives firms' areas of expertise. And lastly, asset managers will be at the centre of efforts by sovereign investors to invest and diversify their huge pools of assets; alternative firms are ideally positioned to partner with them.

As a result, alternative assets are expected to grow between now and 2020 to reach more than $13.6 trillion in our base-case scenario and $15.3 trillion in our high-case scenario. Assets under management in the SAAAME (South America, Asia, Africa and the Middle East) economies are set to grow faster than in the developed world as these economies mature. This growth will be evidenced by the projected emergence of 21 new sovereign investors, the vast majority of which will originate from SAAAME. This growth in assets will be driven principally by three key trends: a government-incentivised shift to individual retirement plans; the increase of high-net-worth individuals from emerging populations; and the growth of sovereign investors. This creates the need for more tailored, outcome-based alternative products that provide capital preservation, but provide upside opportunities.

Alongside rising assets, there will also continue to be increased regulatory requirements, rising costs and pressure to reduce fees. Alternative firms do not escape this pressure, and will seek to respond proactively.

Furthermore, distribution will be redrawn, as regional and global platforms dominate. New markets and untapped investor types will open up if alternative firms can develop the products and access the distribution channels to tap them. By the early 2020s, four distinct regional fund distribution blocks will have been formed allowing products to be sold pan-regionally. These will be North Asia, South Asia, Latin America and Europe. However, these blocks benefit traditional firms more than alternatives firms, so distribution alliances will be critical for alternatives firms.

Meanwhile, alternatives will become mainstream. The term "alternative" - already strained to reflect a mix of different strategies, products and firms - becomes further flexed. The growth of liquid alternative products, either in the form of mutual funds or UCITS, continues to create greater integration between alternative and traditional asset management. By 2020, alternative asset management will become synonymous with "active asset management" and, increasingly, "multi-asset class solutions".

1 This article was excerpted from "Alternative Asset Management 2020: Fast Forward to Center Stage." For the complete report, please visit www.pwc.com/alts2020.

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As a result, a new breed of global manager will emerge. Traditional managers leverage their existing platforms, distribution capabilities and brands to develop full-service, multi-asset class alternative businesses. A few of today's largest diversified alternative firms will become mega-managers in their own right, establishing a presence in all the key geographies and investor segments. The largest alternative firms will continue their growth trajectory and diversification through product, asset class and distribution expansion, fuelled by build, buy and borrow strategies. Specialist firms will seek "best-of-breed" status by producing sustained performance, while certain emerging firms will fight for shelf space.

And finally, by 2020, technology and data-informed decision-making will become mission-critical to drive investor engagement, data analytics, operational and cost efficiency, and regulatory and tax reporting. Data management and investment in technology have not always have been a top priority for alternative firms – but this will change.

Six key business imperatives

We believe that this evolving landscape will create six key business imperatives for alternative asset managers:

1. Choose your channels

Alternative firms by 2020 will adopt world-class ideas and practices from the broader financial services industry and from traditional asset managers. They will develop more sophisticated market strategies, more focused distribution channels and better recognised brands. Most alternative firms will work out exactly which investor channel or channels they want to target and develop relevant strategies and products. Some will focus more systematically on sovereign investors, pension funds, other sophisticated institutions and private wealth markets. Others will target emerging markets, and still others will pursue the potentially huge asset flows through liquid alternative products. A small number of mega-managers in the alternatives space will operate across all major geographies, channels and strategies.

2. Build, buy or borrow

Greater segmentation of investors will, in turn, drive greater segmentation of the managers themselves. Deciding which segment of the market to inhabit will require alternative firms to more consciously evaluate what they are as an organisation and where they want to be. They will typically aspire to be one of the following types: diversified alternative firms, specialty firm or multi-strategy firm.

All these models exist today. The difference is that firms will by 2020 explicitly choose a growth strategy in order to remain competitive. To develop the chosen business model, firms will pursue one or more of three growth strategies: building, buying or borrowing. Builders grow by building out their internal organizations, leveraging and developing their existing capabilities and investment talent.

Buyers expand their alternative capabilities across asset classes and strategies by acquiring talent, track record and scale overnight. Borrowers partner with other institutions, including asset managers, wealth managers, private banks and funds-of funds, to expand their investment capabilities and distribution channels. These borrowing relationships include, but are not limited to, distribution arrangements, joint ventures and sub-advisory relationships.

3. More standardisation, more customisation

The polarisation of the alternatives industry into standardised and customised solutions, already in evidence in 2015, becomes even more marked by 2020. This shift responds to three key investor demands. The first is the ongoing demand by the largest institutional investors for made-to-order products, providing greater customisation and strategic alignment. The second is demand for next-generation commingled funds that are more focused on outcomes. The third is demand for liquid alternative funds in standardised formats as some institutional investors, as well as the mass affluent and newly wealthy, seek easy access to alternative strategies.

4. From institutional quality to industrial strength

Owners, investors and regulators will broaden their expectations from "institutional quality" to "industrial strength". They will expect alternative firms to operate in a way that goes beyond the prerequisite quality standards to operate even more effectively and offer a broader range of capabilities. Having institutionalised their businesses, alternative firms will seek the higher standard of "industrial strength".

Firms will revamp their operations in a cost-effective way that is not disruptive to their day-to-day business. This includes embedding more data-informed decision-making to estimate the impact of business mix changes

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and process improvement on costs and revenues. They will then implement these process improvements, eliminating operating inefficiencies by automating and outsourcing processes. Firms will look to transform labour-intensive functions like compliance, tax and investor servicing into ones that are more technology-enabled, scalable and integrated within the overall operating environment. To do this, larger firms will build in more resource bandwidth with change agents who will drive process improvement while core teams continue to drive day-to-day operations. Firms will also seek to better control operational risk, systematically identifying, prioritising and managing operational risks to target areas of potential vulnerability.

