AIMA JOURNAL

AIMA

FCA issues final rules for marketing cryptoassets in the UK
Dechert LLP

Driving portfolio returns with tax-efficient investing
SS&C Technology

SFDR implementation: More answers. More questions?
Clifford Chance

and more...

Edition 135 |Q3 2023 | aima.org

Contents

03 **The Long-Short, Perspectives:**
Industry leaders on the future of the hedge fund industry

04 **Message from AIMA's CEO Jack Inglis**

05 **AIMA Events**

06 **Help for Children: 17th annual London charity ball**

07 **K&L Gates**

08 **Citco**

09 **Trend-following: A different point of skew -** *Man AHL*

15 **A shifting landscape: Recent trends shaping the European hedge fund industry -** *KPMG in Ireland*

19 **FCA issues final rules for marketing cryptoassets in the UK -** *Dechert LLP*

25 **SFDR implementation: More answers. More questions? -** *Clifford Chance*

29 **Growth companies and MiFID II: The painkiller prescription nobody saw coming -** *ACA Group*

33 **Joint ventures: Is your fund caught under the UK AIFMD? -** *Norton Rose Fulbright LLP*

38 **Regulatory guidance on fund costs** - *Clerkin Lynch LLP*

41 **Driving portfolio returns with tax-efficient investing -** *SS&C Technology*

44 **Achieving T+1 multi-party reconciliation through automation of the reconciliation process -** *Metaframe Technology Solutions*

47 **Prime brokerage: Why a high touch service is critical for fund managers -** *TD Cowen*

50 **Enhanced data and technology infrastructure no longer nice-to-have -** *State Street*

54 **CSRC issued the Measures for the Supervision and Administration of Derivatives Trading (consultation paper) - A possibly new era for PRC offshore derivative transactions -** *Simmons & Simmons*

58 **Recent Cayman Islands regulatory developments -** *Maples Group*

63 **New corporate governance framework for Cayman managers and funds -** *Carey Olsen Singapore LLP*

69 **Publication plan 2023**

70 **Contact us**

The Long-Short

Podcast

AIMA

aima.org

Seth Fischer
CIO and Founder
Oasis Management

Ken Tropin
Chairman and Founder
Graham Capital Management

PERSPECTIVES

Industry leaders on the future of the hedge fund industry

Anthony Todd
CEO and Co-Founder
Aspect Capital

Robert Koenigsberger
Founder, CIO
and Managing Partner
Gramercy Funds Management

Mark Wong
Co-CEO, COO and CRO
Dymon Asia

KPMG

Message from AIMA's CEO

This latest edition of the AIMA Journal is a welcome and timely reminder of the important regulatory and policy challenges that AIMA and its members must grapple with.

Nowhere is this more true than in the United States. As we go to press, the adoption of the SEC Private Fund Adviser Rules has necessitated AIMA to join an industry-wide coalition of business trade associations to file suit against the SEC to protect our industry against these unlawful changes. No doubt, this topic will be revisited multiple times in future editions of this journal, and we look forward to sharing these with you.

Multiple contributors note that MiFID II, SFDR and AIFMD are among the long-standing European regulatory issues that are going through revisions and require attention. The UK is very active in advancing its distinct post-Brexit regulatory environment, and as one contributor outlines, one area of particular focus is the development of a regulatory regime for the cryptocurrency market.

Elsewhere in this edition, other important jurisdictions such as the Cayman Islands continue to refine their rules and frameworks for our industry.

This edition is not exclusively focused on regulation however and readers are encouraged to discover what contributors have to say on other evergreen issues for alternative investment funds including operational efficiencies and optimal relationships with service providers. As all these issues, and a host of others, play out around the world where AIMA remains fully committed to serving our global members in their respective regions.

Finally, I would like to draw your attention to a guest piece by Help for Children, the charity formed within our industry and one that it is my privilege to chair. which highlights its progress in its mission to prevent and treat child abuse. The piece explains how you can help by sponsoring and attending this year's UK charity ball in November. I along with many of my AIMA colleagues will be in attendance and we hope to see you there

Sincerely,

Jack Inglis
CEO, AIMA

HELP FOR CHILDREN
—UNITED KINGDOM— Prevent & Treat Child Abuse

PRESENT THE 17TH ANNUAL LONDON CHARITY BALL

6.30PM THURSDAY. NOVEMBER 16TH, 2023

ONE MARYLEBONE, LONDON

All proceeds from this event will support HFC grants to the most effective child abuse prevention and treatment programs in the UK. For further information, please contact fgray@hfc.org or lfisher@hfc.org or visit hfc.org/events.

Worldwide, it is estimated that 40 million children are subject to some form of abuse each year. Help For Children UK is a charity that funds life-changing projects to support the children who have been victims of that abuse.

HFC is a partner charity to the alternative investment industry, raising funds around the world to combat child abuse and fund programmes to help those who have already been affected. Globally, HFC has raised over US$58 million for projects which have transformed the lives of over a million young people and children.

We have a motto: One Industry, One Mission. Together we can make a significant difference to support children in need through our grantees. Academic and social welfare experts from renowned universities and institutions provide consultation throughout the grant process to guide the HFC boards. Funds raised in each HFC location are granted out locally within that community. HFC has a local impact with a global footprint.

The charities we support in the UK help both prevention and treatment of child abuse. The abuse and neglect of children is a global problem with serious lifelong consequences, cutting across all socio-economic, racial, and religious lines. Child abuse causes suffering to children and families; it can result in conditions that are associated with both physical and mental health including disruptions in early brain development, nervous and immune systems, and increases risk for behavioural, physical and mental health problems in adulthood.

HFC UK supports a number of charities, including supporting young girls at risk of sexual abuse, children at risk of gang affected behaviours or abuse, providing safe spaces for children who need protection from both family members and others, and children who are already victims of violence and sexual abuse. You can see our list of supported charities at www.hfc.org.

We can only continue to provide the essential and life changing support to children by relying on the generous donations made by members of the alternative investment industry. Please join us in November at what promises to be evening to remember. If you can't join us in November but would still like to get involved in fund raising for HFC UK, please get in touch! We run events throughout the year and are always open to new ideas to continue to raise the much-needed funds to support children in their hour of need.

Please contact Fern Gray at fgray@hfc.org for more information.

Graham Robertson
Head of Client Portfolio Management
Man AHL

Rupert Goodall
Client Portfolio Manager
Man AHL

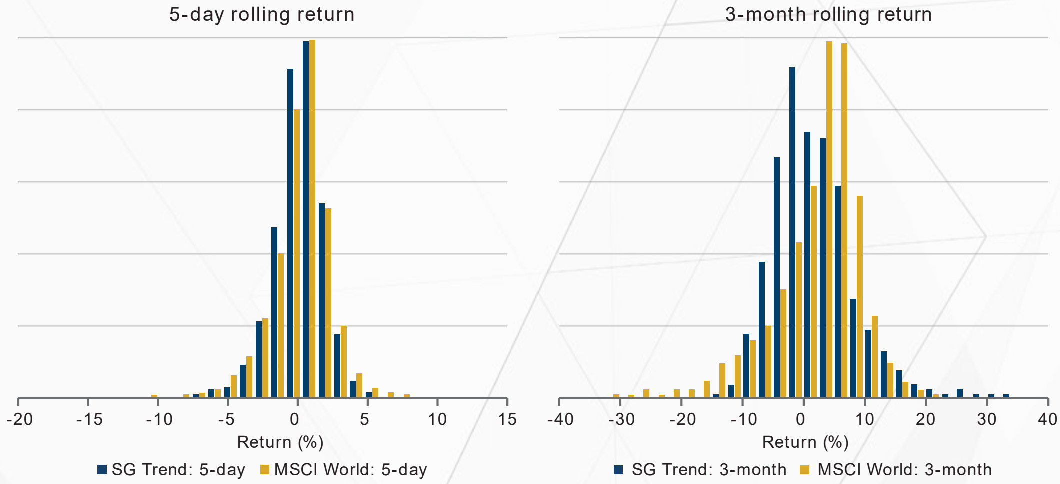
Trend-following: A different point of skew

In [Trend-Following: What's Not To Like?](), we observed that trend-following performs as well as equities in the long term, is lowly correlated, has better risk-management properties, and generally works well when equities don't. In other words, trend-following and equities get you to the same place in the long term, but take different routes to get there. In this article, we examine the different characteristics of these routes in two ways; first, in terms of the distribution of returns; and second, how sudden market reversals and losses for trend-following strategies – such as those observed in March 2023 around the Silicon Valley Bank (SVB) crisis – fit into the narrative.

Trend-following: A different point of skew

Figure 1 below depicts the distribution of returns of trend-following strategies and equities. We use the SG Trend Index, which comprises returns from 10 trend-following managers and for which we have daily data since 2000, and MSCI World equities.

Figure 1. The distribution of returns of world stocks and trend-following over different time periods



	Period	Mean	Median	Mode*	Skewness
SG Trend	5-day	+0.1%	+0.3%	+0.4%	-0.7
MSCI World	5-day	+0.2%	+0.4%	+0.7%	-0.7
SG Trend	3-month	+1.6%	+0.8%	-1.5%	+1.0
MSCI World	3-month	+2.0%	+3.4%	+4.7%	-1.0

Source: Man Group and Societe Generale; January 2001 to June 2023.
Note: World stocks represented by MSCI World Net Total Return Hedged USD.

**Mode is an estimation based on the peak of the probability density function (PDF) of the distribution, which is approximated using a Gaussian kernel density estimator (KDE) . Past performance does not guarantee future results.*

The financial instruments mentioned are for reference purposes only. The content of this material should not be construed as a recommendation for their purchase or sale.

The charts on page 9 illustrate that on a weekly basis:

- The returns of trend-following strategies have similar characteristics to stocks;
- Returns peaks are similar, with a visibly fat and long left tail.

A time horizon of one week is much smaller than the trend-sensitivity of trend-following strategies, which span 2-6 months to our knowledge. As a result, over this timeframe, a trend-following strategy does not have enough time to react significantly to changes in markets.

As a point of comparison, we choose a 3-month window which should allow ample time for a trend-following strategy to react to changing market conditions. This time period also has the benefit of aligning with the quarterly rebalancing cycle typically followed by investors in the manager selection and allocation process. Over this longer horizon, we observe quite different characteristics:

- Large losses from equity strategies are much more frequent than those from trend-following. The left tail of the equities distribution, in yellow, is significantly larger than that of trend-following;
- Large positive trend-following returns are more prevalent than in equity markets. The right-tail of the trend-following distribution is larger than that of equities;
- The most frequently observed 3-month return in equities is larger than that of trend-following. However, the mean 3-month returns are similar.

Of course, we are just describing skewness. Over a long enough timeframe, trend-following returns are positively skewed, while equity returns are negatively skewed. With trend-following, mean > median > mode, while for equities it is the other way around.

Unlike the case for weekly returns, the intuition behind a positively skewed distribution for trend-following returns over a 3-month horizon is that trend-followers have time to react. Profits are run as a trend develops. Positions are quickly cut as the strategy shuts itself down when a trend reverses and losses are experienced. We can examine this more detail by considering performance of trend-following strategies around the SVB crisis earlier this year.

Case study: SVB crisis

Kahneman and Tversky (1979) point out that it is human nature to experience more pain from a loss than pleasure from a gain. Only natural, then, that we focus on the left tail of our distribution in a little more detail. We use the market events surrounding the collapse of SVB and the contagion to Credit Suisse as a case study.

The SVB news caused an initial flight-to-quality effect. Risk assets fell – world stocks dropped 3.6% between the 8 and 13 March. However, the immediate move was in short-dated fixed income: on 9 March, US 2-year Treasury bond yields fell the most on in more than 30 years. By the end of the month, however, stocks had regained their poise and finished 2.6% higher.

Over a long enough timeframe, trend-following returns are positively skewed, while equity returns are negatively skewed.

With trend-following, mean > median > mode, while for equities it is the other way around.

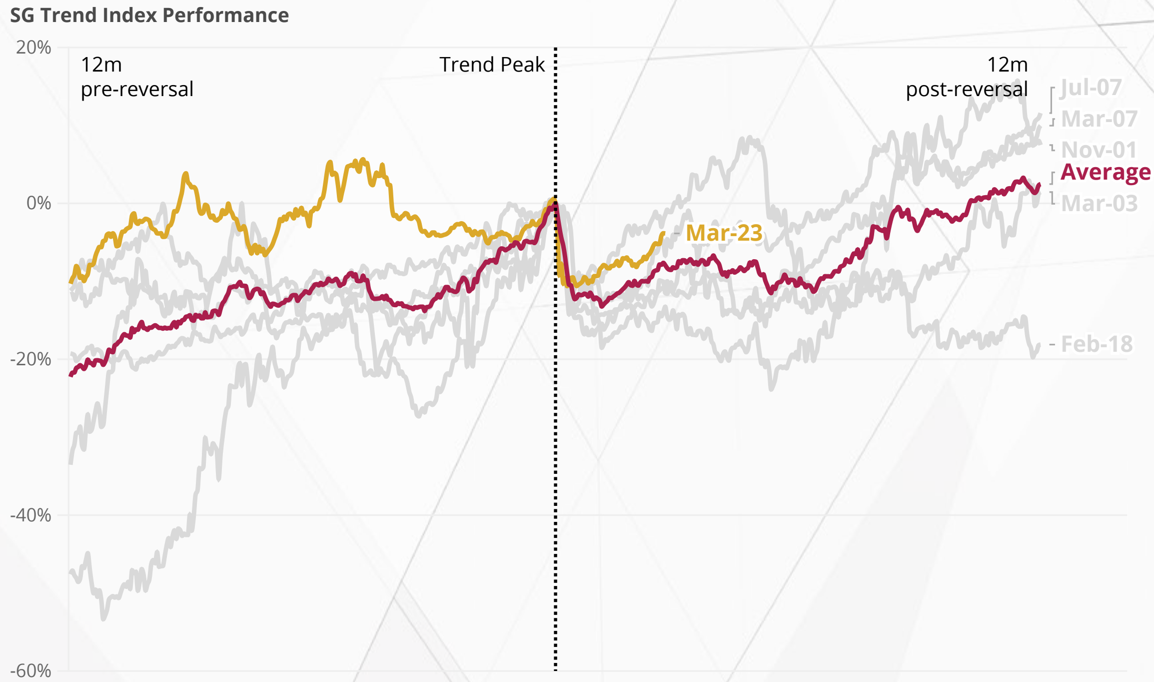
Indeed, by the end of the first quarter, equities were up 7.7% on the year. [1]

Multi-asset investors, including classic 60/40 and risk parity portfolios, were largely oblivious to this turmoil. What was lost in equities was broadly made up for in bonds. Trend-following strategies, on the other hand, were hit hard. The market moves around SVB were counter to the prevailing trend. Equities had been rising and bonds falling, so trend-following strategies were long equities and short bonds, and therefore positioned precisely the wrong way for a flight-to-quality event.

