AIMA Journal - Edition 117

Includes:

#Metoo

SaaS

Cryptoassets

Brexit

Artificial intelligence

ESG

SMCR

...and more

Message from AIMA's CEO

Jack Inglis

Jack Inglis, CEO, AIMA

A warm welcome to the latest edition of the AIMA Journal. As always, the level of expertise and quality of commentary in this edition remains at the highest standard and demonstrates the great depth of insight that our membership possesses. We would like to express our thanks to all those who contributed to this edition.

Readers will benefit greatly from a variety of articles ranging from developing trends impacting industry regulation, the latest thoughts on the consequences of Brexit, understanding co-investment, global enforcement trends relating to crypto-asset investigations, managing event risk, integrating Natural Language Processing (NLP) into investment analysis, computer vision technology and autonomous investment learning strategies (ALIS) and more.

Allen and Overy explores how important an issue sexual misconduct is for the FCA and how this can impact firms from a regulatory perspective. Robert Quinn Consulting outlines its considerations on the extension to the Senior Managers and Certification Regime (SMCR) scheduled to go live in December. Dechert explores the role of private fund side letters, offering an overview of common side letter terms, including the regulatory context and practical guidance for managers navigating the restrictions and obligations that come with using multiple side letters.

On Brexit, Cappitech offers its latest thoughts, examining whether EMIR and MiFIR delegated reporting for asset managers will survive the UK's divorce from the EU, while DRS offers an insightful article on why considering upcoming initial margin regulations is something AIMA members should consider sooner rather than later.

Things to consider when raising co-investment vehicles including structuring, key terms, offering issues and regulatory issues are covered in an insightful piece by Kleinberg Kaplan. CME Group discusses three phases of event risk and what is needed to manage them. It also looks ahead to analyse different event risk debates that are currently at the forefront of market attention.

It seems like no AIMA journal is complete these days without contributions to the debate regarding the increasingly disruptive influence of technology and ESG on the hedge fund sector.

Deloitte offers an interesting article on integrating natural language processing and natural language generation into analytical models to augment research for investment managers. Staying with technology, Citco Fund Services explains how SaaS solutions can enable fund managers to concentrate on alpha-generating activities while leaving logistics and software development to a third party. Mov37 considers the burgeoning role that computer vision technology, both with and without the latest Artificial Intelligence techniques, is already serving in financial services and situate this trend within the larger movement toward computer automation in investment practice.

On the cryptoasset front, Clifford Chance shares data obtained from the FCA by a freedom of information request relating to cryptoasset investigations, and analyses global enforcement trends.

On ESG and sustainable investment, Société Generale discusses barriers to implementation and generating financial outperformance. State Street outlines the development of infrastructure as an asset class, its composition and popularity with institutional investors.

Elsewhere, Maritime Super appraises the 'manager model' of Operational Due Diligence. The piece includes an explanation of how the process provides the foundation for investors to make their operational risk assessments and, by doing so, saves the duplication of ODD groundwork common to all investors.

Finally, Bernadette King of haysmacintyre provides her thoughts on her career to date, including how the accounting profession has become more diverse and the need to remain dynamic in order to keep with a rapidly changing industry.

We hope you enjoy reading edition 117 and wish you well for the year ahead.

What topics would you like to see in future editions?

- ○ SRI/ESG
- ○ Diversity & inclusivity
- ○ Latest policy & regulatory themes
- ○ Investment strategy overviews
- ○ Private credit
- ○ Macro-economic and related commentary
- ○ Operational due diligence and industry sound practices
- ○ Digital assets and blockchain

SEE RESULTS

#Metoo in asset management

by Sarah Hitchins and Robbie Sinclair, Allen & Overy

READ ON

Sarah Hitchins

Senior Associate, Allen & Overy

Sarah.Hitchins@allenovery.com

Robbie Sinclair

Senior Associate, Allen & Overy

Robbie.Sinclair@allenovery.com

If there is one thing that we have learnt from the #metoo fallout, it is that no sector is immune from this type of misconduct. And it is telling that a range of industry bodies in sectors such as law, charities, construction and entertainment have been quick to issue guidance on dealing with these issues.

The Financial Conduct Authority (FCA) has made it clear that it views sexual harassment as an important issue. Its interest in allegations and findings of sexual harassment or other sexual misconduct about individuals who work for the firms it regulates is part of the FCA's broader focus on culture within the UK financial services industry.