5. The right resources in the right places

By 2020, the shift to data-informed decision-making leads to improved organizational designs that can better deliver the right resources to the right places. Design elements that will be adopted by alternative firms include: centres of excellence to leverage expertise; dedicated teams to focus on underserved areas; sourcing strategies to reduce costs for high-volume, repeatable processes; and location strategies to bolster a firm's presence in a particular jurisdiction or to reduce cost.

Many alternative firms will also make more effective use of right-sourcing strategies. In some cases, they will shift to using outsource providers or utility-like platforms where key skills or geographic coverage can be provided more cost-effectively, externally. In other cases, alternative firms will continue to use in-house support functions to take advantage of operating leverage benefits. Successful right-sourcing efforts are accompanied by more systematic and efficient internal oversight to bridge the gap between external service providers and internal resources.

6. It's not only about the data

Data and data-centricity are key business imperatives in 2015. By 2020, the focus of leading alternative firms will have largely moved on. They will have laid the necessary "plumbing", and accessing data across their organisations will be as natural as turning on a tap. To do this, they will adopt data standard protocols allowing all parts of the organisation to exchange information, creating a self-service model. These protocols will also speed information exchange with key counterparties and service providers.

The result will be a data-centric, self-service environment in which time is spent on the analysis and reporting of data, rather than on the manipulation of data. The resulting analytics enable alternative firms to better measure the strength of their operational processes and enhance key functional areas such as tax, compliance, reporting and investor servicing. The model will also help plug the current drain on resources in the manual and non-standardized areas of portfolio monitoring, operational due diligence and investor on-boarding.

michael.s.greenstein@pwc.com
barry.ness@pwc.com
www.pwc.com

Finding catalyst-driven opportunities in a changing investment landscape

AIMA SPONSORING PARTNER

By Pierre-Henri Flamand, Portfolio Manager, Man GLG

Introduction

The noun 'catalyst' is of Greek origin, being derived from the verb 'katalyein', which means to dissolve or become liquid. In the field of chemistry, a catalyst is a substance that increases the rate of chemical reaction without itself undergoing any permanent chemical change.

In everyday life, 'catalyst' has a simpler definition; something or someone that causes change. In the context of financial markets, it could be said that, over the summer of 2015, China was the catalyst for a change in investor sentiment. In fact, China's role as a catalyst in this instance potentially satisfies both the scientific and everyday definitions.

In our view, Chinese woes can be said to have been an accelerant in the sense that the Yuan devaluation brought forward a spate of risk aversion. If investors had not had China to worry about in August, we believe, the prospect of the US Federal Reserve potentially raising interest rates in September might well have prompted a similar market reaction in early-to-mid September.

However, from the perspective that China was the only subject on the lips of investors, it can justifiably be said to have been that something that, of itself, precipitated an abrupt change in investor sentiment.

At the stock level, in our view, the most obvious catalyst for a substantial shift in valuations is merger and acquisition (M&A) activity. Consequently, we will begin by comparing the M&A environment in 2015 to preceding years, before describing the ways in which we seek to capitalize on catalyst-driven opportunities to benefit from market dislocations.

The best year for M&A since the crisis?

In 2015, we have seen a raft of statistics to suggest that new life has finally been breathed into the M&A market after a period of several lean years, which have been punctuated by a number of false dawns. Clearly, transaction volumes fell off the proverbial cliff in 2009, dropping around 60% from 2007 levels, as company management focused primarily on rebuilding balance sheets.

While the extended delay in the recovery of volumes has come as a surprise and disappointment to many, it may simply be, on reflection, the case that there have been too many reasons for CEOs not to commit balance sheet cash, with the global economy lurching from one miniature catastrophe to another. Consequently, what we really needed to see was a change of mind-set.

In the table below, we have identified six historic drivers of M&A activity alongside the relevant rationale. Ironically, it can be argued that, with rising volatility and widening credit spreads, the M&A environment may well have become less favourable recently than at

Six historic drivers of M&A

Driver	Rationale
Low growth	Difficult to grow organically
Low interest rates	Cost of capital is attractive
Low stock multiples	Cheap equity
Robust credit markets	Appetite for debt securities
Low volatility	Narrower bid/offer spreads
Strong corporate confidence	Increased willingness to act

Source: Man database.

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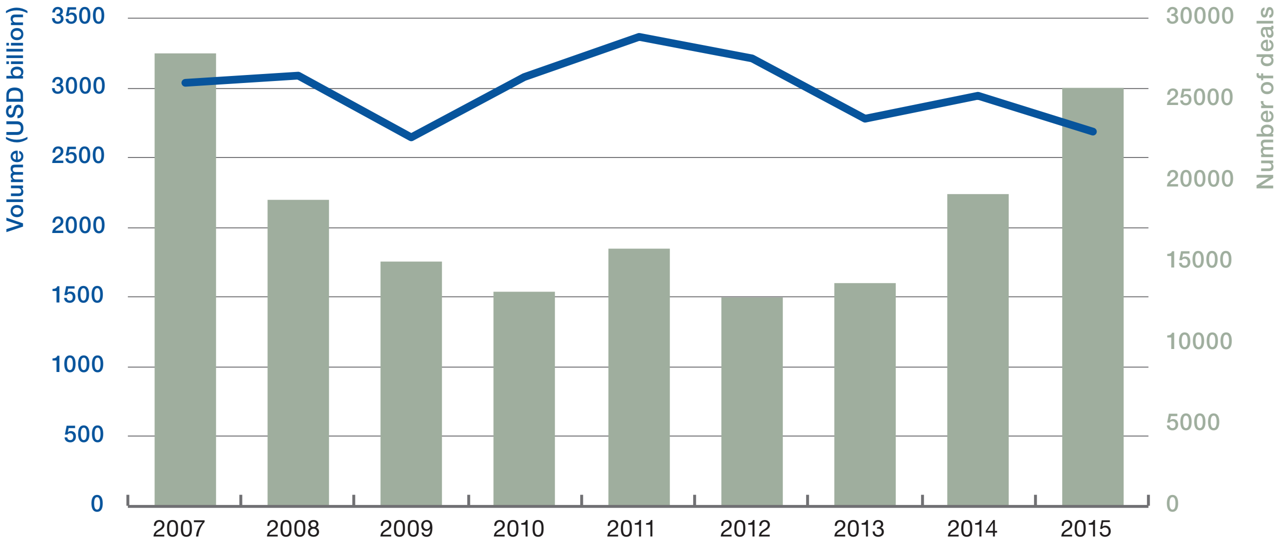
A trend in M&A volumes