We've previously spoken about how trend-following's losses in the week or so following SVB were on a par with the worst episodes for trend-following.[2] Figure 2 shows the five worst weekly returns for the SG Trend Index post 2000, aligned at the start of the loss, and showing performance in the 12 months both before and after. The findings can be summarised as follows:

1. By definition, reversals happen at the end of a trend;
2. Trend-followers incur losses at this point (if you don't, you're not a trend follower);
3. Trend-followers generally lose less in the reversal than they make in the preceding trend;
4. Losses around the reversal are contained, because the reversal leads the strategy to shut its positions down;
5. Trends typically re-emerge after the reversal, and trend-following strategies make up for losses within six to 12 months.

Figure 2. Trend-following returns 12 months pre- and post-reversal



Source: Man Group, Societe Generale; 1 January 2000 to 30 May 2023.
The periods shown are exceptional and the results do not reflect typical performance.

1 Source: Bloomberg
2 Measured by more than two decades of daily data available for the SG Trend Index, which represents 10 trend-following managers.

At the time of writing, it appears that the performance of the SG Trend Index post SVB is playing out somewhat according to the historic script (as illustrated by the yellow line in Figure 2, page 11).

Sudden market shocks like those around SVB often bring into question trend-following's 'crisis alpha' credentials: its convexity profile or skewness. Aren't trend-following strategies supposed to protect on the downside, and have larger positive returns than negative? As we discussed in the previous section, the answer lies in the period over which we want protection. In short, when the duration of a market move is measured in days – a shock event like SVB – the profitability of a trend-follower is a lot like the toss of a coin. A trend-follower could be positioned correctly or incorrectly.

The strategy has little time to react, and the distribution of returns can be quite left-tailed, as per Figure 1, page 9. When market moves are sustained, however, lasting weeks to months, then this is more consistent with the duration of trends and the strategy's positions have time to react accordingly.

What we see in Figure 2 is a good example of how, consistent over time, trend-following strategies are able to cut off that left tail by shutting down positions and going into wait-and-see mode. If the selloff continues, trend-following strategies are potentially able to migrate to short beta positions and turn losses into gains. If the selloff does not materialise, the trend-following strategy may resume its old positions. In contrast, without intervention, a long equities position will continue to generate losses if the environment continues to deteriorate.

Improving skewness

Intuitively, we can improve a trend-following strategy's responsiveness to a crisis by trading faster, by looking for shorter-length trends. We investigated this in "The Need for Speed in Trend-Following" and found that increasing trend responsiveness, or 'speed', did indeed improve skewness albeit at the expense of longer-term returns. Nevertheless, if the goal of allocating to a trend-following strategy is to sit alongside a beta portfolio for 'insurance', then a faster implementation is potentially better. In simple terms, a faster trend-follower can cut losing positions quickly, or even turn short quickly in the event of a crisis.

Drawdowns are another way of making the same point. Figure 1 tells us that there is a much higher probability of a large loss for an equity strategy relative to a trend-following strategy on a 3-month basis. Depending on how these losses follow each other, larger drawdowns might be expected from equities relative to trend-following. Indeed, trend-following strategies perform almost as well as equities in the long term, yet their drawdown is one-third that of equities (which have lost half their value not once, but twice, since the turn of the century; see "Trend-Following: What's Not to Like").

Conclusion

We have concentrated on the comparison between trend-following strategies and equities in this article. Indeed, it is our experience that this is the way investors look at it as well. But trend-following isn't just about equities. As we showed in "The Need for Speed in Trend-Following Strategies", trend-following's crisis alpha properties originate from all asset classes, not just equities.

The SVB crisis (and history) show that losses experienced by trend-following strategies during reversals are well constrained. This is because the strategy shuts itself down whenever it experiences losses; trend-following is an inherently risk-managed strategy. A change in the trend – often accompanied by a rise in volatility – means that positions are naturally cut, losses are truncated, drawdowns are reduced and the strategy prepares for whatever trends subsequently emerge.

Bibliography

- *Mackic, A. (2023), "The Need for Speed in Trend-Following Strategies", Man Institute, Available at: https://www.man.com/maninstitute/need-for-speed-trend-following*
- *Goodall, R., and L. Kissko (2023), "Trend-following: Rolling with the punches", Man Institute, Available at: https://www.man.com/maninstitute/trend-following-rolling-with-punches*
- *Robertson, G. (2023), "Trend-Following: What's Not to Like?", Man Institute, Available at: https://www.man.com/maninstitute/trend-following-what-not-to-like*
- *Kahneman, D., & Tversky, A. (1979). "Prospect theory: An analysis of decision under risk". Econometrica, 47, 263-291.*
- *Icil molorio recuptas sectia eument.*
- *Ur rat voloratur autetur, ab ipit, qui nos doluptia quuntiundam unt eos re sam veligen iatempo ritature, tecestem vel il eum harum aspe nus ma qui alitiun totaquam ius eic tem ipsam, volor ma plaboribus exceatiis antia que nonse perum nossum id et autem harum aut duciet eum hit de dolupturios veliae nemporest deruptatius.*
- *Esecaest, omnis ent minture repella boreseque landani sitat volorio illes id quia sunt, test volo delentiunt, tenda alic te voluptatiur, consequ untiae necusa namet*

A shifting landscape: Recent trends shaping the European hedge fund industry

Gerard Duffy
KPMG in Ireland

Dermot O'Connell
KPMG in Ireland

Europe is the second-largest region for hedge fund activity across the globe, with European located managers and funds accounting for ~15% of global assets under management[1]. Despite this it has been a challenging time for the industry, with changes in the external environment impacting returns. In our view, though, the industry remains resilient with certain players capitalising on market stress conditions.

Keep reading for five key trends shaping the industry.

1. Macroeconomic environment moves the goalposts

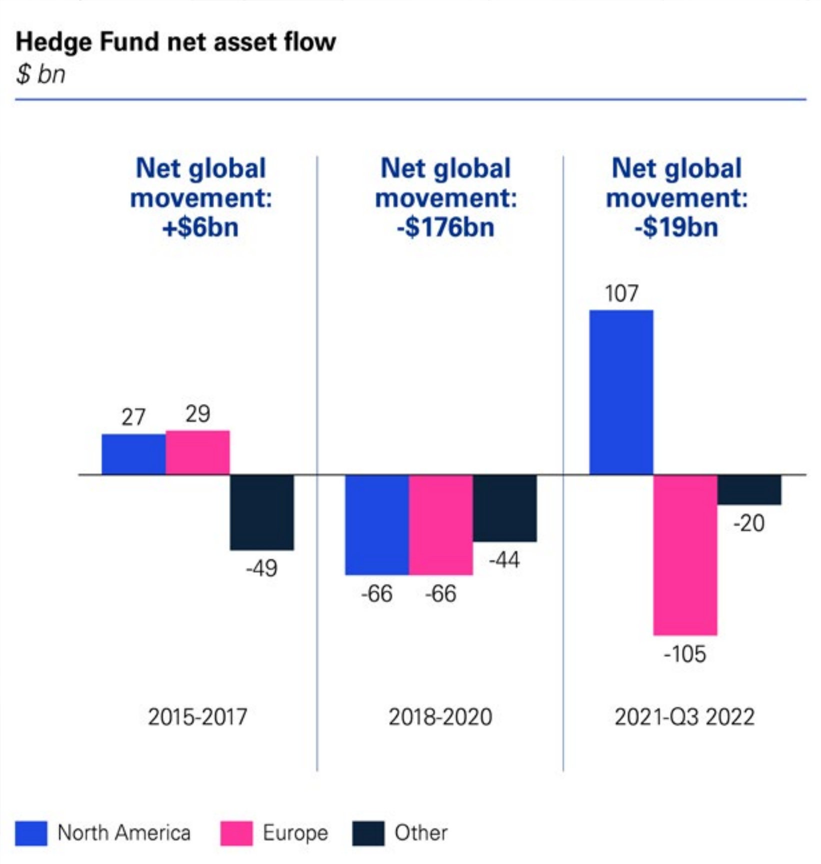
A web of macroeconomic and geopolitical factors over the past number of years has resulted in a significant shift in the economic climate, with a bear market emerging following the prolonged period of growth in the aftermath of the 2007/2008 global financial crisis. In particular, persistently high inflation has led to a rising interest rate environment that has significantly impacted the alternatives landscape, with hedge funds being no exception.

Against this background, there have been winners and losers across all hedge fund investment strategies. For example, macro strategies tended to outperform other approaches such as multi-strategy and relative value strategy approaches.

2. Capital flows and liquidations highlight challenges

Between 2015 and 2017, positive net inflows of capital into European hedge funds totalled US$29 billion. However, since 2017, there have been net outflows of US$171 billion (US$66 billion between 2018 and 2020 and US$105 billion between 2021 and Q3 2023) in response to market volatility and the rise in popularity of other asset classes such as private equity.

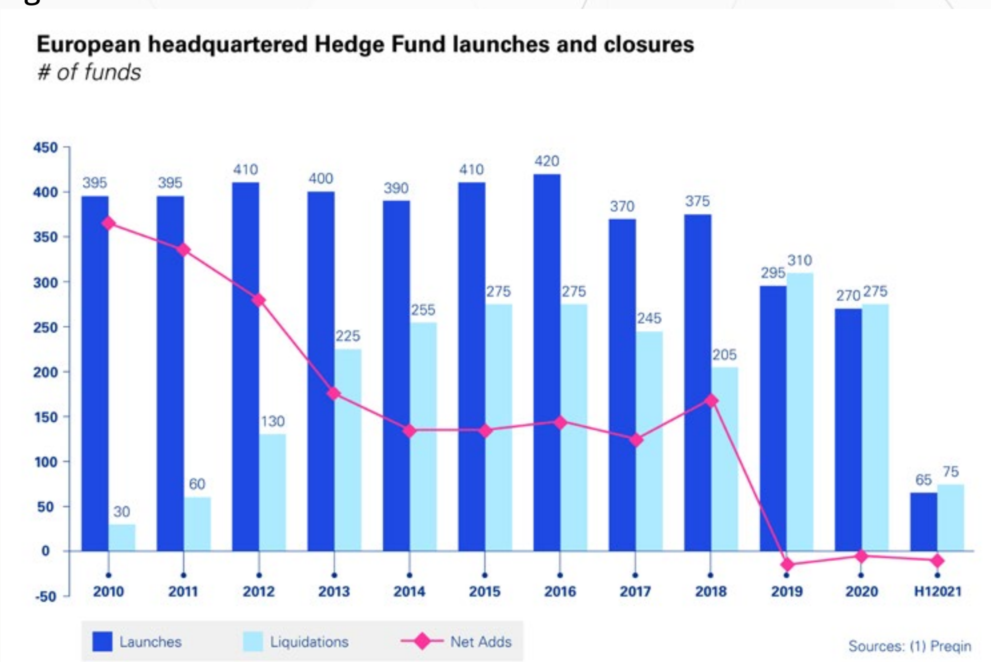
Figure 1



Other indicators of the challenges hedge funds are facing can be observed by the changes in the patterns of hedge fund launches and closures.

Between 2019 and H1 2021, liquidations of European domiciled hedge funds have outpaced fund launches, leading to an overall net decrease in the number of hedge funds. In contrast, during the long bull market run between 2010 and 2018, the number of hedge fund launches (>3,500) far outnumbered the number of liquidations (<1,750).

Figure 2



3. Investor profiles evolving

In the context of the above challenges, the profile of those investing into European-headquartered hedge funds has altered slightly in recent years, with banks now making up a larger proportion of the total investor pool in hedge funds than was previously the case.[2,3] Taking a strategy specific view, banks account for nearly one-third of the capital invested into relative value strategy funds). By comparison, pension funds and insurance companies account for 27% and 24% respectivley. In particular, multi-strategy funds have proven popular with banks, where they account for around 50% of the total investor base in these funds.[1]

4. Use of leverage (including repo) declining

One of the hedge fund industry's defining characteristics is the use of leverage compared to traditional or long-only players. However, there has also been a change in the industry in this regard. Based on latest available data at the industry level, European funds' use of leverage has decreased from 430% of Net Asset Value in 2018 to 315% in 2020, as funds showed greater caution considering broader economic challenges.[2,3]

In contrast, the equivalent figures grew from 11% in 2018 to 130% in 2020 for the alternatives market as a whole.[2,3] There has been an associated knock-on impact on hedge funds using repurchase agreements (repo) as a financing tool.

5. Regulatory evolution, not revolution

Since 2013, hedge funds domiciled in Europe have been subject to Directive 2011/61/EU of Alternative Investment Fund Managers (AIFMD). In 2021, the European Commission published proposed changes that will form the basis of AIFMD II across delegation, marketing, reporting, liquidity, and loan origination. The text is currently still subject to debate and amendment, with changes not expected to take place in the short term.

2023 to date has been challenging for the hedge funds industry, and signs point to much of the same for the beginning of 2024. But its resilience and generally positive investor sentiment bodes well for the industry overall.

This document has been drafted using material downloaded from ESMA's website ESMA does not endorse this publication and in no way is liable for copyright or other intellectual property rights infringements nor for any damages caused to third parties through this publication.

1 Source: Preqin Ltd
2 [EU Alternative Investment Funds, ESMA Annual Statistical Report 2022]
3 [EU Alternative Investment Funds, ESMA Annual Statistical Report 2021]

FCA issues final rules for marketing cryptoassets in the UK

Richard Frase
Partner
Dechert LLP

Simon Wright
Counsel
Dechert LLP

Key Takeaways

1	Financial promotions of qualifying cryptoassets are now within the scope of the UK financial promotion regime.
2	The FCA has published its final policy statement on rules for communicating financial promotions of qualifying cryptoassets and has issued guidance on compliance with these rules.
3	Qualifying cryptoassets will be treated as “restricted mass market investments” for the purposes of the FCA’s financial promotion rules.

1. The new regime

The United Kingdom Financial Conduct Authority (**FCA**) published its final policy statement in June 2023 setting out its rules for FCA-authorised firms communicating the ‘financial promotion’ of cryptoassets (**PS 23/6**). The rules in PS 23/6 come into force on 8 October 2023.

To supplement this, the FCA has also issued Guidance Consultation GC 23/1 (**GC 23/1**), which proposes guidance on how firms should comply with, the FCA’s requirement that cryptoasset financial promotions must be fair, clear and not misleading. GC 23/1 closes for responses on 10 August 2023, with final guidance likely be published in Q3 of this year.

2. Means to promote cryptoassets in the UK

As highlighted in our "Treating Crypto Fairly" OnPoint[1], the UK government has now legislated to bring financial promotions of "qualifying cryptoassets"[2] within the scope of the UK financial promotion regime.

This has been implemented by an amendment to the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the **FPO**), so that the following 'controlled activities' now include qualifying cryptoassets:

(i) dealing in securities and contractually based investments;

(ii) arranging deals in investments;

(iii) managing investments;

(iv) advising on investments; and

(v) agreeing to carry on specified kinds of activity.

The amendment to the FPO comes into force on 8 October of this year.

There will then be four routes to communicate a financial promotion in the UK relating to a qualifying cryptoasset:

(i) The financial promotion is communicated by an FCA- or PRA- authorised person.

(ii) The financial promotion is made by an unauthorised person but approved by an FCA- or PRA- authorised person.

(iii) The financial promotion is communicated by (or on behalf of) a cryptoasset business registered with the FCA under the UK Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (the **MLRs**) in reliance on the exemption in Article 73ZA of the FPO.