The FCA's interest in this area is not new. Many firms (especially banks and building societies that are already subject to the FCA's Senior Managers and Certification Regime (SMCR)) have been taking a more holistic view of misconduct for some time, recognising that non-financial misconduct (including sexual harassment and other sexual misconduct) can have regulatory implications. However, the issue has received considerably more public attention following the recent publication of a letter written by the Executive Director of Supervision at the FCA, Megan Butler, to the Women and Equalities Committee which emphasised the interest that the FCA is taking in relation to 'poor personal misconduct, including allegations of sexual misconduct'.

It therefore comes as no surprise that we find ourselves being asked with increasing regularity how allegations and findings of sexual harassment or other sexual misconduct impacts firms and individuals from a regulatory perspective.

How will things look after the implementation of the SMCR?

The spotlight on individual accountability and overall culture will be intensified following the implementation of SMCR for FCA-only authorised firms, which will include alternative investment managers, on 9 December 2019. From this date firms will be turned into mini-regulators with responsibility for assessing the fitness and propriety of their Senior Managers and Certified Persons, as well as assessing potential breaches of the FCA's Code of Conduct for almost all employees as and when issues arise. The FCA has made it clear that firms' responsibilities in relation to these matters will extend to allegations of sexual harassment or other sexual misconduct.

Fitness and propriety

Some firms may have viewed #metoo type allegations as 'HR issues'. That is not the FCA's view. Even though this type of misconduct may not appear as relevant to FCA's traditional areas of regulation in the same way as financial misconduct (e.g. misstating the value of a position), it is misconduct which the FCA still expects firms to consider from a regulatory perspective.

Even before the SMCR comes into force for alternative investment managers, allegations of sexual misconduct should be considered in light of the fitness and propriety requirements that apply to approved persons and the FCA's Statement of Principle and Code of Conduct for Approved Persons (APER). With the introduction of SMCR, however, one of the factors that firms are required to consider when assessing the fitness and propriety of an individual is their 'personal characteristics'. This criterion has led to firms taking a more holistic view of an individual's suitability to perform a particular role, and has led to firms considering the fitness and propriety implications of some individuals' 'strong' or 'robust' management styles, as well as allegations of bullying and non-sexual harassment. In the wake of the #metoo movement, allegations or findings of sexual harassment or other sexual misconduct now fall to be considered within an individual's 'personal characteristics'.

While the FCA has been clear that issues of sexual harassment should be considered from a fitness and propriety perspective, its guidance has been less clear on the action firms should take in relation to individuals who are implicated or potentially implicated in these situations.

Invariably, each allegation or finding of sexual misconduct has to be assessed on a case by case basis looking at all the circumstances including the individual's role and relationship with the victim, the surrounding evidence and any explanation given. Bear in mind that, when looking at the factual matrix, the relevance of the misconduct to the role that an individual performs for a firm may be critical, given that a number of allegations made about #metoo type behaviour relates to the alleged abuse of power by a senior individual over a more junior individual. For example, take a senior male in a firm who holds a Significant Influence Function (under the current approved persons regime) or holds a Senior Manager or Certified Person role (under the SMCR) who manages numerous women. If he acted towards one or more of these women in a way that was sexually inappropriate, the FCA may view this behaviour as undermining his supervisory responsibilities, thereby calling into question his competence and capability and potentially also his integrity to carry out his role.

Obviously, the more serious the misconduct, the more likely that it will impact on an individual's fitness and propriety and, in particular, their honesty and integrity. For example, committing sexual assault is a clear example of conduct that impacts an individual's fitness and propriety, whereas a one-off comment made by an individual that includes sexual innuendo is likely to be less clear-cut. When misconduct arises (including but not limited to #metoo type misconduct), firms will often need to make nuanced judgement calls based on the specific facts. Developing a robust and consistent approach to assessing fitness and propriety in these situations is an issue with which banks and building societies are still grappling, almost three years after the SMCR came into force for them.

Wherever a firm comes out in relation to the fitness and propriety of an individual who is implicated in a #metoo complaint, it is important for a firm to carefully record the thought process followed in reaching that decision and the rationale for it.