Source: Dealogic (August 2015). Period analysed 1 January to 11 August each calendar year to provide like-for-like comparison.

any time in the preceding three years (although the summer sell-off in capital markets will at least have taken the froth off stock multiples and delivered cheaper equity).

However, we often refer to the 'M&A cycle' for the very reason that momentum is such a critical element. As the following chart demonstrates, we are currently seeing a positive trend in transaction volumes.

Indeed, according to a survey conducted by PricewaterhouseCoopers at the beginning of this year, no fewer than 54% of US CEOs were planning to complete an acquisition in 2015, while 51% of CEOs globally expected to enter a new strategic alliance.

Consequently, there is every reason to believe that M&A transactions will provide a good source of potential alpha in the period ahead. Nevertheless, it is important to point out that, in addition to capitalising on M&A situations, we seek to exploit a much broader range of opportunities through our catalyst-driven approach.

A more expansive view of the opportunity set...

'Event driven' funds per se are fabled for generating so-called 'telephone number' returns in the aftermath of the bursting of the technology bubble and the era of accounting scandals, such as those relating to Enron and Worldcom, that followed. 'Distressed situations' effectively became the new panacea for those seeking outsized investment returns.

As such, the event driven universe has been the subject of some disappointment and adverse press coverage in respect of the comparatively lean returns that have been generated during the last decade. However, event driven was actually the top performing hedge fund category in both 2012 and 20131.

Nevertheless, as we have already seen, opportunities to benefit from M&A activity dried up in the aftermath of the financial crisis, while the central bank 'medicine' of asset purchase programs and near-zero interest rate policy has effectively suppressed the default cycle. Consequently, the crowding of positions has proved a problem for some managers, particularly those specializing in just one of a number of event driven sub-strategies. Our approach is more holistic in nature, as we seek to benefit from many identifiable catalysts with the potential to prompt a significant shift in asset prices. John Maynard Keynes once observed that the essence of successful investing is 'anticipating the anticipation of others' and that is very much the spirit of what we are trying to achieve.

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Indeed, our primary source of investment ideas comes from events that have already been announced. We apply our own knowledge of sectors and situations to identify investment drivers that are not yet widely perceived. As such, we focus on 'soft' catalysts which we believe will unlock value (where long positions are taken) or create a sense of unease (on the short side).

In addition to M&A, the categories of announcements that could prompt further investigation and research on our part include, but are not restricted to, divestitures and changes to management teams, the corporate capital structure and the regulatory regime.

Aside from various announcements, we also seek sources of ideas from macroeconomic and thematic views, one-on-one meetings with corporate management teams and analysis of companies' competitive positions.

With this expansive view of the opportunity set, we are confident that we should be able to tap into alpha sources, regardless of the trading backdrop. This sets us apart from the more specialized event driven strategies that may rely on harvesting returns at a particular stage in the macroeconomic, default or M&A cycles.

…across the entire economic cycle

Our aim is to find potential opportunities across the capital structure throughout the economic cycle. This, of course, means that we can take positions in credit as well as equities. In this respect, it is important to point out that we always approach any given investment idea with the same underlying view developed from the soft catalyst angle. It is purely the case that we will deploy capital in the credit space where specific views can be expressed with a superior risk/ reward profile compared to holding the equity.

This flexibility provides us with additional room to manoeuvre in our efforts to opportunistically capitalize on market dislocations, the culmination of this process being deeply researched positions with low correlation to overall market movements and other traditional assets. Consequently, given that we focus on a broad range of catalyst-driven opportunities in addition to M&A, we believe that our approach should deliver returns that are compelling from a portfolio diversification perspective as well as being attractive in their own right.