(iv) The financial promotion is otherwise communicated in compliance with the conditions of an exemption in the FPO.

---

1 OnPoint is available [here.]

2 A "qualifying cryptoasset" is any cryptoasset which is:

(a) fungible; and

(b) transferable.

For these purposes, the circumstances in which a cryptoasset is to be treated as "transferable" include where:

(a) it confers transferable rights; or

(b) a communication made in relation to the cryptoasset describes it as being transferable or conferring transferable rights.

A "cryptoasset" means any cryptographically secured digital representation of value or contractual rights that:

(a) can be transferred, stored or traded electronically, and

(b) uses technology supporting the recording or storage of data (which may include distributed ledger technology).

3. The new rules in PS 23/6

PS 23/6 sets out the final rules that an FCA- or PRA-authorised person must follow when communicating a financial promotion relating to qualifying cryptoassets.

(a) Qualifying cryptoassets as "restricted mass market investments"

PS 23/6 confirms that qualifying cryptoassets will be treated as "restricted mass market investments" (**RMMIs**) for the purposes of the FCA's financial promotion rules in COBS 4 *(Communicating with clients, including financial promotions)* and will be subject to the specific rules in COBS 4.12A *(Promotion of restricted mass market investments).*

As such, risk summaries and a specific risk warning will need to be included in the financial promotion if it is made available to a retail client.

Risk summaries: The risk summaries that apply to RMMIs under COBS 4.12A have been amended to include qualifying cryptoassets and to set out that consumers should not expect to be protected by the FSCS or the ombudsman service if something goes wrong.

Firms will be allowed to vary the prescribed risk summary in COBS 4.12A where they have a good reason – for example, the wording would be misleading or irrelevant. Equally, a firm can include any key investment risks that are not covered by the template risk summaries in COBS 4.12A, but it must make an adequate record of any divergence and the rationale behind any change.

Risk warnings: The mandatory risk warning that the financial promotion must contain is:

Don't invest unless you're prepared to lose all the money you invest. This is a high-risk investment, and you should not expect to be protected if something goes wrong. Take 2 mins to learn more.

(b) Banning incentives to invest

Under the existing rules in COBS 4.12.A, financial promotions for RMMIs are banned from offering any monetary or non-monetary benefits that incentivise investment activity, such as 'refer a friend' or 'new joiner' bonuses. These rules will apply to financial promotions of qualifying cryptoassets, without the current carve-out for 'shareholder benefits' from this ban (i.e., products and services produced or provided by the issuer of, or borrower under, the relevant investment).

(c) Direct offer financial promotions (DOFP)

Cooling off period rules: The FCA will apply the cooling-off period rules in COBS 4.12A to DOFPs[3] of qualifying cryptoassets to retail clients. As such, there will be a minimum 24-hour cooling-off period for first-time investors with a firm. A retail client will not be able to receive a DOFP relating to a qualifying cryptoasset unless they have reconfirmed their request to proceed after waiting at least 24 hours.

However, the cooling-off period does not apply to each individual transaction in a qualifying cryptoasset, so that the rule only applies to first-time investors with a specific firm i.e., where a consumer has not previously received a DOFP from that firm.

3 A DOFP here means a financial promotion that contains:

(a) an offer by the firm or another person to enter into a controlled agreement with any person who responds to the communication; or

(b) an invitation to any person who responds to the communication to make an offer to the firm or another person to enter into a controlled agreement and which specifies the manner of response or includes a form by which any response may be made.

Risk warnings pop-ups: The personalised risk warning rules in COBS 4 will now apply to DOFPs of qualifying cryptoassets. As such, before a DOFP can be communicated in a digital medium, the following wording must be communicated to the potential investor:

[Client name], this is a high-risk investment. How would you feel if you lost the money you' re about to invest? Take 2 min to learn more.

Client categorisation: The FCA will restrict DOFPs of qualifying cryptoassets to "restricted investors,"[4] "high net worth investors"[5] and "certified sophisticated investors."[6]

Before a DOFP can be made in relation to a qualifying cryptoasset, the investor must be categorised as falling into one of these categories, and requiring the investor to sign a declaration stating that they meet the relevant criteria. The investor declarations are only valid for a 12-month period.

Appropriateness assessments: The FCA will proceed with applying the appropriateness assessment requirements in COBS 4.12A to DOFPs of qualifying cryptoassets.

As such, before an application or order for a cryptoasset can be processed in response to a DOFP, the firm must assess the specific cryptoasset as appropriate for the consumer. This requires the firm to assess that the consumer has the necessary experience and knowledge to understand the risks involved in relation to the specific product or service offered or demanded.

(d) Record keeping requirements

The record-keeping requirements in COBS 4 relating to client categorisation and appropriateness assessments will apply to financial promotions relating to qualifying cryptoassets.

4. GC 23/1

GC 23/1 sets out draft FCA guidance regarding the following qualifying cryptoasset financial promotion scenarios:

(i) Guidance on ensuring that qualifying cryptoasset financial promotions are fair, clear, and not misleading in a way which is appropriate and proportionate.

(ii) For stablecoins and other cryptoassets whose value is linked to fiat currency, guidance on how a firm can show that it has undertaken due diligence that claims regarding stability or links to a fiat currency are capable of being fair, clear, and not misleading and genuine.

(iii) For cryptoassets that are backed by a commodity or an asset, guidance on how a firm can show that any claim of commodity or asset backing is capable of being fair, clear, and not misleading, including information on the particular model/arrangement the cryptoasset uses, proof of ownership of the underlying commodity/asset, evidence of the custodian (if any) and any further reasonably foreseeable dependencies that may significantly impact the value or volatility of the underlying asset.

(iv) For complex yield cryptoasset models or arrangements (e.g., borrowing, lending, and staking), guidance on how the advertised rates of return can be achieved, clear and prominent disclosure of any fees, default rates, commissions, or other charges, and clear and prominent disclosure of the legal and beneficial ownership of a consumer's cryptoassets once they enter an arrangement.

4 This term means, in summary, a person who has signed a statement set out in COBS 4 that they are not willing to invest more than 10 percent of their net assets in RMMIs.
5 This term means a person who meets the requirements set out in article 21 of the Promotion of Collective Investment Schemes Order, in article 48 of the FPO or in COBS 4.12B.38R.
6 This term means a person who meets the requirements set out in article 23 of the Promotion of Collective Investment Schemes Order, in article 50 of the FPO or in COBS 4.12B.39R.

GC 23/1 further emphasises that the financial promotion regime is “technologically neutral,” meaning that there is no derogation or carve out for financial promotions via social media and sets out the range of due diligence considerations a firm must consider before a financial promotion is communicated.

5. Firms registered under the MLRs

PS 23/6 also sets out which provisions of the FCA Handbook will apply to firms registered under the MLRs when communicating financial promotions in reliance on the new exemption in Article 73ZA of the FPO:

(i) Principle 7 (Communications with clients);

(ii) relevant parts of GEN (Statements about authorisation and regulation by the appropriate regulator);

(iii) COBS 4 (Communicating with clients, including financial promotions; and

(iv) COBS 10 (Assessing appropriateness).

Note that the FCA’s new “consumer duty”[7] will not apply to firms registered under the MLRs but will apply to authorised firms communicating or approving qualifying cryptoasset financial promotions.

7 OnPoint is available here.

SFDR implementation: More answers. More questions?

Paul Ellison
Partner
Clifford Chance

Maren Stadler-Tjan
Partner
Clifford Chance

Lily Marcel
Partner
Clifford Chance

Charlotte Chopping
Senior Associate
Clifford Chance

Jacqueline Jones
Knowledge Director
Clifford Chance

Implementing the EU's Sustainable Finance Disclosure Regulation (SFDR) has been a challenge for industry and regulators alike. One of the reasons for this has been a lack of clarity over the definition of 'sustainable investment' and other fundamental concepts underpinning the SFDR framework. Numerous questions have also been raised on how to apply the requirements in practice, especially as many of the rules are not fully compatible with alternatives investment strategies.

This has led to the publication by the European Commission (Commission) and the European Supervisory Authorities (ESAs) of several sets of Q&A, covering both interpretational questions, as well as answers to a whole host of questions on the practical implementation of SFDR, culminating in the publication of a consolidated set of Q&A in May 2023. However, as we highlight in this article, SFDR is still very much a moving target. Recent developments on SFDR, such as the ESAs' consultation on the SFDR Delegated Act and the upcoming evaluation of the SFDR framework, alongside developments affecting other EU sustainable finance regulations that interrelate with SFDR, particularly the Taxonomy Regulation and the Corporate Sustainability Reporting Directive, are likely to raise further important questions. The end outcome of these questions is important, as it will shape the future direction of the SFDR framework and how firms are expected to reflect these outcomes in their implementation processes.

More answers

The SFDR began to apply in March 2021. Since that date, firms' implementation projects have caused a series of interpretational questions to surface. This led to the publication of Commission Q&As on the SFDR in July 2021 and May 2022 (see our earlier briefing).

In September 2022, the ESAs submitted a further set of eight interpretational questions to the Commission. These related to:

- How to interpret the phrase 'sustainable investment';
- Products that have the objective of reducing carbon emissions;
- The nature of product-level principal adverse impacts (PAI) disclosures;
- How to interpret the 500 employee threshold that triggers mandatory PAI disclosures; and
- The frequency with which firms providing portfolio management services should publish their periodic SFDR reports.

On 14 April 2023, the Commission's responses to these questions were published. The responses emphasise the status of the SFDR as a disclosure regulation, leaving firms to determine their underlying approach to sustainability rather than mandating that approach centrally. In particular, the Commission confirms that it is for firms to determine whether investments are 'sustainable investments'. This flexibility is likely to be welcomed by firms, although leaves scope for divergence over firms' resultant approaches. The Commission therefore provides a corollary warning: firms must exercise caution when determining whether an investment is sustainable. In other words, freedom should not mean a race to the bottom in terms of determining the threshold at which an investment may be deemed sustainable.

This question, together with the Commission's responses to the remaining questions in the Q&A, are summarised in our earlier briefing.

The proposed changes to the RTS raise several important issues for the industry, particularly those relating to social PAI indicators, treatment of derivatives, DNSH, GHG emission reduction targets and simplification of the templates.

More questions?

More questions on SFDR implementation are likely to arise in the future, as publication of the Commission's Q&A has occurred against a backdrop of continuing SFDR developments, the consequences of which are still playing out.

The first of these developments was the ESAs' public consultation on potential changes to the SFDR Delegated Regulation. Published two days prior to the publication of the Commission's Q&A, the ESAs' proposals aim to broaden the disclosure framework and address the main technical issues that have emerged in implementing SFDR. They include:

- Extending and enhancing the list of social indicators for PAIs;
- Refining the content of some of the other indicators for adverse impacts and their respective definitions, applicable methodologies, metrics and presentation;
- Making amendments regarding GHG emissions reduction targets;
- The potential introduction of more specific disclosure requirements regarding DNSH under PAIs for sustainable investments, to increase transparency and support some degree of comparability;
- Extensive changes to the recently finalised reporting templates; and
- Making other technical adjustments to the RTS as regards the treatment of derivatives.

The proposed changes to the RTS raise several important issues for the industry, particularly those relating to social PAI indicators, treatment of derivatives, DNSH, GHG emission reduction targets and simplification of the templates. Firms will be watching closely the approach ultimately taken by the ESAs in these areas. Many of the questions have arisen because of ongoing developments in other EU workstreams that impact the SFDR framework. Notable among these is the phased implementation of the Corporate Sustainability Reporting Directive (EU) 2022/2464) (CSRD) and finalisation of the European Sustainability Reporting Standards (ESRS) upon which the Commission issued a Consultation Paper in June 2023. These affect the availability of data that is needed for SFDR reporting.

In particular, the introduction of 'materiality assessments' in the ESRS for data needed for mandatory SFDR PAI disclosures adds to the 'data challenge' already faced by the industry, where data quality and availability is an important issue, particularly for non-equity asset classes.

This problem extends beyond the EU, where different reporting standards would apply and where data on investments is not necessarily collected or comparable, as is the case for some of the data needed for the new social indicators, for example. The ESAs will deliver their final report on the draft RTS to the Commission by the end of October 2023, so at the moment it is not clear what changes to the RTS will be made.

A further complication is that the Commission and ESAs' Q&A are not necessarily the only sets of guidance that firms need to be aware of. Some national regulators, including the CSSF, have issued their own guidance and on 10 July 2023, the German financial services regulator, BaFin, announced a supplement to its own Q&A on SFDR and issued detailed guidance on the related RTS.

BaFin supplementary Q&A on SFDR and guidance on the SFDR RTS

BaFin has announced a supplement to its Q&A on SFDR and issued detailed guidance on the related regulatory technical standards.

BaFin notes that the SFDR contains certain undefined legal terms that financial market participants and financial advisors have found difficult to interpret in practice. In its Q&A, BaFin addresses questions on the practical implementation with respect to the SFDR and RTS that are not covered in the SFDR questions answered by the EU Commission, or in the RTS questions answered by the ESAs. BaFin has now supplemented the existing five Q&A by clarifying issues on product related templates in Annex II and III of the RTS. Together with the Q&A supplement, BaFin has published detailed guidance on these templates.

Unless a dissenting assessment on these questions is published by either the Commission or the ESAs, BaFin will base its administrative practice on the legal interpretations set out in its updated Q&A.

The second significant development which has raised many questions in the industry is the upcoming evaluation of the wider SFDR framework, due to commence in the Autumn of 2023. This will focus on assessing shortcomings in the SFDR framework to improve legal certainty, enhance usability, and improve effectiveness in tackling 'greenwashing'. The review may lead to a legislative proposal, something the industry will be watching closely, given that they will be formalising their SFDR implementation with the prospect of changing regulatory expectations on the horizon.

As well as questions concerning the future direction of the SFDR framework, whether it moves towards a labelling regime for example, many concerns have been raised about the prospect of further wide-ranging changes. These are due to the compliance costs involved and a desire to avoid a series of ongoing changes over the next few years, given the SFDR review is coming so soon after the ESAs' consultation.

With so many concurrent developments, SFDR is still very much a moving target, and there remains uncertainty in many important areas. What is certain, however, is that firms are likely to have many more questions in the coming months, as they continue to grapple with their SFDR implementation projects and the challenges of implementing sustainable finance regulations more broadly.

SFDR – upcoming developments

	2023		2024				2025	
Development	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**
EU SFDR	ESMA final guidelines on fund names expected Q3 2023.	Commission consultation on assessing the SFDR expected in Autumn 2023. ESAs to report to Commission on PAI and financial product disclosures by 28 November 2023.		ESAs expected to provide final reports to European Commission on greenwashing risks and supervision of sustainable finance in May 2024.				

SFDR

The Sustainable Finance Disclosure Regulation (SFDR) sets out harmonised rules on disclosures to investors regarding the integration of sustainability risks and the consideration of adverse sustainability impacts in investment decision-making and investment advice.

Whilst many of SFDR's provisions began to apply in 2021, staggered implementation deadlines and the development of underlying technical standards have meant that firms' implementation projects have continued long past this date.