APER and the FCA's Code of Conduct

#metoo type misconduct which raises fitness and propriety issues will not, however, always amount to a breach of one or more of the Conduct Rules set out in the FCA's Code of Conduct (which will come into force for alternative investment managers with the SMCR in December 2019). This is because, unlike fitness and propriety (which can take into account any conduct engaged in by a person), the scope of the Code of Conduct is narrower. It will apply to (among other things) activities that have, or might reasonably have, a negative effect on the integrity of the UK financial system or the ability of a firm to meet its own fitness and proprietary requirements. Although the FCA does not specifically refer to #metoo type misconduct when it defines the scope of activities to which the Code of Conduct will apply, the Individual Conduct Rules are sufficiently broad to capture this type of misconduct in some circumstances. The FCA has publicly reinforced that this could be the case. In her recent letter, Megan Butler confirmed that: '[s]exual harassment and other forms of non-financial misconduct can amount to a breach of [the FCA's] Conduct Rules'.

From the starting point that #metoo type misconduct can fall within the scope of the Code of Conduct, the next question firms will need to answer is which (if any) of the Conduct Rules have potentially been engaged in a particular case. The FCA's general and specific guidance relating to the Code of Conduct does not specifically refer to how conduct such as bullying, harassment and #metoo type misconduct should be interpreted under the Code of Conduct. However, the FCA's guidance in this area is not intended to be exhaustive and, as a result, firms are left to come to their own views about which of the Conduct Rules may be engaged by #metoo type misconduct. The most obvious candidates are Individual Conduct Rule 1 (acting with integrity) and Individual Conduct Rule 2 (acting with due skill, care and diligence).

The activities that fall within the scope of APER are narrower than the activities that will fall within the scope of the Code of Conduct from December 2019 onwards. APER applies to the performance by an approved person of their controlled functions or in relation to the carrying on of regulated activities, whereas the Code of Conduct applies to a much broader scope of conduct, including unregulated activities. In light of this narrower scope, it is less likely that #metoo type misconduct could fall within the scope of APER.

What is clear though is that the FCA expects firms to consider whether misconduct (including #metoo type misconduct) falls within the scope of APER or the Code of Conduct and, if not, to record the reasons why. While firms may conclude for a variety of reasons that some (but not necessarily all) #metoo type complaints which concern events that took place outside of work fall outside the scope of APER or the Code of Conduct, it will be important for firms' records to show how these decisions were reached and that a robust process was following in reaching them.

Linking tolerance of sexual harassment to a poor culture

We can now say categorically that the FCA is interested in allegations and findings of sexual misconduct, and that such misconduct (as well as other forms of non-financial misconduct) may form the basis for an adverse finding in relation to an individual's fitness and propriety and potentially also their compliance with the Code of Conduct. #metoo misconduct can no longer be considered an 'HR issue' within financial services firms.

Addressing the Women and Equalities Committee in relation to their work on sexual harassment in the workplace on behalf of the FCA, Megan Butler felt confident in making a link between a culture where sexual harassment is tolerated and one 'which would not encourage people to speak up and be heard, or to challenge decisions'. For the FCA, tolerance of sexual harassment is not only 'a driver of poor culture' but also a barrier to ensuring that firms retain their best talent and make the best business decisions and risk decisions.

Walking the walk

Not only is the FCA talking the talk in this area, it is walking the walk. Through Megan Butler's letter, the FCA has made it clear that it has a number of tools to ensure that firms take allegations of sexual harassment and misconduct seriously. Her comments are very helpful as they give a degree of clarity in an area in which the FCA had previously been silent, particularly in the following:

- **Fitness and propriety**: Sexual misconduct may have an adverse impact on an individual's honesty, integrity and reputation for the purposes of assessing their fitness and propriety, in the same way that a criminal conviction can. Interestingly, findings of discrimination and harassment more generally may also have a similar impact on an individual's fitness and propriety.

- **Code of Conduct**: Sexual misconduct can amount to a breach of the FCA's Code of Conduct when it comes into force for alternative investment managers from December 2019 (for Senior Managers and Certified Persons) and December 2020 (for all other in-scope employees). If a breach of the Code of Conduct is established, that breach must be reported to the FCA (within seven days in the case of Senior Managers). Whether sexual misconduct can amount to a breach of APER is less clear-cut, given its narrower scope.

- **Regulatory references**: If a disciplinary sanction has been imposed on an individual in relation to sexual misconduct (or if an individual resigns when allegations have been made) this is something that a firm is likely to need to include on any regulatory reference provided in respect of that individual, regardless of what (if any) decision is taken about that individual's fitness and propriety or compliance with the Code of Conduct or APER.