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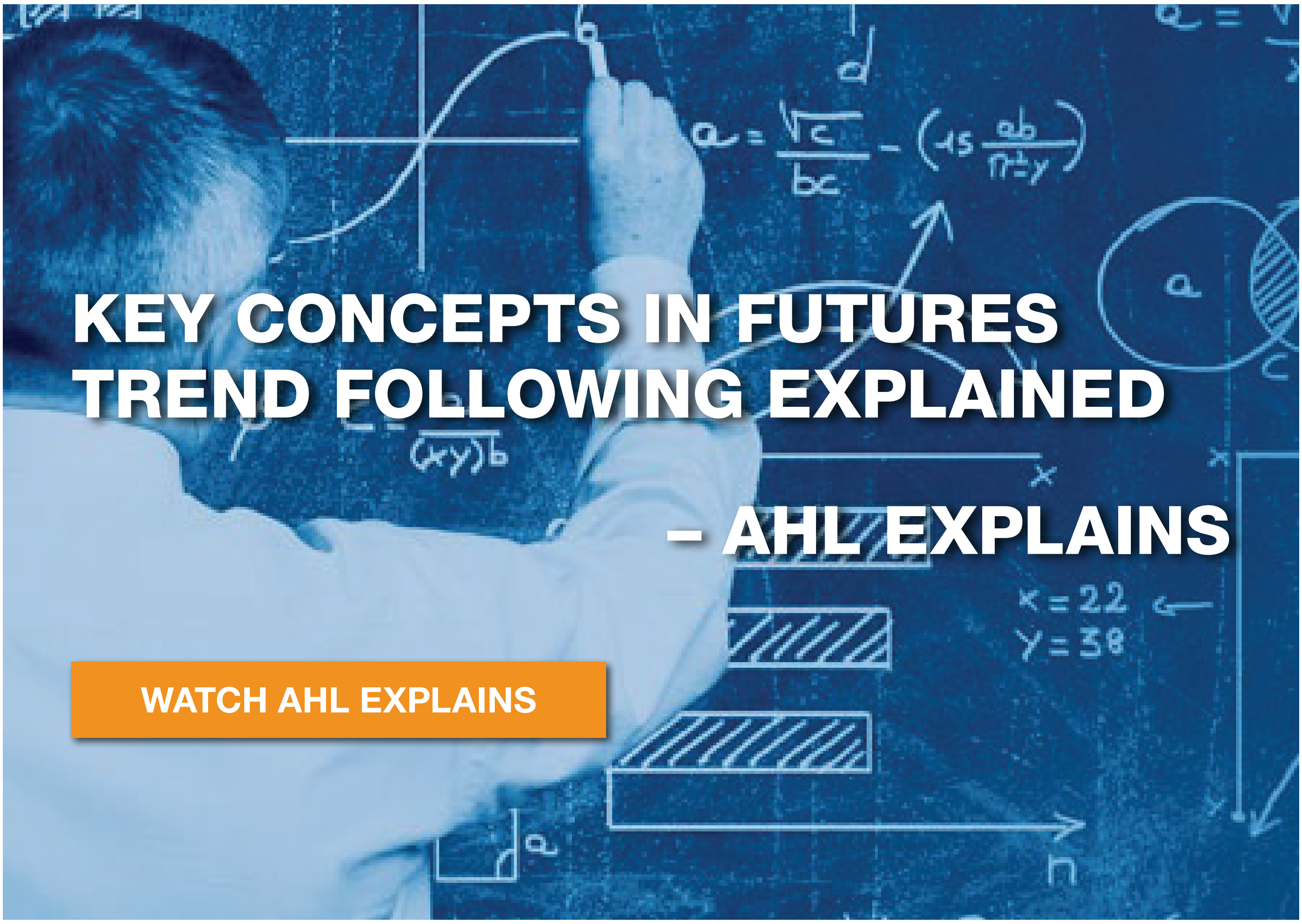

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Guide to political risk insurance for financial institutions

AIMA SPONSORING PARTNER

By Alexander van Kuffeler, Regional Head for the Financial Institutions Group for Central and Eastern Europe, Middle East and Africa (CEMEA), Willis

Political risk insurance (PRI) is a product designed to help mitigate the political uncertainties investors and lenders face when investing or lending into emerging markets. Typically clients are concerned about the long-term political stability of a country, and a PRI policy is designed to provide insureds with the comfort that even if the sociopolitical situation in the country implodes or a new government is elected on an anti-foreign investment platform, they can exit the country without losing the investment or debt.

The inception of political risk insurance was in the 1948 Marshall Plan – US Government promotion of US equity investments to rebuild post-war Europe in the form of political risk guarantees. This has developed over the years from government-backed schemes to promote national companies' overseas investments (which still exist in the form of export credit agencies) into a burgeoning private market based largely out of the London market. Political risk insurance will cover the parent company's:

- fixed investments
- shareholding
- retained profits
- intercompany loans
- dividends to be paid by foreign subsidiary
- stock
- machinery

From a financial institution basis, the cover is most frequently bought to protect against a default by a borrower under a loan agreement or lease as a result of political risk events. As an example, Bank A lends $100m to an oil and gas company in Argentina and six months later the Argentinian government nationalises the company. Subsequently the borrower defaults as they no longer have the revenue to repay the loan.

The cover is also bought when financial institutions are prevented by a government from accessing security under a loan agreement and also where they are trading commodities as principal on their own balance sheet. The groups within financial institutions that have the greatest need for the product are those operating in the following areas:

- Project & export finance
- Commodity finance
- Trade finance
- Leasing
- Securitisations/capital markets
- Asset-based finance

Essentially any area where the bank's balance sheet is exposed to a credit risk.

What risks are covered?

Callout: Political risk insurance covers an act by government resulting in a loss where the government had no right to take that action.

Political risk insurance for lenders cover banks against the default of borrowers under a loan agreement (includes asset leasing) as a result of the following:

Confiscation – perils insured:

- Confiscation / expropriation / nationalisation
- Deprivation
- Forced divestiture
- Forced abandonment
- Selective discrimination
- Licence cancellation / revocation
- Currency inconvertibility / exchange transfer
- Embargo

Physical damage – perils insured:

- War on land
- Strikes / riots / civil commotion
- Terrorism and malicious damage

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There is also the ability to cover arbitration award default in the event that insurers will not offer cover for license cancellation / revocation.

What risks are not covered?

Political risk insurance for lenders covers default by a borrower or loss to financial institution as a result of political events only. It does not cover loss resulting from the ordinary insolvency of a borrower or general commercial defaults by third parties. Comprehensive non-payment insurance (which I'll cover next week) covers insolvency and protracted payment default.