Read our in-depth briefings on this development here and here.

What's on the horizon?

- A delegated regulation incorporating nuclear and gas disclosures into SFDR disclosures has applied from 20 February 2023.
- In April 2023, the ESAs launched a consultation on amendments to the RTS on content and presentation of principal adverse impact (PAI) and product disclosures. The consultation closed on 4 July 2023 and the ESAs are expected to report to the Commission by 28 November 2023.
- The Joint Committee of the ESAs published a consolidated set of Q&As on the SFDR and SFDR RTS on 18 May 2023.
- The Commission was due to evaluate the SFDR by 30 December 2022. In June 2023, the Commission announced, as part of its Sustainable Finance Package, that a consultation on assessing the SFDR will be launched in Autumn 2023. The focus will be on assessing shortcomings in the SFDR to improve legal certainty, enhancing usability and improving the legislation's role in mitigating greenwashing
- In November 2022, the ESAs launched a Call for Evidence on greenwashing. Each of the ESAs delivered a progress report on 1 June 2023, with final reports to be delivered in May 2024.
- The ESAs are due to report to the Commission on best practices relating to voluntary disclosures annually, by 10 September of each year. The next report is due by 10 September 2023.
- EMSA ran a consultation between November 2022 and February 2023 on guidelines on funds' names using ESG or sustainability-related terms. It expects to issue final guidelines in Q3 2023.

Growth companies and MiFID II: The painkiller prescription nobody saw coming

Dan Campbell
US Regulatory Advisory
ACA Group
Email Dan Campbell

Jaqi Hummel
Director of thought leadership
ACA Group
Email Jaqueline Hummel

Charlotte Longman
Director, UK Regulatory Advisory
ACA Group
Email Charlotte Longman

Andrew Poole
Director, UK Regulatory Advisory
ACA Group
Email Andrew Poole

The Markets in Financial Instruments Directive (MiFID II) is not a new regulation, it is not even a new iteration of a regulation, but aspects of this European directive, particularly the 'unbundling' of research from execution services, are like a headache that won't go away. A major contributor to this pain is the different treatment of payments for research on either side of the Atlantic.

In October 2017, the US Securities and Exchange Commission (SEC) provided a painkiller ahead of the 2018 implementation of MiFID II, by issuing a "no-action" letter allowing US broker-dealers to provide investment research to European Union (EU) domiciled clients in return for 'hard dollars', without having to register as investment advisers.

In late 2019, an additional dose of painkiller was administered as this no-action relief was extended for a further three years, setting the expiration date of 3 July 2023. As the UK and the EU look to invigorate investment into growth companies, however, further painkillers may no longer be necessary.

There has been a lot of press about the lack of investment from UK sources in UK growth companies recently, including the trend of firms listing on US exchanges rather than the London Stock Exchange. While somewhat embarrassing for the UK Government, Chancellor Jeremey Hunt addressed these concerns in his recent Mansion House speech. He unveiled reforms to the UK pension scheme sector, aimed at unleashing an estimated £75 billion in investments into UK Unlisted Equity. This includes an agreement with the nine largest defined contribution (DC) pension scheme providers, covering roughly 75% of the DC schemes, to increase their allocation to unlisted equities from 1% currently to at least 5% by 2030.

To further support this investment, and bringing us back to the MiFID II painkillers, the UK will also continue to reform its approach to the inducement rules brought into force through the regulation.

Having already declared that research across the Fixed Income, Currency and Commodities (FICC) sector, along with SMEs (small, medium, enterprises) with a £200 million market capitalisation, would be exempt from the FCA inducement rules, the Chancellor announced the UK Financial Conduct Authority (FCA) would start immediately engaging with the market to remove the 'unbundling' requirements. He noted that the Government had accepted the recommendations of Rachel Kent's UK Investment Research Review, which include allowing asset managers to pay for research out of their own resources, charge clients directly, or combine the cost of research with execution charges, which was allowed prior to MiFID II.

In an entirely coincidental quirk of timing, the EU is also looking at 're-bundling' research in an effort to invigorate investments. As mentioned, the UK set a market capitalisation at £200 million when amending the inducement rules. The EU, however, went a little further, establishing the threshold of €1 billion market capitalisation as the limit above which the inducement rules would still be in effect.

As part of amendments proposed in December 2022, market capitalisation is set to be increased to €10 billion and would be applicable at the pre-IPO stage. Both the EU and the UK argue that removal of the unbundling requirements is essential to ensure that in-depth, quality research is more readily available and thus provide greater access to the capital markets for SMEs looking for funding. With the recent increases in cost of debt funding, this in turn may provide cheaper financing to smaller cap and growth companies.

The US regulatory framework, in direct contradiction to the general European trend, has never been particularly concerned about including research and execution services as a package. Indeed, under US law, a broker-dealer who receives separate hard dollar payments for research could be deemed an investment adviser and required to register with the SEC as such, subjecting them to yet another set of regulations under the Advisers Act. And so, the MiFID II headache was brought on for US Broker-Dealers engaging with firms caught under the European directive.

Though the adjustments made by the FCA and UK alleviated the headache slightly in 2022, a speech by William Birdthistle, director of the SEC Division of Investment Management in July 2022, did not provide too much additional comfort. He said the "Division does not intend to extend the temporary position beyond its current expiration date in July 2023," setting the clock ticking towards the 3 July deadline.

While some broker-dealers dealt with the issue by becoming dually registered or using a registered adviser affiliate to provide research services, these options may not have been palatable, or even possible, for some. Generally, most US broker-dealers believe that registering as an investment adviser is not a viable solution to the conflicts of interest challenges that they would face under the US Investment Advisers Act of 1940 in connection with the MiFID II unbundling requirement.

The only other practical option would be to shift hard dollar payments to an affiliated, but separately organised business entity in the UK for non-US clients, to comply with regulations

Both the EU and the UK argue that removal of the unbundling requirements is essential to ensure that in-depth, quality research is more readily available and thus provide greater access to the capital markets for SMEs looking for funding.

enacted under MiFID II, while also segmenting soft dollar payment operations in the US affiliate for the benefit of US clients. However, this approach could raise questions about the extraterritorial application of US law that may limit the availability of US advice. Overall, there is a concern that the expiration of the no-action relief will put US broker-dealers at a competitive disadvantage to their non-US peers and to US peers with a European presence.

3 July came and went and with it the expiration of the "no-action" letters. It is noteworthy that SEC Commissioner Mark Uyeda issued a public statement shortly afterward describing his disappointment that the SEC did not extend the no-action relief for a modest additional time period to accommodate the potential changes, highlighting the possible challenges this will create for US broker-dealers to provide research to asset managers subject to MiFID II.[1]

[...] The SEC's refusal to extend this relief has drawn criticism from the markets and there appears to be an overwhelming desire for it to be extended indefinitely.

Though potential relief via the UK and European adjustments is on the horizon, or perhaps just over it, given the inevitable bureaucratic steps that will be required, the old headache once again returned. The SEC's refusal to extend this relief has drawn criticism from the markets and there appears to be an overwhelming desire for it to be extended indefinitely.

It is therefore no surprise that trade bodies, such as Securities Industry and Financial Markets Association (SIFMA), heaped praise on the US House of Representatives for passing a bill on 11 July (just over a week after the final expiry of the no action letter), which directs the SEC to extend the MiFID II no-action relief for a further six months. The proposals are now on their way to the Senate's Committee on Banking, Housing and Urban affairs before potentially and ultimately being enacted.

It's possible that this extension could cure the MiFID II Research question for good in the US, given the changes being considered across the Atlantic. By the time the US relief expires (again), the changes that caused the conflict may be repealed or changed beyond recognition, and the conflict of law with the Advisers Act no longer exists.

Though questions remain about how badly growth companies have been impacted by the apparent restricted access to research, resolving this five-year headache will come as a welcome relief. As inflation appears to be slowly coming under control, or at least no longer increasing, attention can turn to assessing the growth market for future investments and identifying the companies of the future. With legislative changes clearly signposted, and political winds blowing in potentially different directions, there will no doubt be plenty of opportunity to dig out those painkillers once again.

1 *Statement on the Expiration of the SEC Staff No-Action Letter re: MiFID II*, Commissioner Mark T. Uyeda, July 5, 2023.

Joint ventures:
Is your fund caught under the UK AIFMD?

Hannah Meakin
Partner
Norton Rose Fulbright LLP

Jonathan Herbst
Global Head of Financial Services
Norton Rose Fulbright LLP

Taher Ahmed
Associate
Norton Rose Fulbright LLP

Joint ventures (**JVs**) often establish a corporate vehicle, such as a private limited company (the **JV Vehicle**), which holds the money received from the parties to advance the JV's commercial goals. For example, a property JV may bring together a real estate manager with a real estate capital provider to pursue a business venture in building new properties. The money received from the capital provider would usually be put into the JV Vehicle, which is managed in accordance with the underlying JV agreement.

While JVs are not new and are common arrangements set up by firms, there are implications if the structuring of such arrangements falls within scope of regulation. Specifically, JV participants should take care to ensure their arrangements do not amount to the setting up, directly or indirectly, of an alternative investment fund (**AIF**).

The Alternative Investment Fund Managers (**AIFM**) Directive (2011/61/EU) (**AIFMD**) came into force on 22 July 2014 and is the primary piece of legislation governing the operation and management of an AIF. As the UK was an EU member at the time, it on-shored the AIFMD through the AIFM Regulations 2013 (SI 2013/1773) and the Financial Conduct Authority (**FCA**) Handbook (**UK AIFMD**).

Managers of UK AIFs (i.e., funds domiciled in the UK that meet certain criteria, as we will explore below) must comply with the provisions of the UK AIFMD. The UK AIFMD does not generally apply to JVs, but the arrangements must be closely scrutinised to determine whether a JV in fact meets the definition of an AIF. If it does, the JV parties will need to comply with the UK AIFMD. The rules are prescriptive and, where not considered from the initial structuring stage, may result in additional costs and on-going regulatory obligations (such as the need to appoint a depository, periodic reporting requirements and further marketing restrictions in addition to the standard UK financial promotions regime).

This article discusses some of the factors that firms should consider when structuring their JV arrangements to determine whether they fall in-scope of the UK AIFMD.

What is an AIF?

An AIF is a collective investment undertaking (**CIU**) which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors, and which is not a UK undertaking for collective investment in transferable securities (**UCITS**). Four key elements must therefore be satisfied in order for a proposed JV to be an AIF, namely that the JV:

(a) is a CIU;

(b) has a defined investment policy;

(c) raises capital with a view to investing that capital for the benefit of those investors in accordance with the investment policy mentioned in (b) above; and

(d) is not a UK UCITS.

If a JV Vehicle meets the definition above it will be deemed an AIF. It is therefore crucial that JV parties ensure the structuring of such arrangements fall out-of-scope if they are not intended to constitute an AIF. In order to be classified as an AIF, all elements of the definition above must be satisfied.

What is a collective investment undertaking?

A collective investment undertaking, or CIU, is one which raises capital from a number of investors with a view to investing that capital in accordance with a defined investment policy for the benefit of those investors (i.e., it satisfies (c) above), and its units can be repurchased or redeemed, directly or indirectly out of its assets (at the holder's request).

It is important to note that the definition of an AIF refers to a CIU and not a collective investment scheme (**CIS**). While the two concepts overlap considerably, a CIU may be a body corporate (although not technically required to be) whereas a CIS cannot be a body corporate unless it is an open-ended investment company (**OEIC**), a limited liability partnership (**LLP**) or one of certain other types of mutual body. Therefore, where a JV Vehicle is incorporated as a UK company, the JV parties must consider whether it meets the definition of an OEIC and if it does (or if it is an LLP or relevant mutual body), they should also consider the regulatory requirements regarding operating a CIS.

The European Securities and Markets Authority (**ESMA**) highlights in its 'Guidelines on key concepts of the AIFMD' that there are certain characteristics of a vehicle (i.e., the JV Vehicle) that would show the undertaking is indeed a CIU. These characteristics, which are replicated in the FCA's Perimeter Guidance Manual (**PERG**), are that:

(a) the vehicle does not have a general commercial or industrial purpose;

(b) it pools together capital raised from its investors for the purpose of investment with a view to generating a pooled return for those investors; and

(c) its unitholders / shareholders as a collective group have no day-to-day control

What should you consider when structuring a JV to fall out of scope of AIFMD?

Some common themes must be considered when structuring a JV to ensure it is not an AIF. The FCA's PERG provides guidance on this which, even post-Brexit, references and is largely based on ESMA's Guidelines. According to the guidance in PERG, factors suggesting that a proposed JV will not fall within the definition of an AIF include where:

(a) The arrangement has a general commercial or industrial purpose as opposed to a specified investment purpose.

Where, for example, the JV is established by a real estate operator and a real estate capital provider to build properties, this is less likely to constitute an AIF as the focus of the JV arrangement is on the parties' commercial goals rather than an investment focus. Similarly, if the parties came together in the proposed project before the JV was structured, had a pre-existing business relationship or were carrying on similar activities in partnership prior to the set-up of the JV, this would help evidence that the JV has a commercial rather than a pure investment focus.

(b) There is no defined investment policy.

A defined investment policy for these purposes is a policy about how the vehicle's pooled capital is to be managed to generate a pooled return for its investors. Factors likely to indicate the existence of a defined investment policy include where there is a legally enforceable requirement for the vehicle or its manager to follow the policy, or where the policy specifies investment guidelines that prescribe (for example) the type or geographical location of assets that can be invested in and/or certain strategies that must be followed.

(c) All of the JV parties have day-to-day control over the assets of the JV Vehicle as opposed to being merely passive investors.

The FCA's guidance makes clear that the requirement for the JV parties to have day-to-day control must go beyond the ordinary exercise of decision or control that a party might have through voting at shareholder meetings. Many firms therefore ensure that the underlying JV agreement gives control rights, which may include enhanced 'reserved matter' rights to ensure the parties have joint control over the JV Vehicle and are not merely passive investors (which would be more akin to an investment fund). If the underlying JV agreement contains restrictions such as control provisions that do not allow all of the parties to participate in the active management of the JV, the arrangement is more likely to constitute an AIF.

(d) The JV does not seek to raise external capital from investors who are not party to it.

The guidance explains that the definition of an AIF envisages a distinction between the undertaking that raises capital and the parties who invest capital – where there is no such distinction, as is often the case in a JV where commercial parties come together on their own joint initiative, there is no external capital and therefore no AIF.

Consequences of inadvertently operating an AIF

Care must be taken to ensure the JV parties comply with the relevant regulatory regime. If a JV is found to be an AIF, the parties may be subject to enforcement action as 'managing an AIF' is a regulated activity in the UK under article 51ZC, Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544). If the parties are found to be 'managing an AIF' without the requisite FCA authorisation, this is a criminal offence which can result in imprisonment of up to two years and the possibility of an unlimited fine. The FCA may also wish to take enforcement action for any failure to comply with UK AIFMD (for example failing to appoint a depository if required, to comply with investor information requirements or to meet the relevant reporting requirements imposed on managers of an AIF).

If the parties are found to be 'managing an AIF' without the requisite FCA authorisation, this is a criminal offence which can result in imprisonment of up to two years and the possibility of an unlimited fine.