- **Whistleblowing**: In addition to using a firm's internal whistleblowing procedures to report allegations of sexual misconduct, the FCA has expressly invited individuals to raise such allegations directly with it through its whistleblowing procedure. The FCA said in Megan Butler's letter that it would be particularly interested in any reports that indicated that a firm was ‘systematically mishandling allegations or incubating a culture of sexual harassment’.

And there’s more…

If necessary, the FCA has said that it will discuss allegations of sexual harassment and how such allegations are handled by firms in the course of its supervisory work, and that it will continue to focus on the issue in its strategic planning as well as its day-to-day operational work. So we should not expect #metoo to slip down the regulatory agenda for the FCA in 2019.

For more information please visit our website.

Saas: The Next Frontier in Fund Outsourcing

By Albert Bauer, Citco

READ ON

Albert Bauer
Head of Products, Citco Fund Services (USA) Inc.
abauer@citco.com

Software as a Service is a subscription-based approach that can deliver unlimited scalability, unprecedented flexibility and increased accessibility for fund operations.

It is no secret that fund managers are constantly looking for ways to do more with less. Their problem has always been that improving efficiency in fund operations also increases operational risk. For example, installing new technology increases the risk of system downtime and data loss. It may also require the installation of new and unfamiliar hardware.

But there is now a more effective way for managers to implement better tools within their organizations and access just the services they need. It's called Software as a Service – SaaS.

SaaS solutions enable managers to use complete outsourced, managed services – or they can simply implement a better tool for a specific job within their organization. Whichever approach they take, SaaS solutions enable managers to concentrate on alpha-generating activities while leaving operational logistics and software development to a third-party.

The Citco group of companies' ("Citco") new Æxeo Treasury system is an example of a tool that can either be fully used by a manager's operations team or provided as an outsourced managed service. That managed service can be anything from simply providing help with processing third-party invoices all the way to having Citco manage all cash movements to fund counterparties.

SaaS solutions use cloud-based software. This means that the hard work of running applications is carried out on centrally-hosted systems that are specifically designed for this task, and there are dedicated teams that keep the applications secure and up-to-date.

As a result, the SaaS approach offers lower up-front costs, reduced roll-out time and a near-endless capability for scalability and integration, compared to traditional inflexible models of software installation. Moreover, because SaaS applications are hosted and managed in the cloud, the software is always up-to-date, with state-of-the-art solutions for security and the changing regulatory environment rolled out to all users as soon as they are ready.

Where the installation of traditional fund administration systems required huge upfront effort and cost, SaaS is scalable, so funds can begin by using just a small subset of the total tools on offer. Instead of receiving a large initial bill, managers pay by subscription for the services they actually use.