Exclusions under PRI policies include (but not limited to):

- Failure to maintain or secure necessary permits,
- Non-compliance with laws of the foreign country (in place at inception)
- Currency fluctuations
- Commodity price fluctuations
- Breach of the loan agreement by the insured
- Fraud

A PRI policy will not cover defective contracts - i.e. if the underlying investment agreement or concession agreement allows the government to take a 50% free hold at any time, then you can't claim under a PRI policy when the government executes this right.

It is important to note that the policy is designed to cover an act by government resulting in a loss where the government had no right to take that action. If a government acts in its role as legally appointed governing authority to improve public safety or environmental safety (which of course is seen by international arbiters to be reasonable) then insurers will be unwilling to respond positively.

It is important to note that, if a financial institution is lending to a sub sovereign or sovereign entity, then only comprehensive non-payment cover is appropriate as you will find it impossible to differentiate between the political and commercial actions of a sovereign or sub-sovereign entity (any company owned >50% by the government).

Market characteristics

Commercial/ private market insurers:

- Lloyd's
- Company markets

Others:

- Export credit agencies – for example SACE, the Italian export credit agency, COFACE who are the French export credit agency
- Multilaterals – MIGA (Multilateral Investment Guarantee Agency - part of the World Bank) ATI (African Trade Insurance)

Private markets vs export credit agencies:

- Flexibility
- Tenors
- Coverage
- Speed of response
- Documentation risk
- Local content rules
- Rating
- Down-payment /commercial loan
- Double trigger cover

Appropriate limits

As most PRI for lenders loss scenarios (apart from physical loss or damage as a result of political violence) are 100% of the policy limit, the limits need to reflect the full value of the loan or investment, unless the financial institution has the appetite to take some of the risk on their own book. If a loan, it is highly unlikely that the borrower will be able to suddenly make payments again further down the line following a government confiscation for example.

Pitfalls

It must be made clear to financial institutions that PRI for lenders is country risk mitigation only and does not provide cover against insolvency of a borrower. Wording negotiations can be complicated as there is much interpretation into what an appropriate act of a government is and what is political and what is commercial.

PRI isn't a cheaper version of comprehensive non-payment cover, it is only covering a portion of the risk.

There should be a cross border element to the transaction, i.e. UK bank lending to UK-listed company for the purpose of developing a project in Guinea Bissau. Insurers will not cover domestic political risk.

Emerging issues

Instances of outright expropriation by governments are less frequent today, however assets are still

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expropriated but by much more subtle means. This is what is known as "creeping expropriation". This normally takes the form of a number of small actions by the government, which individually cannot be seen to be an expropriation, but when seen as a whole they have the same effect as an outright expropriation.

Increasingly, resource-rich countries in emerging markets are flexing their muscles as they seek to take a greater share in the proceeds of strategic projects. This is known as resource nationalism – which is typically seen as when a State thinks that a foreign investor is not sharing the profits from an operation, especially when prices for the natural resource rise beyond the levels originally anticipated. In these cases, the State may seek to impose new terms or regulations on the investment or the foreign investors to improve the position of the State.

avkuffeler@willis.com
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ABN AMRO CLEARING BANK N.V.
Country: UK
Contact: Delphine Amzallag
Telephone: +44 (0)20 3192 9000
Business activity: Prime Brokerage Services

ALPHAGEN CAPITAL LIMITED
Country: UK
Contact: Nicki Pentz
Telephone: +44 (0)20 7818 2111
Business activity: Hedge Fund Manager / Adviser
Website: www.alphagen-capital.com

ALTIS PARTNERS (JERSEY) LIMITED
Country: Jersey, Channel Is.
Contact: Natasha Reeve-Gray
Telephone: +44 (0)1534 787 770
Business activity: Hedge Fund Manager / Adviser
Website: www.altispartners.com

ANALYTIC INVESTORS, LLC
Country: USA
Contact: Ryan Shelby
Telephone: +1 213 688 3015
Business activity: Hedge Fund Manager / Adviser
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Country: South Korea
Contact: Daniel Perez
Telephone: +822 2156 2800
Business activity: Hedge Fund Manager / Adviser
Website: www.andaasset.com

APSLEY SPECIALITY LIMITED
Country: UK
Contact: James Lawrie
Telephone: +44 (0)20 7297 4320
Business activity: Consultant (Other)
Website: www.apsleyspeciality.com

ARENDT & MEDERNACH
Country: UK
Contact: Camille Bourke
Telephone: +44 (0)20 7456 9800
Business activity: Legal Services
Website: www.arendt.com

ASIA RESEARCH AND CAPITAL MANAGEMENT LTD
Country: Hong Kong
Contact: Bill Wong
Telephone: +852 3710 2000
Business activity: Hedge Fund Manager / Adviser

BATTEA - CLASS ACTION SERVICES, LLC
Country: USA
Contact: Bob Williamson
Telephone: +1 203 987 4949
Business activity: Other Service Providers
Website: www.battea.com

BCA RESEARCH INC
Country: Canada
Contact: Arun Kumar
Telephone: +1 514 499 9550
Business activity: Consultant (Other)
Website: www.bcaresearch.com

BELGRAVE CAPITAL MANAGEMENT LTD
Country: UK
Contact: Francis Lunn
Telephone: +44 (0)20 7340 4700
Business activity: Hedge Fund Manager / Adviser
Website: www.belgrave.com

CAMBRIDGE ASSOCIATES INVESTMENT CONSULTANCY (BEIJING) LTD
Country: China
Contact: Hamlin Zhao
Telephone: +86 10 6535 4700
Business activity: Consultant (Other)
Website: www.cambridgeassociates.com