Regulatory guidance on fund costs

Mark Browne
Partner
Clerkin Lynch LLP

Costs and charges paid by funds have become a key focus of regulators in Europe in recent years. A recent letter from the Central Bank of Ireland (the Central Bank) to the chairs of relevant boards outlines some specific actions to be undertaken to ensure compliance with the governance obligations pertaining to this topic (the Costs and Fees Letter). This letter provides useful general guidance regarding addressing related issues including for managers and funds subject to alternative regulatory oversight.

Background

Citing concerns at the detrimental impact of costs for retail investors in particular, the European Securities and Markets Authority (**ESMA**) issued a briefing entitled "Supervisory Briefing on the Supervision of costs in UCITS and AIFs" on 4 June 2020 (the **ESMA Briefing**). It subsequently named costs and fees charged to funds as one of its two supervisory priorities to be addressed for 2021 and, noting the related requirements in both the underlying UCITS Directive and AIFMD as well as relevant supplementary provisions in the Level 2 legislation, announced it was launching a common supervisory action (**CSA**) across the EU to assess related matters including compliance with the obligation to ensure funds were not paying undue charges. This background is further explained and explored in greater detail an earlier article on this topic Scrutiny due for undue charges, also by Mark Browne, published in the AIMA Journal 28 June 2021. ESMA's final report on the CSA was published on 31 May 2022 (the **Final Report**). This was followed on 17 May 2023 by the release by ESMA of an Opinion on Undue Costs of UCITS and AIFs which proposes updating the underlying primary legislation to be more prescriptive on related matters and to further supplement this by means of Regulatory Technical Standards (**RTS**) which will detail the circumstances where costs are to be deemed undue costs and circumstances where additional costs may be permissible. These recommendations have in turn been followed up on by the European Commission by including relevant provisions in the draft Retail Investment Package released on 24 May 2023.

The costs and fees letter

The Costs and Fees Letter reflects the findings of the Central Bank from its actions on foot of the CSA and it should be considered in conjunction with the Final Report. This letter was issued in late March 2023 with a stated expected compliance date of quarter 3 2023 for plans to be put in place to address any related deficiencies identified. It was addressed to the chairs of Irish authorised UCITS but has broader application as it states that "it is the expectation of the Central Bank that the findings and actions of this review are also considered by AIFMs with respect to cost and fees charged to AIFs" and the respective underlying pieces of legislation contain similar obligations regarding both categories of funds.

Supervisory expectations and related guidance

The Costs and Fees Letter has six main findings, several of which have general application.

Firstly, there is a general expectation that all relevant firms should have structured, formalised pricing policies and procedures in place. These should include clear oversight and approval processes from senior management to facilitate the transparent identification and quantification of all costs charged to each fund as well as related controls over these. A failure to maintain detailed and documented policies and procedures to govern the calibration and imposition of costs and fees would give rise to a risk that the control environment for costs and fees is ineffective and increases the potential for undue costs to be imposed on investors.

Secondly, there is a requirement for the periodic review of costs and fees on a planned and systematic basis. It is inadequate to solely approve fee structures on establishment or launch and not continue to keep them under review during the life of a fund. Furthermore, such reviews should take account of the investment objective and strategy of the fund, the target and actual level of performance achieved and the role and responsibilities of service providers. The viability of the fund should also be considered in this regard and the potential to generate not only a positive return for investors but one commensurate with the risk profile of the fund should be taken into account.

Thirdly, the design process and ongoing oversight of fee structures should also be the subject of appropriate policies and processes. It is not acceptable from a governance perspective to merely rely on delegate investment managers to determine the pricing structure of funds without proper engagement with boards and subsequent ongoing oversight of the pricing process. Accordingly regular reporting and review is an essential component.

Fourthly, the analysis of costs and charges should be holistic in nature and ensure that potentially hidden costs such as revenue from, or costs for, services connected to techniques such as Efficient Portfolio Management (which are often provided by firms associated with the investment manager) are also included in the scope of related analysis and addressed in the policies and procedures and in sufficient detail.

Fifthly, there should be an obligation to look under the hood of the constituent costs for services provided as part of Fixed Operating Expense Models (**FOEM**) and to include such analysis in the periodic review process. While FOEMs have the benefit of providing investors with protection and certainty with respect to the maximum fees being incurred, there should be awareness of all underlying expenses and the model should be calibrated so that the differential of any excess above the amalgamation of appropriate constituent fees is minimised to avoid undue costs being charged to investors.

[...] the design process and ongoing oversight of fee structures should also be the subject of appropriate policies and processes.

It is not acceptable from a governance perspective to merely rely on delegate investment managers to determine the pricing structure of funds without proper engagement with boards and subsequent ongoing oversight of the pricing process.

Accordingly regular reporting and review is an essential component.

Finally, firms should ensure that the fee arrangements are appropriate for the services provided. One area of concern in this regard relates to investment advisors with only a non-discretionary advisory role being paid a greater fee than the delegated investment manager. This practice raises concerns as to actual nature of the role of the investment advisor and whether relevant fees have been negotiated in the best interests of investors. It would also give rise to concerns that this party is acting with more influence and control than is appropriate given its actual role.

Further considerations

While regular periodic reviews are to be expected, consideration should be given to including a requirement in the policies for reviews to be undertaken on an ad hoc basis on the occurrence of certain tigger events, such as a significant change in fund size for example as a result of a large redemption or market correction, a shift in market dynamics such as significant adjustments to interest rates or foreign exchange rates etc. Naturally it would be appropriate for any such triggers to be relevant to the nature of the fund and its cost base.

The stated requirement for 'independent' reviews as part of this process is interesting and may require a two step process to be put in place to ensure this element is satisfied. In particular, while in many cases management companies will be expected to perform such analysis in the first instance since they are the 'responsible person' under relevant legislation, they may not be regarded as independent given that they are responsible for appointing delegates and they themselves are beneficiaries of fees from the underlying funds. Accordingly, it will be appropriate for analysis to be undertaken at fund board level, ideally with the benefit of external data from third party data providers to assist in gauging relative costs and expenses for similar products.

Conclusion

The Costs and Fees Letter provides useful guidance regarding governance steps to be put in place to ensure appropriate oversight of fee related matters. It has general application in this regard for all fund boards rather than merely those it was directly addressed to. Adherence to the steps outlined in this letter can help ensure management are following best practice in the industry as well as providing documentary evidence of this. As such this can assist in providing a solid defence in the event of any future related regulatory investigations or shareholder suits.

While regular periodic reviews are to be expected, consideration should be given to including a requirement in the policies for reviews to be undertaken on an ad hoc basis on the occurrence of certain tigger events, such as a significant change in fund size for example as a result of a large redemption or market correction, a shift in market dynamics such as significant adjustments to interest rates or foreign exchange rates etc.

Christopher Madpak
Managing Director - Tax & Tax Technology
SS&C Technology

Driving portfolio returns with tax-efficient investing

At a time when it's increasingly tough to outperform the market, more and more fund managers are realising tax-efficient investment strategies are the smart, simple way to unlock operational and after-tax alpha.

Tax is one of the undeniable factors in portfolio performance. Experienced investors know tax efficiency is on the same level with asset allocation and security selection when it comes to delivering results – so they expect their managers to pursue strategies to optimise their tax positions. However, things like tax compliance and reporting are enormous responsibilities and operational burdens for investment fund managers. There's no margin for error. Filing deadlines are unforgiving. And investors expect timely delivery of accurate tax information for their own filing purposes.

Increasingly, fund managers realise tax accounting is not just a quarterly or annual exercise. We're seeing more managers try to improve returns for investors through tax-aware strategies, by factoring tax impacts into their investment decisions before executing them. However, diligent tax-efficient investing requires access to real-time portfolio data and advanced analytics software. The problem is most firms don't have it, so are unable to understand their precise tax position and the impact of their investment decisions. CPA firms, auditors and tax advisors are experts at long-term tax management; investors need more immediate access to data and expertise to optimise returns in real-time.

Today, technology can support tax-efficient investing and simplify the process of timely and accurate filing and reporting. But you must make sure the solution meets five key criteria:

1. **A single source of truth**

   Too often in the tax compliance and analysis process, the tax team needs to go to multiple ledgers, spreadsheets or programmes to gather data. To avoid the resulting data redundancies and inconsistency, all portfolio and transaction data for tax reporting, compliance and analysis should be aggregated into one system.

2. **Seamless process integration**

   The same applies to the performance of analytics and tax reporting. Wash sales may be done in one system, tax adjustments in another and tax reporting in yet another. The solution is to integrate every process into one system.

3. **Intelligent automation**

   Today's advanced automation technologies ensure data integrity and process efficiency – enabling decision-makers to spend less time corralling data and more time analysing it.

4. **Advanced analytics**

   Avoid stale data aggregated from multiple systems and vendors by having access to real-time tax data to inform trading, investment decisions and planning, including "what-if" scenarios. Insight is valuable year-round — not just at tax time.

5. **Investor-level tax analysis and reporting**

   To communicate the tax benefits of your strategy to investors so they can understand their exposure and reporting obligations, you need access to time critical decision-support information. Having it centralised on one integrated platform makes the process much more swift and efficient.

Many managers may be so focused on the search for alpha, they miss an opportunity to add to their returns through tax-efficient investment strategies. The ability to manage a fund's tax exposure all year-round has a number of potential benefits. It enables a firm to maximise alpha, or consistent after-tax returns in excess of designated benchmarks, through data-driven, tax-efficient investment strategies. At the same time, it can help minimise the overall tax impact on a fund and its investors while enabling the firm to meet its tax compliance obligations efficiently, accurately, and in a timely manner. Moreover, the ability to demonstrate a systematic approach to tax-efficient investing and communicate its benefits to investors can help fund managers strengthen relationships, engender loyalty and increase retention.

Fund managers who are serious about tax efficiency are turning to technology to deliver the mix of trusted data and smart analytics they need. Today's intelligent technologies make it possible for investment managers to easily incorporate tax strategies into their everyday decision-making processes, while simultaneously mitigating the annual tax bite. Managers with a demonstrable systematic approach to tax efficient investing have a significant competitive advantage. So are you using differentiated strategies, or are you leaving money on the table?

Learn more at https://www.ssctech.com/

Achieving T+1 multi-party reconciliation through automation of the reconciliation process

J-P Lee
Principal
Metaframe Technology Solutions
Email J-P Lee

The process

The necessary task of hedge fund reconciliation has become more demanding in recent years. Trade volume hit a record high in the first quarter of 2023 following an upward trend. Increasingly stringent regulations, like the upcoming SEC T+1 settlement rule, puts more pressure on operations teams leaving less room for error. Regulations are matched by heightened demand by investors for transparency in an increasingly competitive hedge fund market. Probably the most challenging aspect of the reconciliation process is the expanded use of exotic instruments. It is estimated that the derivatives market already exceeds a quadrillion dollar. These elements of the hedge fund landscape are problematic for the reconciliation process by themselves, but funds don't act alone. A hedge fund isn't navigating the reconciliation landscape solo but joined by its partners, prime brokers, and administrators.

While a hedge fund, custodian, and fund administrator are each independent with different teams and systems, they share, process, and report data among themselves. The multi-party reconciliation required among multiple parties can be resource-intensive, time-consuming, and error-prone. With settlement cycles shrinking and increased trade volume, the task of reconciliation by itself, let alone with multiple parties, becomes more and more onerous.

A hedge fund reports its trades to a prime broker and a fund administrator. Each of the three parties builds a separate portfolio based on the trades reported. The prime broker and the administrator reconcile between themselves and the prime broker and the administrator each provide their portfolios to the hedge fund. For the prime broker, fund reconciliation occurs daily. For the administrator, reconciliation matters most at the end of the month when they close their books in terms of performance and compile and transmit reports for investors.

To summarise:

- Hedge funds send trades to both prime broker and administrator.
- All parties build a portfolio based on the trades received.
- The prime broker and administrator reconcile between themselves.
- The prime broker provides their portfolio to the hedge fund.
- The administrator provides their portfolio to the hedge fund.
- The hedge fund reconciles the portfolio with the prime broker's and again with the administrator's.

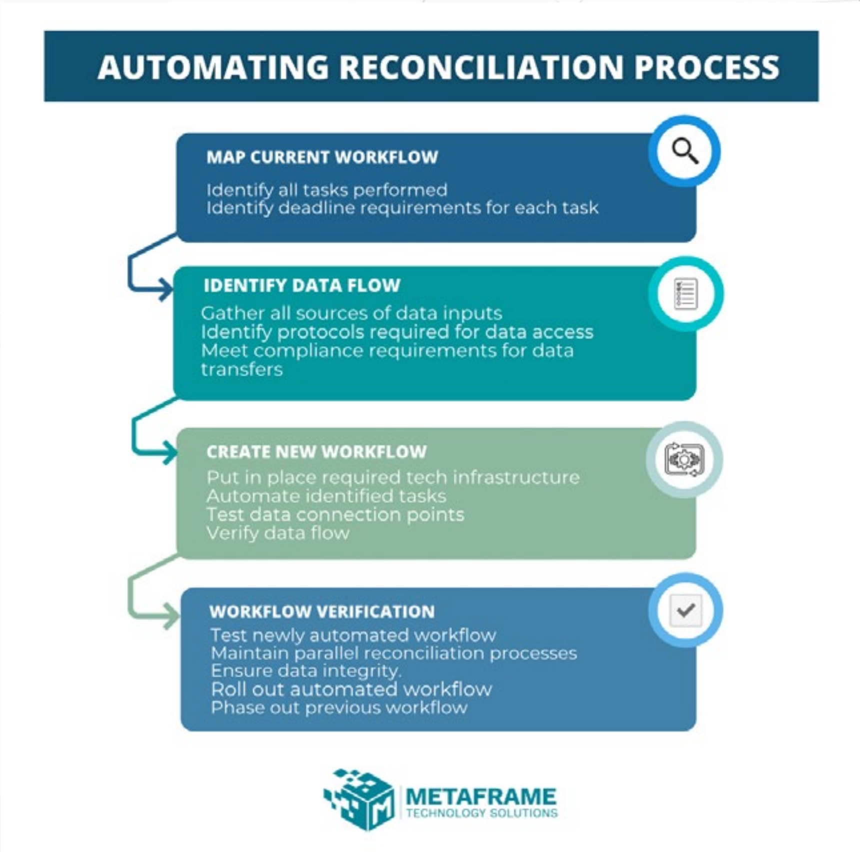
Operational efficiency

A reconciliation process is tedious but can be vital to a hedge fund's reputation. The approach the COO chooses to tackle reconciliation depends on a number of factors: the complexity of the fund's structures, reporting obligations to counterparties, the cadence of the reporting to each counterparty, resources available to the hedge fund operations team, and available manpower. In most cases, the reporting cadence is the major deciding factor on how often reconciliation takes place. On the prime broker side, trades are settled on a daily basis, leading to the trade reports being generated daily. On the administrator side, performance reports are issued monthly or quarterly, yielding a monthly reconciliation cadence. If the fund is working with multiple prime brokers, multiple trade reports are issued on a daily basis. When it's time to generate monthly reports, the operational team must look at 30+ days of transactions and data, poring over reports in search of discrepancies and resolutions to any errors. These month-end reports become an operational focus on top of the daily trading reports. The additional efforts become an operational stressor to the normal day-to-day workflow for the team.