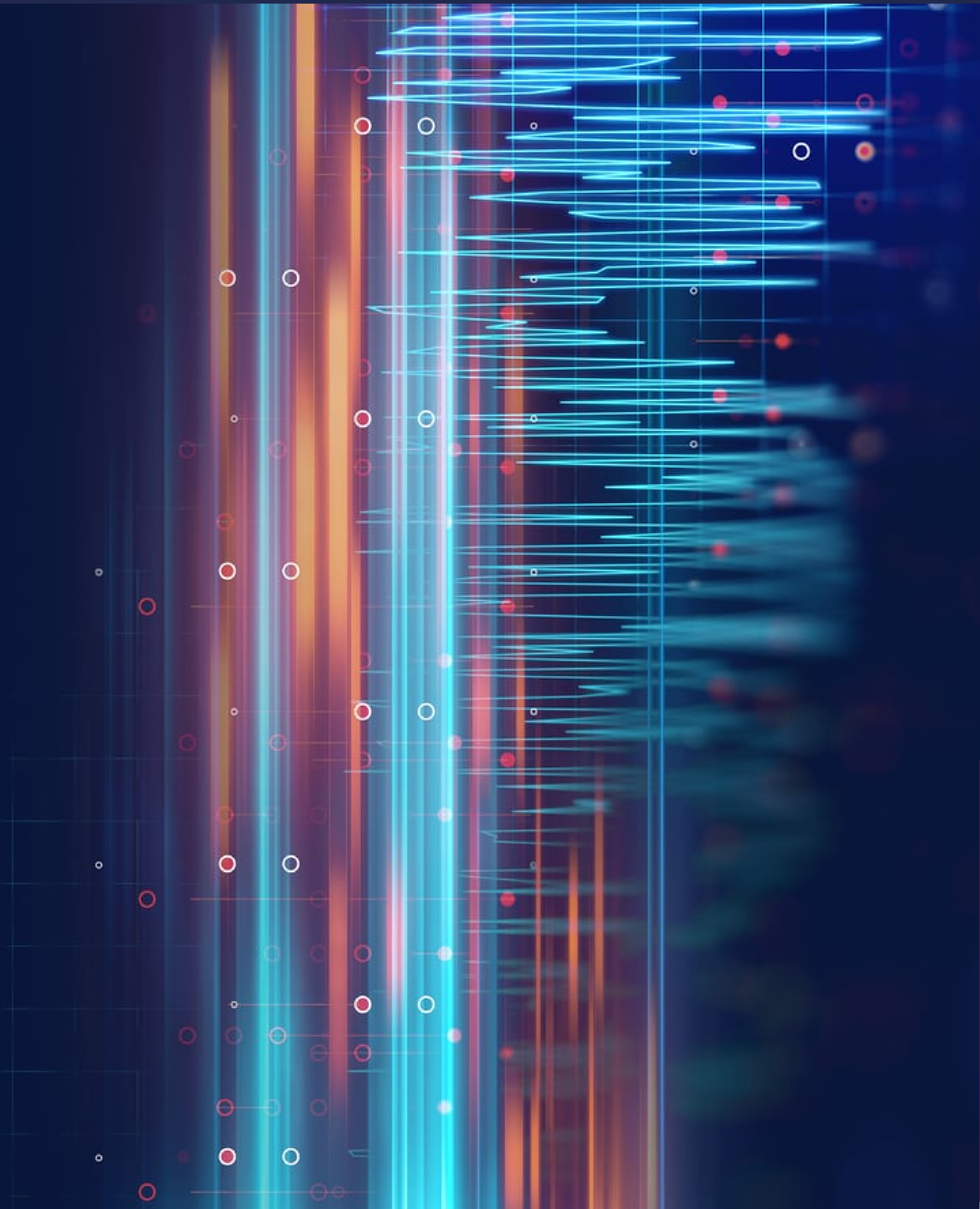
The development of SaaS systems in fund administration can be seen as an evolution of outsourcing. For some years, the traditional one-size-fits-all model of running operations internally has not been suitable for all managers. Depending on where a manager is in his/her lifecycle, the full internal model can be less effective and costlier. As a result, many asset managers are choosing to outsource some or all of their middle and back office operations. Outsourcing ensures that those best equipped to handle tasks are delegated exclusive responsibility for them, and thus can dedicate all their resources to guaranteeing utmost efficiency.

Providers of outsourced solutions, such as Citco, have always been at the forefront of developing and delivering technological solutions that can manage the growing complexities of fund administration. One benefit of being a third-party vendor is that we have the capability and resources to innovate specifically for operational processes, which is the crux of our service for clients. As a result, the last decade has seen a broad adoption of emerging technology in fund outsourcing.

Since 2008, fund managers have increasingly adopted cloud-based solutions, commoditized data subscription services, and a hybrid mix of cyber security and reporting applications. The direct benefits of this adoption have been increased flexibility, data accuracy, team collaboration, transaction expediency, compliance management and improvements across all workflows.

At Citco, Saas is simply the next step on this journey. As our clients' needs change, so too do our solutions. We partner continually with our clients to deliver innovative technology and will soon introduce the next generation of born-on-the-cloud SaaS solutions. Our goal is to develop these solutions in the most flexible manner possible to suit our clients' varied demands, while always enabling quick onboarding for new clients and the ability to roll out additional functionality. This approach will continue to enhance fund managers' operations and improve resiliency across all administrative functions.

SaaS is the ultimate solution for outdated traditional software models because it improves on legacy inefficiencies while retaining the highest levels of security and control. Without a doubt, the future for financial services is SaaS-based.