COR CAPITAL PTY LTD
Country: Australia
Contact: Davin Hood
Telephone: +61 3 9823 6296
Business activity: Hedge Fund Manager / Adviser
Website: www.corcapital.com.au

COVISTA CAPITAL CORP
Country: Canada

Contact: Spencer MacCosham
Telephone: +1 604 661 4450
Business activity: Hedge Fund Manager / Adviser

CREDIT SUISSE ASSET MANAGEMENT

Country: Japan
Contact: Noriaki Nakashima
Business activity: Fund of Hedge Funds Manager

D'ALEMBERT CAPITAL MANAGEMENT

Country: UK
Contact: Antoine Mallard
Telephone: +44 (0)20 7622 5324
Business activity: Hedge Fund Manager / Adviser
Website: http://www.dalembertcap.com/

DOMINICE & CO - ASSET MANAGEMENT

Country: Switzerland
Contact: Aiste Ortiz
Telephone: +41 22 319 2080
Business activity: Hedge Fund Manager / Adviser
Website: www.dominice.com

DYNAMIC CAPITAL MANAGEMENT (UK) LIMITED

Country: UK
Contact: Julian Knight
Telephone: +44 (0)20 3369 9000
Business activity: Hedge Fund Manager / Adviser
Website: www.dynamicfunds.com

DYNAMIC CAPITAL MANAGEMENT LIMITED

Country: Jersey, Channel Is.
Contact: Camille Hayek
Telephone: +44 (0)1534 723 825
Business activity: Hedge Fund Manager / Adviser
Website: www.dynamicfunds.com

DYNAMIC CAPITAL MANAGEMENT LLC

Country: USA
Contact: David Prevot
Telephone: +1 212 246 9000
Business activity: Hedge Fund Manager / Adviser
Website: www.dynamicfunds.com

EMPEROR DESIGN

Country: UK
Contact: Steve Paul
Telephone: +44 (0)20 7729 9090
Business activity: Office Suppliers / Potential Suppliers
Website: www.emperordesign.co.uk

FINEX CTA

Country: USA
Contact: Robert Kamicar
Telephone: +1 312 369 0436
Business activity: Hedge Fund Manager / Adviser

FINEX LLP

Country: UK
Contact: Andrew Gebhardt
Telephone: +44 (0)20 3008 2520
Business activity: Hedge Fund Manager / Adviser
Website: www.finexlondon.com

FOUNTAINCAP RESEARCH & INVESTMENT (HONG KONG) CO, LTD

Country: Hong Kong
Contact: Andriy Chu
Telephone: +852 2170 3333
Business activity: Hedge Fund Manager / Adviser
Website: www.fountaincapri.com

FREEHOLD INVESTMENT MANAGEMENT

Country: Australia
Contact: Andrew Smith
Telephone: +61 3 8609 7127
Business activity: Hedge Fund Manager / Adviser
Website: www.freeholdim.com.au

FUSE THREE FINANCE LIMITED

Country: UK
Contact: Ifti Akbar
Telephone: +44 (0)20 7305 7493
Business activity: Consultant (Other)
Website: www.fusethree.co.uk

GLOBAL RISK MANAGEMENT ADVISORS, INC

Country: USA
Contact: Samuel Won
Telephone: +1 212 230 1099
Business activity: Consultant (Other)
Website: www.grmainc.com

GSO

Country: Ireland
Contact: Alan Kerr
Telephone: +353 1 436 0100
Business activity: Fund of Hedge Funds Manager
Website: www.blackstone.com

HARMONY ADVISORS LIMITED

Country: Hong Kong

continued ▸

Contact: Alex Leung
Telephone: +852 3628 2623
Business activity: Hedge Fund Manager / Adviser

HILLTOP FUND MANAGEMENT LLP

Country: UK
Contact: Trevor Simon
Telephone: +44 (0)20 7788 7799
Business activity: Hedge Fund Manager / Adviser
Website: www.hilltop.co.uk

HORIZON CAPITAL MANAGEMENT S,A

Country: Uruguay
Contact: Sebastian Roda
Telephone: +598 2 626 2210
Business activity: Hedge Fund Manager / Adviser
Website: www.horizon.com.uy

HUTCHIN HILL CAPITAL LP

Country: Hong Kong
Contact: Clare Arnold
Telephone: +852 2586 3861
Business activity: Hedge Fund Manager / Adviser

HUTCHIN HILL CAPITAL LP

Country: USA
Contact: Scott Kislin
Telephone: +1 212 757 4490
Business activity: Hedge Fund Manager / Adviser
Website: www.hutchinhill.com

INVESTMENT TECHNOLOGY GROUP LIMITED

Country: Ireland
Contact: Sharon Reid
Telephone: +353 1 633 8000
Business activity: Other Service Providers
Website: www.itg.com

INVESTOR ANALYTICS, LLC

Country: USA
Contact: Andrew Lamanno
Telephone: +1 646 553 4500
Business activity: Consultant (Investment)
Website: www.investoranalytics.com

INVESTORBIT

Country: USA
Contact: Andrew Porter
Telephone: +1 203 359 5757
Business activity: Consultant (Other)
Website: www.investorbit.com

ISAM (EUROPE) LLP

Country: UK
Contact: Jaco Wentzel
Telephone: +44 (0)20 7258 9940
Business activity: Hedge Fund Manager / Adviser
Website: www.isam.com

ITG

Country: UK
Contact: Melissa Ellis
Telephone: +44 (0)20 7670 4000
Business activity: Other Service Providers
Website: www.itg.com

ITG AUSTRALIA LTD

Country: Australia
Contact: Gaye Anable
Telephone: +61 2 9779 4600
Business activity: Other Service Providers

ITG HONG KONG LTD

Country: Hong Kong
Contact: Clare Witts
Telephone: +852 2846 3567
Business activity: Other Service Providers
Website: www.itg.com