One way to alleviate this pain and speed up reconciliation for all counterparties is to set up a multi-party reconciliation process. Multi-party reconciliation involves matching the cadence for all data sources ensuring trades and positions are in sync. Initially, performing reconciliation on the prime broker and the administrator seems like an overuse of operational resources, but daily reconciliations catch discrepancies as soon as they happen. The operations team can address issues immediately if needed. For firms not wishing to add additional daily tasks to the operations team, daily break reports can still be beneficial. When it is time to prepare and verify the monthly or quarterly reports, the team can pinpoint the sources of breaks quickly by reviewing the daily break reports rather than combing through the entire time span of transactions and data.

For this to work optimally, reconciliation must be automated. The process of automating the reconciliation is outlined in Figure 1 below.

Figure 1

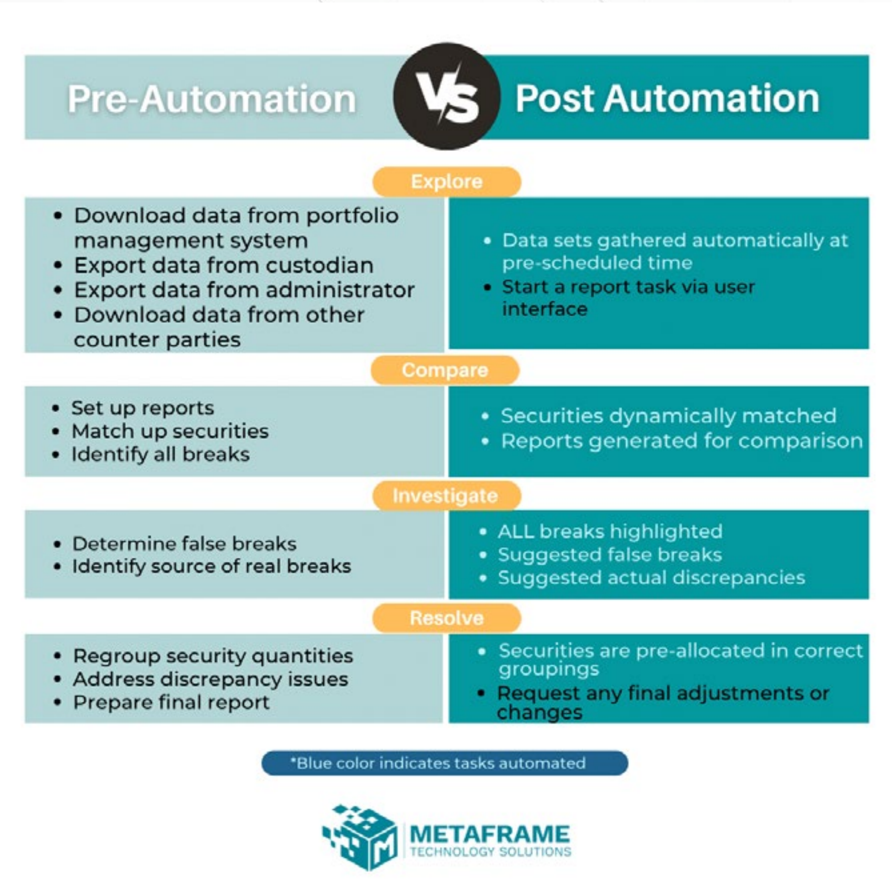


Without automating the multi-party reconciliation process, the hedge fund operations team is importing and exporting data, combing through files, spreadsheets, and reports for breaks and discrepancies, and creating reports from this muddle of sources. Once automated, data is gathered automatically, sorted, and matched automatically, with reports generated automatically. The intelligent software identifies, and highlights breaks and discrepancies.

The benefits of automated reconciliation

- Automation saves time. Clients report a reduction of end-of-month reconciliation time from weeks to days. Automating tasks and repetitive steps streamlines the reconciliation processes creating a multiplier effect that improves operations elsewhere.
- Staying ahead of reporting requirements. Looking ahead to new regulations on the horizon, such as the T+1 settlement requirement, or the halving of the Section 13 D reporting timeline, saving time and effort now will pay dividends later.
- Intelligent automation reduces the possibility of error. Human manipulation of spreadsheets creates errors. With three parties using different symbology, the application of artificial intelligence to symbology reconciliation is a powerful automation tool.

Figure 2



COOs acknowledge automation is the answer, but they also admit there's a high bar in adopting new technologies. There is a balance to strike between minimising operating costs, maximising staff performance, and staying ahead of regulatory requirements. With the right balance, automating reconciliation is a worthy endeavor for COOs to undertake. Spending the upfront effort to set up a process like multi-party reconciliation will reduce costs over time, improve the operation team's performance, and be ready to easily meet additional reporting requirements.

Prime brokerage: Why a high touch service is critical for fund managers

Chris Elliott
Head of Europe Prime Brokerage Business Development
TD Cowen

Chris Elliott, Head of Europe Prime Brokerage Business Development at TD Cowen explains what is meant by a high touch service and, importantly, why selecting a prime broker with a high-touch offering should be a priority for fund managers, particularly in the current climate.

When hedge funds are sizing up potential prime brokers to see which firms might best meet their needs, they have a lot of boxes to tick. So, it's understandable that the subject of banks' balance sheet trends is probably not the first thing on their minds. But there's a good reason why this topic looms large and is worth dwelling on.

Put simply, banks – even the bulge bracket firms – do not have endless balance sheets. If anything, the sizes of balance sheets are starting to taper off after years of growth. Central banks themselves have been unwinding their quantitative easing strategies and looking to reduce their own balance sheets, which has knock-on effects.

For new and emerging funds in particular, all of this has implications. As the number of large providers has contracted, the remaining bulge bracket firms have ended up taking on lots of recently displaced clients. But they cannot simply expand their balance sheets ad infinitum in order to absorb these new clients while still retaining all of their existing ones.

Instead, the biggest prime brokerage providers end up having to become more selective. The cold reality is, they need to make the call as to which funds will move the needle when it comes to their own business. It inevitably leads to dislocation and off-boarding.

The dislocation dilemma

For funds that have themselves been off-boarded, their first priority is to think which providers are best placed to serve their needs. And for new funds that are just getting started, they need to think about whether they want to risk the chance of dislocation further down the road by focusing purely on the largest providers. We have been hearing from firms in each of these categories.
What both camps will have in common is that they would benefit from focusing on providers that have a high-touch service approach. It may come down to a fund's size. Or it may be due to what a fund hopes to achieve. Or it may be because a fund is new to the market and likely to be encountering unfamiliar situations.

In fact, this last consideration is increasingly the case in today's markets, as risks accumulate from multiple directions. Unusual or unfamiliar market scenarios may be the result of macroeconomic shifts, regulatory changes, geopolitical factors, or a host of "unknown unknows".

Whatever the cause, having a prime broker in your corner that can help you deal with the unfamiliar is a big plus – and therefore finding the right prime broker to help you to navigate today's market is absolutely critical to the fund's success.

Defining a high touch service

A high touch service covers a range of things, including:

1. **A client-centric approach: working around the client, not the other way around** – for example, tailoring a system or process to fit the client's requirements, or if new or different functionality is needed, figuring out a way to deliver exactly what the client needs. Many prime brokers may have evolved their offerings over the years, but a client-centric service approach requires being flexible in incorporating client needs immediately, not over time.

2. **Responsiveness:** Another important element concerns how quickly issues can be escalated. Partner with a prime broker that has a flat structure which is easy to navigate. This means that if a client does have any issues, they are not far away from senior management. Busy hedge fund managers have enough to worry about without having to deal with slow, bureaucratic processes from their prime brokers. They need to know they will be listened to and responded to, quickly.

3. **A holistic approach - supporting the *whole* business**. A prime broker needs to have the experience and resources to offer a full suite of services, from raising capital to trading and execution to operational support to consulting.

Partner with a prime broker that has a flat structure which is easy to navigate. This means that if a client does have any issues, they are not far away from senior management.

Busy hedge fund managers have enough to worry about without having to deal with slow, bureaucratic processes from their prime brokers. They need to know they will be listened to and responded to, quickly.

A return to normalcy?

The prime brokerage industry has been in a state of flux for the past couple of years, which makes the question of who to pick and what factors to weigh all the more complicated.

How long the dislocation trend will continue, no one can say for certain. But we do know that more funds are launching, offering signs of a return to normalcy for a hard-hit buy-side community.

Quarterly data for fund launches at one point in 2022 reached their lowest level since the 2008 financial crisis, but Q4 showed a 35% jump to 96 launches, according to HFR data. It means more funds are going to need to navigate a tricky prime brokerage landscape. Focusing on high-touch service could be one of the keys to their success.

Cowen International Limited (CIL) is authorised and regulated by the Financial Conduct Authority.

TD Cowen
a division of TD Securities

TD Cowen Prime Brokerage

Delivering deep industry knowledge and tailored solutions

Learn more at tdcowen.com

Enhanced data and technology infrastructure no longer a nice-to-have

Eric Chng
Head of Alternatives and Private Markets, Asia Pacific
State Street

Data and technology play a crucial role in improving efficiency and standardisation in private market operations, and assessing environmental, social, governance (ESG) risks.

The recent market and economic turmoil sparked by high inflation and rising interest rates in response have forced private markets managers and investors into a reckoning with their process efficiency. However, lack of streamlined data management processes and disparate data sources are major hindrances to growth.

Data management in the sphere of private equity and real assets has long been both complex, piecemeal, and inconsistently applied, leaving market participants frequently unable to access vital information reliably or in a timely fashion.

Owing to the slow-paced changes in the economic landscape, investors have not addressed the concerns that a fragmented data management strategy brings. Additionally, wide availability of attractive investment opportunities has resulted in better internal capacity for analysing deals that have not given a sufficient advantage to make the necessary operational investment worthwhile.

However, in the last two years markets have witnessed highest inflation in decades. This has shrunk the pool of available deals from which investors can expect above inflationary returns or yields. Meanwhile, interest rates have risen throughout the economically developed world to their highest levels since before the 2008 financial crisis, increasing the cost of borrowing money and impacting institutions' abilities to raise cash for leveraged private markets investments. Higher interest rates also mean higher yields on traditional fixed income and cash, which puts further pressure on expected returns for private markets investments.

Against this backdrop, it not surprising that the majority of respondents to the State Street 2023 Future of Private Markets Study[1] described "manual processes and outdated systems" for managing data as a "considerable" waste of their time and resources.

1 Towards the end of 2022, we conducted a survey of nearly 500 investment institutions, including 120 insurers, across North America, Latin America, Europe and Asia Pacific (APAC) to understand the outlook on private markets of generalist asset managers, private markets managers, insurers and asset owners. This has formed the basis of the State Street 2023 Private Markets Study, in which we analyse the macro environment and its relation to private markets, what is driving demand for private markets assets among retail investors, and the role of emerging technologies and new fund types. Additionally, we took a deep dive into the role of technology in addressing data management, efficiency and transparency.

On the other hand, a similar majority said improving their data management and analysis capabilities conferred a “competitive advantage” on their organisation.

However, respondents did not, for the most part, want to reduce their private markets exposure; more than two thirds (68%) said they planned to continue with their existing allocation targets, despite the difficult environment. They simply acknowledged that they need to improve their ability to assess opportunities and, in the case of managers, communicate essential information about investments to asset owners, who want more frequent, verifiable and standardised data about various aspects (for instance return, risk, ESG) of their private market investments.

Figure 1: Results of survey question: Thinking about private markets data management, to what extent do you agree with the following statements? (% Agree or Strongly Agree)

The impact of technology on data operations

Survey respondents said that the heightened focus on deal scrutiny and the data essential to better understand private markets holdings went hand-in-hand with investment in technology infrastructure aimed at improving their abilities to view and analyse disparate types of data from various sources.

Our data shows significant technology investment is being directed towards private markets operations across the spectrum of institutional investment organisations. More than three quarters (77%) said that at least 10%of their overall technology budget was being allocated to their private markets operations. Additionally, more than half of the respondents (52%) were spending more than 20%of their technology expenditure on private markets.

From an institutional investors’ perspective, most of these investments are centred around data collection, aggregation, and harmonisation across disparate information sources, which are highly manual and complex. As the number of investment managers increase, the lack of standardisation across different reports adds to the complexities.

In particular, aligning disparate technology systems from across different areas of their organisations, operationally and geographically, scored highly when respondents were asked to assign importance to various areas of their private markets data management processes. However, the same options received low scores when respondents gave assessments of their competence in these areas.

Cloud technology was a priority direction for institutions' technology investments, with 71% saying they were spending there, due to the simultaneous importance and underdevelopment of data systems' interoperability, data lakes, and warehousing. The next most popular form of technology was artificial intelligence, which approximately a third (36%) were investing in. This is an interesting emerging technology for data management in particular, as it is increasingly essential to extracting and analysing information from large cloud-based 'lakes' of unstructured, raw data.

ESG data in private markets

Another area of high importance but relatively low competence for institutions' private markets data operations was assessing ESG characteristics of investments, particularly from a risk perspective. ESG data has been a thorny issue for the investment industry for a long time, with a lack of consistent standards, reliable, directly comparable, and affordable sources of data.

In private markets, these challenges are accentuated by two trends. Firstly, private companies and real assets are generally less transparent than their public counterparts, adding to the difficulty of finding reliable ESG information. In addition, the level of transparency across different asset classes differs due to the disparate nature of such investments.

Secondly – there is a lack of standardisation when it comes to private markets. ESG data varies with each asset class and generally, metrics are hard to define in a consistent manner between asset types. A real estate exposure and the ESG metrics associated with that asset class is significantly different with a Private Equity portfolio company. The increase in regulatory focus on ESG will continue and this will lead to standardisation across each asset type and the way metrics are defined and adopted.

A trend that's not going away

Investment institutions' new focus on making fundamental improvements to their private markets data operations is a product of external, macro-economic headwinds. However, it is not likely to dissipate with those conditions. Over a quarter of respondents (26%) believed the current inflationary environment is likely to be short lived, or that the old market conditions will return as inflation subsides, compared to nearly half (47%). Forward thinking organisations, making the right amount of investments in sophisticated data management technology will benefit from the advantages conferred by better processes, enabling them to make informed investment decisions and help gain alpha even in a low yield environment.

SG data varies with each asset class and generally, metrics are hard to define in a consistent manner between asset types. A real estate exposure and the ESG metrics associated with that asset class is significantly different with a Private Equity portfolio company.

The increase in regulatory focus on ESG will continue and this will lead to standardisation across each asset type and the way metrics are defined and adopted.

CSRC issued the Measures for the Supervision and Administration of Derivatives Trading (consultation paper)

A possibly new era for PRC offshore derivative transactions

On 17 March 2023, the China Securities Regulatory Commission (**CSRC**) issued the *Measures for the Supervision and Administration of Derivatives Trading (Consultation Paper)* (the **Consultation Paper**). The Consultation Paper comprises draft rules (the Draft Rules) aiming at unifying and aligning regulations for different aspects of the thriving derivatives market, increasing market transparency, as well as strengthening risk control.