Cryptoasset Enforcement - where are we at the end of 2018? What to expect in 2019?

by Robert Rice, Steven Gatti, Kelwin Nicholls, Oliver Pegden and Ben Peacock, Clifford Chance





Robert Rice
Partner, Clifford Chance

Steven Gatti
Partner, Clifford Chance

Kelwin Nicholls
Partner, Clifford Chance

Oliver Pegden
Senior Associate, Clifford Chance

Ben Peacock
Senior Associate, Clifford Chance

On 11 December 2018, Andrew Bailey, Chief Executive of the UK FCA, speaking to an audience in London, praised the enforcement action taken by the SEC in relation to initial coin offerings (ICOs) and said that European regulators could learn from the SEC's strong interventions. The FCA is expected to consult on the regulation of cryptoassets early in 2019 but has not yet taken any enforcement action.

In this briefing, we share data obtained from the FCA by freedom of information request relating to current cryptoasset investigations and analyse enforcement trends globally.

UK investigative activity

In October, the Cryptoasset Taskforce (HMT, FCA and Bank of England) published its Final Report which identified the main risks associated with cryptoassets as financial crime, risks to consumers, risks to market integrity and risks to financial stability.

Subsequently, we made a freedom of information request to the FCA asking for detailed information regarding the FCA's investigations or enquiries relating to cryptoassets (broadly defined to include: cryptocurrencies, derivative instruments referencing cryptocurrencies, investment assets in cryptocurrencies, security tokens and utility tokens).

As at November 2018, there were no current cryptoasset-related FCA enforcement investigations (the same position as existed in May 2018). However, the FCA was conducting 21 separate enquiries in relation cryptoasset perimeter issues (i.e. whether firms that are involved in some form of cryptoasset business might be carrying on regulated activities without appropriate authorisation). These enquiries were not solely focused on issuers - they included enquiries into firms who may be conducting regulated activities through advising and/or arranging deals in cryptoasset investments.

There were two ongoing enquiries into authorised firms in relation to cryptoasset activities. One enquiry related to the potential misappropriation of client funds, the other related to providing account services to a cryptocurrency exchange. There were two open enquiries relating to the money laundering risks associated with cryptoassets.

There were no market abuse enquiries relating to cryptoassets and, perhaps surprisingly given the reports of manipulation in cryptocurrency derivative markets, the FCA was unable to find any record of having received any Suspicious Transaction and Order Reports (STOR) relating to cryptocurrency derivatives over the last two years.

Wider enforcement trends

It is unsurprising to see the FCA focused on perimeter issues.

The past two years have been characterised by uncertainty as to whether cryptoassets, particularly tokens issued as part of ICOs, constitute securities falling within existing regulatory perimeters.

During this period, enforcement investigations globally have focused heavily on perimeter issues, playing an important role in enabling authorities to develop their understanding of cryptoasset businesses and products and to signal interpretations of the perimeter.

As Andrew Bailey indicated, the US has led the way. Prior to 2017, publicly-announced SEC actions focused on products that clearly qualified as U.S. securities, such as offerings of shares in bitcoin investment trusts or tokens that purported to represent shares in a company. The SEC's enforcement efforts broadened in 2017 beginning with the publication of the Slock.it Decentralized Autonomous Organization (DAO) Report which concluded that the tokens issued by the DAO constituted investment contracts, and therefore securities. The SEC declined to penalise Slock.it because the DAO Report was the first instance in which the SEC asserted broad authority to regulate ICOs, but since then the SEC has settled multiple enforcement actions related to ICOs and is actively investigating additional ICOs. Most recently in November 2018, the SEC announced that it settled charges against two firms for securities offering registration violations in connection with ICOs. These were the first occasions on which the SEC has imposed civil penalties against ICO issuers for securities offering registration violations only (a prior enforcement action for securities offering registration violation in connection with an ICO was settled without imposition of a penalty after the issuer voluntarily refunded all proceeds of the ICO).

Elsewhere in the world, enforcement activity has been more limited, but has also focused on perimeter issues.

In May 2018, the Singapore MAS, in its strongest public reprimand over digital tokens, stopped an issuer of an ICO from continuing with its fund-raising bid as its tokens represented equity ownership in a company and therefore would be considered securities. The MAS also warned eight unnamed digital token exchanges in Singapore not to facilitate trading in digital tokens that are securities or futures contracts without the MAS' authorisation.

The Hong Kong SFC has not yet taken any formal enforcement action against any cryptocurrency exchanges or issuers of ICOs. However, in February 2018, the SFC issued letters to various cryptocurrency exchanges and ICO issuers warning them that they should not trade or issue cryptocurrencies that are "securities" under the SFO without authorisation. In March 2018, ICO issuer Black Cell Technology Limited (Black Cell) halted its ICO to the Hong Kong public and agreed to unwind ICO transactions for Hong Kong investors after the SFC had expressed concerns that Black Cell had engaged in potential unauthorised promotional activities and unlicensed regulated activities. We see a similar pattern elsewhere.