ITG SINGAPORE LTD

Country: Singapore
Contact: Nadia Hussey
Telephone: +65 6694 8907
Business activity: Other Service Providers

K&L GATES

Country: Australia
Telephone: +61 3 9205 2000
Business activity: Legal Services
Website: www.klgates.com

K&L GATES

Country: Belgium
Telephone: +32 2336 1900
Business activity: Legal Services
Website: www.klgates.com

K&L GATES

Country: Germany
Telephone: +49 69 945 196 0
Business activity: Legal Services
Website: www.klgates.com

continued ▸

K&L GATES
Country: Hong Kong
Telephone: +852 2230 3500
Business activity: Legal Services
Website: www.klgates.com

K&L GATES
Country: Italy
Telephone: +39 02 3030 291
Business activity: Legal Services
Website: www.klgates.com

K&L GATES
Country: Japan
Contact: Matthew Prinn
Telephone: +81 3 6205 3600
Business activity: Legal Services
Website: www.klgates.com

LEVITAS CAPITAL
Country: Australia
Contact: David O'Halloran
Telephone: +61 2 8076 9545
Business activity: Hedge Fund Manager / Adviser

LIMMAT CAPITAL ALTERNATIVE INVESTMENTS AG
Country: Switzerland
Contact: Martin Pacanovsky
Telephone: +41 44 204 1919
Business activity: Hedge Fund Manager / Adviser
Website: www.limmatcapital.ch

MANAGING PARTNERS CAPITAL LIMITED
Country: UK
Contact: Gan Wyndham-Jones
Telephone: +44 (0)12 4378 5600
Business activity: Hedge Fund Manager / Adviser

MANAGING PARTNERS INVESTMENT MANAGEMENT LIMITED
Country: Cayman Islands
Contact: Nicholas Calleja
Telephone: +1 345 769 0030
Business activity: Hedge Fund Manager / Adviser
Website: www.mpinvestmanagement.com

MONT-FORT FUNDS AG
Country: Switzerland
Contact: Roman Pelka
Telephone: +41 22 508 15 47
Business activity: Consultant (Other)
Website: www.montfortfunds.com

MSCI LIMITED
Country: UK
Contact: Ajinder Banns
Telephone: +44 (0)20 7618 2000
Business activity: Risk Management Advisory
Website: www.msci.com

OLIGO SWISS FUND SERVICES SA
Country: Switzerland
Contact: Luis Pedro
Telephone: +41 21 311 1777
Business activity: Consultant (Other)
Website: www.oligofunds.ch

ORION COMMODITIES MANAGEMENT LP
Country: USA
Contact: Robert Chmiel
Telephone: +1 212 596 3492
Business activity: Hedge Fund Manager / Adviser
Website: www.orionresourcepartners.com

PARADIGM CONSULTING LIMITED
Country: Hong Kong
Contact: Tim Nicholls
Telephone: +852 2251 9081
Business activity: Public Relations
Website: www.paradigmconsilting.com.hk

PEDDER STREET INVESTMENT MANAGEMENT LIMITED
Country: Hong Kong
Contact: Lester Poon
Telephone: +852 2869 7000
Business activity: Hedge Fund Manager / Adviser

QUAY PARTNERS INVESTMENTS (UK) LLP
Country: UK
Contact: Lina Zubaite
Telephone: +44 (0)20 8144 1388
Business activity: Hedge Fund Manager / Adviser
Website: www.qpinvestments.com

REFRACTION ASSET MANAGEMENT LTD
Country: Canada
Contact: Michael Yurkovich
Telephone: +1 557 352 5071
Business activity: Hedge Fund Manager / Adviser
Website: www.refractionam.com

RISE REIT
Country: Canada
Contact: Peter Figura
Telephone: +1 604 330 0091

continued ▶

Business activity: Hedge Fund Manager / Adviser
Website: www.risepropertiestrust.com

SAGA TREE CAPITAL ADVISORS PTE. LTD.

Country: Singapore
Contact: Mandeep Tahim
Telephone: +65 6222 3631
Business activity: Hedge Fund Manager / Adviser
Website: www.sagatreecapital.com

SERONE CAPITAL MANAGEMENT LLP

Country: UK
Contact: Adrian King
Telephone: +44 (0)20 7947 4415
Business activity: Hedge Fund Manager / Adviser
Website: www.seronecapital.com

SOCIETE GENERALE NEWEDGE GROUP

Country: United Arab Emirates
Contact: Saleha Osmani-Eliard
Telephone: +971 4 704 9888
Business activity: Prime Brokerage Services
Website: www.newedge.com

SPRINGS CAPITAL MANAGEMENT (SINGAPORE) PTE LTD

Country: Singapore
Contact: Mike Curry
Business activity: Hedge Fund Manager / Adviser

STANDARD CHARTERED BANK

Country: Hong Kong
Contact: Joost Lobler
Telephone: +852 2821 1941
Business activity: Fund Administration, Accounting & Custody Services
Website: www.standardchartered.com

SUNGARD

Country: USA
Contact: Ryan Maloof
Business activity: Consultant (Other); IT/Systems/Software Services
Website: http://sungard.com/assetmanagement

SUNGARD (AUSTRALIA)

Country: Australia
Contact: Rod Dew
Telephone: +61 2 8224 0080
Business activity: Consultant (Other); IT/Systems/Software Services
Website: www.sungard.com

SUNGARD (CANADA)

Country: Canada
Contact: Mohsen Namazi
Business activity: Consultant (Other); IT/Systems/Software Services

SUNGARD (DUBAI)

Country: United Arab Emirates
Contact: Ghassan Taleb
Business activity: Consultant (Other); IT/Systems/Software Services