Melody Yang
Partner
Simmons & Simmons
Email Melody Yang

Notably, the supplementary provisions to the Draft Rules seek to extend CSRC's regulatory reach to cover overseas derivative transactions where *"the relevant hedging transactions take place in China"* (Article 50, paragraph 2). Such extension of jurisdiction may have significant implications (as explained below) to foreign investors investing in the PRC market through overseas over the counter (**OTC**) derivatives products such as total return swap (**TRS**), which is a popular indirect means for foreign investors to gain access to the The People's Republic of China (**PRC**) market.

Yuying Wang
Managing Associate
Simmons & Simmons
Email Yuying Wang

Current regulations on overseas TRS

Commercially, an offshore TRS arrangement commonly comprises two separate and distinct transactions:

1. **The offshore swap:** Dealings between an offshore investor (i.e., buy-side) on one hand, and an offshore counterparty (i.e., sell-side, e.g., a broker) on the other, outside of the PRC for the purpose of offering the offshore investor economic interest synthetically derived from Chinese market.
2. **The hedging transaction:** The abovementioned offshore counterparty then hedges its position with respect to the Offshore Swap by investing into the PRC market through direct market access schemes such as QFI, various Connect Program, internationalised futures regime and the like, or back-to-back swap(s) with its PRC affiliates or other third-party brokers.

In the past, Chinese regulators have focused on regulating the latter part of the arrangement, whereby sell-side is required to comply with the relevant laws and subject to scrutiny, facing increasing more restrictions to carry out the Hedging Transactions.

On 1 August 2022, the *PRC Futures and Derivative Law* took effect, bringing the former part of the arrangement under the possible supervision of the Chinese regulators, granting them with competent jurisdiction over trading activities that take place outside of the PRC which *"disrupts the order of the domestic market and causes any damage to the lawful rights and interests of domestic traders"* (Article 2). Whilst it was clear that Offshore Swap is to be regulated, no concrete rules (or implementation rules) were put in place to provide the specific behaviors triggering such provision and the corresponding liability.

CSRC clarifies that the Draft Rules exclude the interbank derivatives market and OTC derivative markets organised by banking and insurance financial institutions.

The consultation paper

Some of the main features of the Draft Rules are as follows:

(A) ***Applicability*** – The Draft Rules apply to (i) derivative markets organised by securities and futures trading venues; (ii) securities companies (i.e., securities brokers) and their subsidiaries engaged in the OTC derivative markets; and (iii) futures companies (i.e., futures brokers) and their subsidiaries engaged in the OTC derivative markets. Regarding offshore derivative transactions, the Draft Rules applies where (1) the derivative transactions between offshore operation institutions (which refer to the sell-side brokers) and offshore trading institutions (which refer to the buy-side investors) take place outside of China and (2) "the relevant hedging transactions take place within China" (Article 50, paragraph 2). Therefore, such transactions shall comply with obligations set out in Article 9, 12, 14 to 22 of the Draft Rules, summarised as followings. As a result, the step (1) of an offshore swap arrangement, i.e., the Offshore Swap, may also be subject to direct supervision and regulation of the CSRC due to the fact that the step (2), i.e., the Hedging Transaction, takes place within China.

CSRC clarifies that the Draft Rules exclude the interbank derivatives market and OTC derivative markets organised by banking and insurance financial institutions. This indicates that the Draft Rules, once promulgated, only intend to regulate those participants who are and/or asset classes which are within the purview of CSRC's regulation, whilst excluding those derivatives linked to bonds, interest rate or currencies traded via China Interbank Bond Market.

(B) ***Obligation of the sell-side*** – the operation institutions (which refer to the sell-side brokers) shall keep a record of all its derivative transactions corresponding to the hedging transaction taking place within China, such as counterparties, trading contracts, trading strategies, trading details and etc. Upon request of the exchanges, those sell-side brokers shall provide such data requested (Article 12). Moreover, the operation institutions also have a regular reporting obligation made to CSRC, on information of their business scale, transaction counterparty, underlying assets, holding positions, profits & losses, etc. (Article 35).

Under the QFI rules, the sell-side as well as buy-side QFIs already have ad hoc obligations to provide to CSRC, upon the latter's ad hoc request, their "overseas hedging transactions in connection with the QFI's China investments". The new Articles 12 and 35 in the Draft Rules, aim to further reinforce the regulators' power to review and assess any overseas derivatives transactions.

(C) ***Obligation of the offshore buy-side*** – look-through ownership and aggregation of positions acquired via derivatives and via cash trading would be required, as the Draft Rules require that *"a derivative contract held by a trading institution with the stocks of a listed company or a company whose stocks are traded on any other national securities trading venue approved by the State Council (the "targeted stocks") as the targeted assets, shall be calculated in aggregation with the targeted stocks directly or indirectly held by the trading institution in accordance with the provisions of the securities trading venue."* (Article 14). When implementing the position limit system and the reporting system for large positions in derivatives trading or futures trading, *"the positions of derivative transactions and futures transactions directly and indirectly held by derivatives operation institutions and trading institutions in derivatives contracts with underlying assets linked to the same or similar assets shall be aggregated in accordance with the regulations of industry associations for derivatives, derivative trading venues, or futures trading venues."* (Article 9)

As at today, we see no explicit requirements (but for those in the Draft Rules) imposed on the offshore investors to aggregate their positions acquired via a common derivative transaction and those acquired via cash trading, if the transaction is only cash settled and the investors only gain synthetic economic interest.

(D) ***Prohibited trading activities*** – prohibition of fraudulent acts, insider trading, market manipulation, interest tunnelling, and other illegal behaviours through derivative trading, indicating that the market conduct rules may directly apply to the ultimate investors of the swaps (Articles 15 to 22).

This indicates that those investors who access to Chinese market through derivative structures may face outright obligations to comply with Chinese rules including rules against market abuse.

The ambit of the Draft Rules, however, are in need of clarifications from the CSRC. For example, it is not entirely clear whether or not the derivative transactions with "the relevant hedging transactions take place within China" (i.e., (A) above) capture offshore derivative transactions where the offshore broker hedges via its affiliate or another PRC broker (as opposed to hedging via a direct market access regime). Moreover, there is also ambiguity as to whether derivative transactions (e.g., TRS) solely for the purpose of acquiring synthetic economic rights of stocks, as opposed to the stocks as the targeted assets via certain options products, are captured in the shareholding aggregation requirement (i.e. (C) above).

Impact to the industry

Whilst the full force of the Draft Rules is subject to further clarifications by CSRC, its impact on the PRC overseas derivative market is significant and can be seen as China's first step in excising its extraterritorial jurisdictions over these derivative transactions. Offshore financial institutions engaging in offshore derivative transactions such as offshore TRS arrangement should be aware of this potential repercussion.

Simmons & Simmons' regulatory update on China's New Futures and Derivatives Law can also be found here.

If you would like any more information on the contents of this insight, please get in contact with us or your usual Simmons contact.

simmons + simmons

Investor Insights

Investor Insights allows you to create tailored reports including only the specific prospective investors you are planning to market investment funds and investment management services to. This way you can plan your marketing activities in the Middle East in advance in a targeted and user-friendly way. This service leverages the many years of experience we have in the Middle East, a diverse and ever-changing region.

Expertise plus technology
A combination of our legal expertise and technology means faster responses to your requests. We can also provide secure online access to this service.

Bespoke reports
We'll tailor your reports to only cover the specific prospective investors you are interested in marketing to.

Tailored training
We can help your people get the most out of our service with a tailored training and development programme.

Backed by decades of experience in the Middle East
We've advised clients on the Middle East for more than 40 years. We have developed Investor Insights based on this experience and are constantly expanding and refining our guidance.

Interested? Get in touch.

Muneer Khan
Partner, Dubai
T: +9714 709 6600
E: muneer.khan@simmons-simmons.com

simmons-simmons.com

Recent Cayman Islands regulatory developments

Cayman Islands satisfies all FATF AML/CFT recommendations and action points

Chris Capewell
Partner and Head of Cayman Islands Regulatory & Financial Services
Maples Group Cayman Islands

Martin Livingston
Consultant, Cayman Islands Regulatory & Financial Services
Maples Group New Zealand

Yunie Wong
Legal Manager, Cayman Islands Regulatory & Financial Services
Maples Group Hong Kong

Daniel Moore
Associate, Cayman Islands Regulatory & Financial Services
Maples Group Hong Kong

In order for jurisdictions to participate effectively in global financial markets, it is imperative to meet international standards set by supra-national agencies.

A key example includes the Financial Action Task Force's (FATF) evaluation of countries' anti-money laundering / counter-terrorist and proliferation financing (AML/CFT) regimes. The FATF now assess these regimes for both 'technical compliance' (i.e., whether the FATF's Recommendations have been implemented in local laws) and 'effectiveness' (i.e., whether such local laws are being applied and enforced).

Why was the Cayman Islands added to the FATF's and EU's AML/CFT 'Monitoring List'?

The Caribbean Financial Action Task Force (CFATF) conducted the 4th round of mutual evaluation of the Cayman Islands in late 2017 and produced the mutual evaluation report in March 2019. While the report recognised the well-established AML/CFT framework, it identified certain shortcomings in effectiveness, which led to an extension of scope of the AML/CFT National Risk Assessment, greater regulation of the securities sector, further transparency of beneficial ownership and greater interaction between the investigative agencies for enforcement and prosecutions.

On the latter point, the FATF noted that the Cayman Islands Action Plan should include "(1) applying sanctions that are effective, proportionate and dissuasive, and taking administrative penalties and enforcement actions against obliged entities to ensure that breaches are remediated effectively and in a timely manner; (2) imposing adequate and effective sanctions in cases where relevant parties (including legal persons) do not file accurate, adequate and up to date beneficial ownership information; and (3) demonstrating that they are prosecuting all types of money laundering in line with the jurisdiction's risk profile and that such prosecutions are resulting in the application of dissuasive, effective, and proportionate sanctions" (Action Points).

Accordingly, in February 2021, the FATF added the Cayman Islands to its AML/CFT 'Monitoring List' (sometimes referred to as the FATF's 'grey' list). The jurisdiction made a high-level political commitment to work with the FATF and CFATF to strengthen the effectiveness of its AML/CFT regime and remediate the Action Points. Consequently, in February 2022 the European Commission added the jurisdiction to its list of AML/CFT high risk jurisdictions.

How has the Cayman Islands satisfied all FATF Recommendations and Action Points?

The Cayman Islands Government, regulatory and enforcement agencies, and the jurisdiction's stakeholders, made the removal of the Cayman Islands from these lists their greatest priority over the past three years. Action Point (1) was the remit of the Cayman Islands Monetary Authority (CIMA) and other AML Supervisory Authorities to resolve. Over the past three years, CIMA has increased the frequency and scope of its prudential inspections and has issued several breach notices and administrative fines to licensees for failures in AML/CFT controls. Similarly, for Action Point (2), the Ministry of Financial Services, as the competent authority for the beneficial ownership register regime, issued several enforcement notices for failure to file or record appropriate information.

Action Point (3) may have been the hardest to resolve, given the nature of money laundering prosecutions. Ordinarily, prosecutions are conducted in the jurisdiction where the predicate money laundering offence (i.e., the crime underlying the money laundering) occurred. For the Cayman Islands, and other offshore financial centres, while transactions may involve investment or finance vehicles established offshore, the activity or transaction is usually conducted or effected onshore.

As such, the offshore authorities usually support an onshore investigation or prosecution by sharing information with those authorities. Fortunately, (for the purpose of being de-listed), there were a couple of domestic money laundering matters which were prosecuted in 2022 resulting in sentencing in early 2023.

The Cayman Islands governmental delegations have been attending each FATF Plenary, since being listed, to provide progress updates on each of the Action Points, and any other relevant legislative developments.

On 23 June 2023, the FATF confirmed that the Cayman Islands had satisfied all FATF Recommendations and Action Points on both 'technical compliance' and 'effectiveness', recognising that the jurisdiction has robust and effective AML/CFT regimes. The FATF's decision is a welcome recognition of the Cayman Islands as a jurisdiction, which is fully committed to implementing internationally accepted standards.

What benefits would the removals from the FATF's and EU's AML/CFT 'Monitoring List' bring to users of Cayman Islands vehicles?

Following successful completion of an on-site inspection by the FATF, the jurisdiction will be eligible to be removed from the FATF's 'grey' list at the FATF's October 2023 Plenary. It is expected that the de-listing should also result in the jurisdiction's removal from the EU's AML/CFT List. The Ministry of Financial Services continues to hold direct discussions with EU officials with a view to making progress on regime enhancements to facilitate removal from the EU's AML/CFT List.

Both de-listings should eliminate any restrictions in conducting business with Cayman Islands vehicles and enhance global confidence in the use of Cayman Islands.

New and improved regulatory measures for CIMA regulated entities

On 14 April 2023, CIMA released a series of updated and new regulatory measures for all regulated entities, following industry consultation and feedback. The new measures, which come into effect on 14 October 2023, include the Rule and Statement of Guidance[1] (SOG) on Internal Controls and a Rule on Corporate Governance for Regulated Entities.

Why were the new regulatory measures issued?

In keeping with the commitments made to the FATF for enhanced regulation of certain sectors (including securities), CIMA has updated pre-existing Rules and SOGs and expanded their scope and application to certain regulated entities for consistency. Internal controls and corporate governance are key components across numerous international standards and the new measures align with international standards, e.g., Organisation for Economic Co-operation and Development (OECD) and International Organisation of Securities Commission (IOSCO).

What do regulated entities need to do?

The objective of the new measures is to ensure that all regulated entities establish, implement and maintain a corporate governance framework and adequate and effective internal controls.

CIMA will expect compliance to be evidenced by documentation and in practice. Documents evidencing implementation may include policies and procedures, compliance registers, board resolutions, governing body self-assessments, service agreements and constitutional documents.

The new measures should not create any undue burden for regulated entities, as they largely reflect internationally accepted principles.

CIMA recognises that the application of such requirements is proportionate and may vary subject to the size, complexity, structure, nature of business, risk profile and operations of the regulated entity. Delegation to, or reliance on, the systems and

1 A Rule is a CIMA directive creating a regulatory obligation, breach of which may lead to regulatory enforcement action. A SOG is a measure for CIMA to assess compliance with a Rule or the law.

controls of service providers or group entities through outsourcing arrangements is also permitted, subject to such policies and procedures meeting the requirements within the new measures and generally under Cayman Islands laws and regulations.

Why should regulated entities comply with the regulatory measures?

CIMA oversees regulated entities' implementation of, and compliance with, the applicable Rules and SOGs by: (i) conducting inspections directly on regulated entities (e.g., investment managers and advisers) and indirectly on their service providers (e.g., fund administrators and corporate service providers), during which documents evidencing implementation and compliance would be reviewed by CIMA; and (ii) requesting information and confirmation via annual surveys issued to all regulated entities (except for mutual funds and private funds) to demonstrate implementation and compliance. Any deficiencies are likely to be recorded by CIMA and require remediation or enforcement.

The introduction of these new measures should boost global recognition and confidence in the use of Cayman Islands vehicles in all regulated business relationships. We explain the requirements and their application in further detail below.

New Rule and Statement of Guidance on Internal Controls

The new Rule and SOG on Internal Controls for Regulated Entities (IC Rule and SOG) is divided into two parts. Part I contains general rules and guidelines for all regulated entities (including regulated mutual funds and private funds). Part II contains sector specific rules and guidelines, in relation to fiduciary service providers (e.g., trust companies, company managers and corporate services providers) and securities investment business (e.g., investment managers and advisers).

The five key components that an internal control framework should address are: control environment; risk identification and assessment; control activities and segregation of duties; information and communications; and monitoring activities and correcting deficiencies.

The IC Rule and SOG include several documentation and reporting requirements, as well as enhanced risk assessment and response measures for governing bodies, senior managers and those performing control functions. Regulated entities should carefully examine these requirements against existing systems and controls to determine whether they need to be enhanced to the new standards.

New Rule on Corporate Governance

The new Rule on Corporate Governance for Regulated Entities (CG Rule) applies to all regulated entities, including mutual and private funds.

The new CG Rule requires a regulated entity to establish, implement and maintain a corporate governance framework commensurate with its size, complexity, nature of business, structure, risk profile and operations. Similar to the IC Rule, the CG Rule will also be subject to proportional application.

The corporate governance framework must address, at a minimum: objectives and strategies; structure and governance of the governing body; appropriate allocation of oversight and management responsibilities; independence and objectivity; collective duties of the governing body; duties of individual directors; appointments and delegation of functions and responsibilities; risk management and internal control systems; conflicts of interest and code of conduct; remuneration policy and practices; reliable and transparent financial reporting; transparency of communications; duties of senior management; and relations with CIMA.

In addition to enhanced documentation requirements, governing bodies of regulated entities are required to meet, at least annually, to review and revise, as necessary, aspects of their corporate governance and internal control practices and frameworks to ensure there are no gaps in compliance with CIMA's measures. Governing bodies can also use this meeting to assess outsourcing arrangements and receive updates and reports from service providers.

Statement of Guidance on Corporate Governance for Mutual Funds and Private Funds

The SOG on Corporate Governance for Mutual Funds and Private Funds has been extended to apply to private funds and is intended to provide specific industry guidance with respect to addressing obligations under the CG Rule. The nature of the regulatory requirements is largely unchanged, except to import appropriate terminology in relation to private funds, such as references to 'marketing materials' in addition to offering memorandum. The SOG also replaces previous references to 'Governing Body' with 'Operator', in keeping with the terminology in the underlying Acts.

The new obligations should not impact current operating practices in a material manner, as there is flexibility in how and when the arrangements are implemented, as explained above. The new measures may need to be considered and reflected in the responses to the FAR forms to be filed with CIMA for FY2023 and onwards.

Updated measures

The updated measures include revisions made to existing SOGs on Outsourcing, Records Management and Cybersecurity.

The updated measures continue to apply to the same regulated entities to which they applied previously. The Outsourcing and Cybersecurity measures do not apply to regulated private or mutual funds.

New corporate governance framework for Cayman managers and funds

Tom Katsaros
Principal – Head of Funds, Singapore
Carey Olsen Singapore LLP
Email Tom Katsaros

Toh Wei Xun
Associate
Carey Olsen Singapore LLP
Email Toh Wei Xun

Sponsors working with multi-jurisdictional fund structures are well-acquainted with the use of Cayman entities acting as its investment manager/advisor and/or investment fund vehicle. This typically involves (i) the manager/advisor performing investment business activities being registered with the Cayman Islands Monetary Authority (**CIMA**) under the Securities Investment Business Act (as amended) of the Cayman Islands as a registered person (**registered person**), or (ii) the fund being registered with CIMA as a mutual fund or private fund (Registered Fund and collectively with registered persons, **regulated fund entities**).

In April 2023, CIMA published the following new/updated rules and statements of guidance (the **New CG Framework**) relating to the governance of, among others, regulated fund entities:

- CIMA rule – corporate governance for regulated entities
- CIMA rule and statement of guidance – Internal controls for regulated entities
- CIMA statement of guidance – Corporate governance for mutual funds and private funds
- CIMA statement of guidance – Nature, accessibility and retention of records
- CIMA statement of guidance – Outsourcing regulated entities (Note: This only applies to registered persons and not registered funds)

The majority of the New CG Framework took effect on 14 April 2023, with the rule on corporate governance for regulated entities and the rule and statement of guidance on internal controls for regulated entities recently taking effect on 14 October 2023.

CIMA's Rules impose binding obligations on regulated fund entities and violations may result in administrative fines or regulatory actions. Statements of guidance aid regulated fund entities in meeting regulatory requirements and serve as a basis for CIMA's evaluation of compliance.
The New CG Framework extends to CIMA-regulated entities such as virtual asset service providers, banks and insurers, but this article focuses on its applicability to regulated fund entities – in particular, the rule on corporate governance for regulated entities and the statement of guidance on corporate governance for mutual Funds and private funds.

Summary of New CG Framework

The New CG Framework maintains continuity with the previous corporate governance framework of the Cayman Islands but aims to establish a consistent and enforceable governance regime for all Regulated Fund Entities while simultaneously eliminating gaps in the previous regime.

Notably, it now applies to registered private funds which were not previously covered. Additionally, CIMA updated its measures to align with international best practices and ensure sufficient supervisory and enforcement powers.

To this end, CIMA requires the governing body/operator (i.e., the board of directors for companies and general partners for limited partnerships) of a Registered Fund Entity to implement a framework addressing the following essential points (this list is non-exhaustive):

1. Objectives and strategies	Governing body must: a) establish/oversee implementation of corporate culture, business objectives and strategies for achieving such objectives (including ongoing monitoring and evaluation); b) document objectives and strategies of entity and communicate it to senior management/staff of entity; c) ensure entity adopts management structure commensurate with size, complexity, structure, nature of business and risk profile of operations.
2. Structure and governance	a) Governing body must have: i. appropriate number of individuals with diversity of skills, background, experience and expertise to ensure adequate level of competence in governing body; ii. documented internal governance practices and procedures to promote efficient, objective and independent judgment/decision making by governing body; iii. policies on conflict of interest, code of conduct, private transactions, self-dealing and preferential treatment of favoured internal/external entities; iv. requirement for directors/senior management to declare actual/potential conflicts of interests; v. appropriate succession plan for directors/senior management; vi. nomination, appointment, resignation, disqualification and termination procedures for directors/senior management; and vii. documented responsibilities of sub-committees to ensure no single person has unfettered control of business. b) Governance structure of registered fund entities must be appropriate/suitable for effective oversight. Factors such as size, complexity, business nature, and risk profile are crucial in determining the adequacy of governance framework.
3. Appropriate allocation of oversight and management responsibilities	Define and document roles/responsibilities allocated to governing body, senior management and persons in control functions (i.e., authorised functions serving control or checks/balances function from governance standpoint and carrying out activities including strategy setting, risk management, compliance, actuarial matters, internal audit and similar functions) to promote appropriate separation of oversight function from management responsibilities.

<table>
<tr><td>4. Independence and objectivity</td><td>Governing body must establish and document clear/objective independence criteria met by members/employees to promote objectivity in decision making.</td></tr>
<tr><td>5. Collective duties</td><td>Governing body must:

a) notify CIMA within 10 days of substantive issues which could materially affect regulated fund entity;
b) enquire into affairs of regulated fund entity and request information from management/service providers (service providers);
c) ensure that business of regulated fund entity is conducted in compliance with applicable acts, rules, regulations and regulatory measures in Cayman Islands and applicable jurisdictions; and
i. Operators of registered funds must be satisfied that service providers are monitoring compliance similarly by, among others, requesting appropriate information/regular reporting from service providers and providing directions to rectify any non-compliance by service providers.

d) at least once per year:
i. review strategic objectives/policies of regulated fund entity;
ii. evaluate progress made towards achieving strategic objectives;
iii. review composition of governing body to ensure sufficient knowledge, skills, experience, commitment and independence to oversee regulated fund entity effectively and effectively manage any outsourced operations;
iv. undertake self-assessments of performance of governing body and individual members;
v. review implementation of risk assessment/management systems;
vi. review implementation of internal controls; and
vii. review remuneration policy for senior management.

e) for registered funds:
i. regularly monitor investment manager’s performance in accordance with investment criteria/strategy/restrictions;
ii. at all material times be apprised of investment activities, performance and financial position;
iii. review/approve financial results and audited financial statements; and
iv. regularly monitor NAV policy and whether calculation of NAV is in accordance with policy.</td></tr>
</table>

6.	**Duties of individual directors**	a) Governing body must indicate minimum time commitment expected from non-executive directors in letters of appointment and confirm on-going minimum time commitment expected on annual basis at beginning of each year. b) CIMA has reiterated standard fiduciary duties expected of directors to (i) act in good faith, honestly and reasonably, (ii) exercise due care and diligence, and (iii) act in best interests of regulated fund entity and its stakeholders. c) Each director must maintain knowledge and understanding of regulated fund entity's business and update his/her knowledge periodically. d) Each director must make enquiries where issues/complaints are raised and satisfy him/herself that such concern is addressed appropriately/timely. Such issues/complaints and corrective actions must be properly documented. e) Each director must not be subject to undue influence from senior management and have access to all relevant information about regulated fund entity. f) Directors of operators of registered funds should ensure that they are able to perform duties responsibly and effectively before taking on any additional funds.
7.	**Appointments and delegation of functions and responsibilities**	a) Sub-committees established to carry out delegated powers of governing body should not relieve governing body of responsibilities and must have charter of terms of reference setting out mandate, scope, accountability, reporting obligations and working procedures. Appropriate records of deliberations and decisions of sub-committees must be maintained. b) Compliance committee or person reporting directly to governing body on compliance matters must be appointed. For registered funds, AML compliance officer providing a report at least annually suffices.
8.	**Risk management and internal control systems**	a) Governing body must provide oversight on design/implementation of sound risk management and internal control systems/functions. b) Operators of registered funds should ensure material risks are discussed at meetings and appropriate action taken where necessary.
9.	**Conflicts of interest and code of conduct**	a) Directors/senior management must declare actual/potential conflicts of interest. b) Governing body must establish written 'conflicts of interest' policy for members which includes (i) member's duty to avoid activities that could create/appear to be a conflict, (ii) review/approval process before members engage in certain activities to ensure no conflict, (iii) duty to disclose any matter that may/has resulted in a conflict, (iv) subject to being permitted under constitutional documents, responsibility to abstain from voting on any matter where member may have conflict, (v) procedures for transactions with related parties on arm's length basis, and (vi) manner of dealing with non-compliance with policy. c) Directors/senior management must confirm conflicts declared throughout the year in annual written declaration. d) For registered funds, CIMA has clarified that policy and conflicts may be documented in constitutional documents, offering documents or marketing materials.

10. **Remuneration policy and practices**	Governing body must implement written remuneration policy applying to, among others, directors, senior management and employees in control functions. This may not be applicable to registered funds if no senior management is hired or remuneration paid to directors of operators.
11. **Reliable and transparent financial reporting**	Governing body must establish audit committee responsible for financial reporting process.
12. **Transparency and communications**	A meeting of governing body must be held at least annually (and more frequently if necessary).
13. **Senior management duties**	Governing body must ensure that senior management: a) is sufficiently accountable to governing body; b) carries out operations of entity effectively; c) provides governing body adequate and timely information to enable governing body to carry out duties/functions; and d) maintains adequate/orderly/easily accessible records of internal organisation.

The vast majority of registered funds will be unstaffed, so some rules/requirements may not be relevant in every case. As a result, the role of the operator will largely involve assessing and monitoring the registered fund's service providers.

Where a registered fund Entity's functions are outsourced, it may rely on the internal controls of service providers, provided the governing body/operator is satisfied with their compliance with the rules.

Conclusion

The Cayman Islands is taking significant final steps towards its removal from the Financial Action Task Force (**FATF**) grey list by diligently enforcing sanctions and penalties against obligated entities and ensuring timely remediation of violations. Consequently, CIMA has been actively monitoring and auditing Regulated Fund Entities to ensure compliance with requirements.

Having fulfilled the FATF's action plan for removal from the grey list on 23 June 2023, the Cayman Islands remains committed to upholding its reputation as a leading hub for international financial services and continue their momentum in implementing robust measures to combat money laundering, terrorist financing, and the proliferation of weapons of mass destruction.

Accordingly, while the New CG Framework does not impose drastically different obligations on regulated fund entities, it is advisable to identify any potential gaps in internal controls and policies to avoid issues during CIMA inspections or audits related to the New CG Framework.

This will further strengthen the existing standards and maintain the Cayman Islands' competitive edge as a jurisdiction of choice for regulated fund entities.

We advise regulated fund entities to acquaint themselves with the relevant regulatory measures, and to contact your regular Carey Olsen advisers to discuss further.

Thank you for reading the
Edition 135 of the AIMA Journal.

If you would like to contribute to future editions, please email Caterina Giordo

PUBLICATION PLAN 2023

Q4 Edition 136

Deadline for submission 5pm UK time Monday 23rd October | Publication Monday 20th November

Please note the deadline to reserve a spot for the Q4 edition of the AIMA Journal is 5pm UK time Friday 6th October. Please note that availability is limited, and we cannot accept any additional contributions once all the spots have been filled.

Visit aima.org for more information and to read our editorial guidelines.

CONTACT US

Bermuda
usa@aima.org

Brazil
info@aima.org

Brussels
38/40 Square de Meeus, 1000
Brussels, Belgium
+32 2 401 61 46
info@aima.org

Cayman Islands
cayman@aima.org

Hong Kong
Unit 1302, 13/F, 71-73 Wyndham
Street, Central, Hong Hong
+852 2523 0211
apac@aima.org

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

Middle East
info@aima.org

New York City
12 East 49th Street, 11th Floor.
New York, NY, 10017, USA
+1 646 397 8411
usa@aima.org

Singapore
1 Wallich Street, #14-01 Guoco
Tower, Singapore 078881
+65 6535 5494
apac@aima.org

Shanghai
Suite A10, 28th Floor SWFC, No.
100 Century Avenue, Pudong,
Shanghai 200120, China
+86 136 1191 9817
apac@aima.org

Sydney
+61 (0) 412 224 400
apac@aima.org

Toronto
500 - 30 Wellington Street West,
Box 129, Commerce Court,
Toronto, ON M5L 1E2, Canada
+1 416 364 8420
canada@aima.org

Tokyo
+81 (0) 3 4520 5577
apac@aima.org

Washington
1100 15th St NW,
Washington, DC 20005-1707, USA
+1 202 919 4940
usa@aima.org

THANK YOU TO ALL OUR SPONSORS

ACA

ALLEN & OVERY

CITCO

CLIFFORD CHANCE

Dechert LLP

EY Building a better working world

FORMIDIUM

iConnections

K&L GATES

KPMG

Man

MAPLES GROUP

pwc

RSM

simmons + simmons

SS&C

STATE STREET.

TD Cowen a division of TD Securities

AIMA

THE ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION

aima.org