SUNGARD (HONG KONG)

Country: Hong Kong
Contact: Ross D'Arcy
Telephone: +852 2530 1404
Business activity: Consultant (Other); IT/Systems/Software Services

SYSTEMATICA INVESTMENTS GP LIMITED (GENEVA)

Country: Switzerland
Contact: J Coyras
Telephone: +41 22 583 5700
Business activity: Hedge Fund Manager / Adviser
Website: www.systematica.com

THE ECU GROUP PLC

Country: UK
Contact: André de Klerk
Telephone: +44 (0)20 7399 4600
Business activity: Hedge Fund Manager / Adviser
Website: www.ecugroup.com

THOMSON REUTERS

Country: Australia
Contact: James Land
Business activity: IT/Systems/Software Services

THOMSON REUTERS

Country: UK
Contact: Harjinder Rai
Telephone: +44 (0)20 7250 1122
Business activity: IT/Systems/Software Services
Website: www.thomsonreuters.com

THOMSON REUTERS HONG KONG LIMITED

Country: Hong Kong
Telephone: +852 2520 3688
Business activity: IT/Systems/Software Services
Website: www.thomsonreuters.com

continued ▶

THOMSON REUTERS SINGAPORE

Country: Singapore
Contact: Oliver Otto
Telephone: +65 6403 5555
Business activity: IT/Systems/Software Services
Website: www.thomsonreuters.com

THOMSON REUTERS USA

Country: USA
Contact: John Stewart
Telephone: +1 646 223 4000
Business activity: IT/Systems/Software Services
Website: www.thomsonreuters.com

THREE ARROWS CAPITAL PTE. LTD

Country: Singapore
Contact: Cliff Hartono
Telephone: +65 6780 4830
Business activity: Hedge Fund Manager / Adviser
Website: www.threearrowscap.com

TRIBECA TECHNOLOGY LIMITED

Country: UK
Contact: Simon Foster
Telephone: +44 (0)80 0012 2225
Business activity: IT/Systems/Software Services
Website: www.tribeca-it.com

TURTLE CREEK ASSET MANAGEMENT INC

Country: Canada
Contact: Andrew Doman
Telephone: +1 416 363 7400
Business activity: Hedge Fund Manager / Adviser
Website: www.turtlecreek.ca

VERNO CAPITAL

Country: Switzerland
Contact: Karen Clarke
Telephone: +41 55 417 45 90
Business activity: Hedge Fund Manager / Adviser
Website: www.verno-capital.com

VERNO CAPITAL

Country: USA
Contact: Allison Cummins
Telephone: +1 646 412 5770
Business activity: Hedge Fund Manager / Adviser
Website: www.verno-capital.com

VERNO CAPITAL UK LLP

Country: UK
Contact: Lisa Hall
Telephone: +44 (0)20 3709 3041
Business activity: Hedge Fund Manager / Adviser
Website: www.verno-capital.com

WEI CAPITAL MANAGEMENT LIMITED

Country: Hong Kong
Contact: Jennifer Hsieh
Telephone: +852 3706 8870
Business activity: Hedge Fund Manager / Adviser

WILLIS BAHRAIN

Country: Bahrain
Contact: Paul Tolfrey
Business activity: Insurance Services

WILLIS CZECH REPUBLIC

Country: Czech Republic
Contact: Doug Pritchard
Business activity: Insurance Services

WILLIS HUNGARY

Country: Hungary
Contact: Laszlo Biro
Business activity: Insurance Services

WILLIS POLAND

Country: Poland
Contact: Kate Baczek
Business activity: Insurance Services

WILLIS SAUDI ARABIA

Country: Saudi Arabia
Contact: Bryan Dorner
Business activity: Insurance Services

WILLIS SOUTH AFRICA

Country: South Africa
Contact: Vincent de Charnace
Business activity: Insurance Services

WILLIS UAE

Country: United Arab Emirates
Contact: James Johnston
Business activity: Insurance Services

WILSON WILLIS MANAGEMENT LIMITED

Country: UK
Contact: John Willis
Business activity: Conference Organiser
Website: www.wilsonwillis.com

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Head Office:
The Alternative Investment Management Association Ltd
2nd Floor, 167 Fleet Street, London, EC4A 2EA
Tel: +44 (0) 20 7822 8380
Email: info@aima.org

aima
Alternative Investment Management Association
www.aima.org

Contact us

AIMA Head Office
167 Fleet Street, London EC4A 2EA, UK
+44 (0)20 7822 8380
info@aima.org

AIMA in the USA
230 Park Avenue, 10th Floor, New York, NY 10169, USA
+1 646 397 8411
mnoyes@aima.org

AIMA Hong Kong
Unit 1302, 13/F, 71-73 Wyndham Street, Central, Hong Kong
+852 2526 0211
hongkong@aima.org

AIMA Singapore
12 Marina View, #21-01 Asia Square Tower 2, Singapore 018961
+65 6535 5494
singapore@aima.org

AIMA Australia
GPO Box 3989, Sydney, NSW 2001, Australia
+61 (0)4 1222 4400
mgallagher@aima-australia.org

AIMA Canada
Suite 504 - 80 Richmond Street West, Toronto, Ontario, M5H 2A4, Canada
+1 416 453 0111
jburron@aima-canada.org

AIMA Cayman
cayman@aima.org

AIMA Japan
c/o G-MAC, #3 Div., ICS Convention Design, Inc., Chiyoda Bldg.,
1-5-18 Sarugaku-cho, Chiyoda-ku, Tokyo 101-8449, Japan
+81 3 3219 3644
aimajapan@ics-inc.co.jp

aima

Alternative Investment
Management Association

www.aima.org