Until recently, authorities themselves have defined the regulatory perimeter through published guidance and settled enforcement cases. Recently, however, enforcement actions have started to arrive in the courts, providing an opportunity for judicial guidance.

In September 2018, a Federal Judge in the Eastern District of New York, in the context of the criminal prosecution of Maksim Zaslavisky for securities fraud in connection with two ICOs, ruled that a reasonable jury could conclude that the ICO tokens in question were investment contracts falling with the scope of securities laws.

Meanwhile, also in September 2018, the Higher Regional Court of Berlin held in a criminal enforcement case, that Bitcoins are neither a financial instrument nor units of account within the meaning of the German Banking Act and that therefore operating a Bitcoin trading platform does not require a German banking licence. The German government is currently investigating whether the German Banking Act needs to be amended to support BaFin's current administrative practice of defining the scope of licensable activities and deciding whether an activity is licensable under the German Banking Act.

In recent months we have seen US perimeter enforcement activity expand focus beyond issuers. On 11 September, the SEC announced two settled actions against non-issuers, TokenLot and Crypto Asset Management. These cases marked the SEC's first cryptocurrency enforcement actions against non-issuers for failing to register as broker-dealers and investment companies. TokenLot operated as a broker by facilitating sales of digital tokens offered by nine ICO issuers. CAM managed Crypto Asset Fund, a pooled investment vehicle formed for investing in digital assets. On 8 November, the SEC announced a settlement with the founder of EtherDelta, a trading platform for digital assets, for operating as an unregistered national securities exchange. We expect enforcement authorities elsewhere to expand the focus of their perimeter investigations similarly.

Looking ahead in enforcement

We expect to see continued enforcement activity in relation to perimeter issues as authorities gain confidence in the conduct of these types of investigations and anticipate hardening of the rules. But we also expect that, as changes in law take effect and the perimeter is better defined, authorities will expand enforcement activities to other issues.

We expect, in particular, to see a growth of enforcement activity relating to market misconduct, anti-money laundering and investor protection (within the regulatory perimeter).

As regards market misconduct, we expect to see an increase in enforcement focused on market manipulation of cryptoassets. To-date publicly-announced enforcement activity in this area has been largely confined to action taken by the CFTC in the US. This has focused exclusively on fraud related to bitcoin. Now that bitcoin futures contracts are trading on U.S. exchanges (with bitcoin options scheduled to begin trading soon), it is likely that the CFTC will increase its efforts to police bitcoin manipulation. In summer 2018, it was widely reported that the CFTC was taking aggressive action to obtain trading data from cryptocurrency spot exchanges whose prices are components of the reference rate used to price the CME's Bitcoin futures contract. We expect similar trends elsewhere, particularly in the UK where the FCA has been increasingly focused on market manipulation since 2015.

As regards anti-money laundering risks connected with cryptoassets, whilst we have not seen any public enforcement outcomes, authorities are already focusing on the specific obligations that established regulated firms have in relation to these risks. In June 2018, the UK FCA wrote to bank Chief Executives highlighting the obligations that regulated firms have to prevent and detect financial crime connected with cryptoassets, citing examples of where a regulated firm offers services to cryptoasset exchanges, arranges an ICO, or serves clients whose wealth derives from cryptoassets. Regulatory initiatives to bring cryptoasset exchanges into the anti-money laundering regulations are underway in the EU. The Fifth European AML Directive will extend AML and Counter-Terrorist Financing rules to virtual currencies, such that rules will now apply to entities which provide services holding, storing and transferring virtual currencies. In future, these entities will have to identify their customers and report any suspicious activity to relevant regulators and authorities.

Although cryptoassets may present particular cross-border enforcement issues, particularly concerning where activities take place, we have not yet seen significant examples of large-scale cross-border collaboration and co-ordination in relation to enforcement activity such as that seen in recent years in relation to other forms of conduct. We expect that to change too.

Why sustainability matters?

by Yannick Ouaknine, Societe Generale

Yannick Ouaknine
Head of Sustainability Research, Societe Generale
Yannick.Ouaknine@socgen.com

Introduction

Sustainability matters differently for different entities. For listed corporations and multi-national companies, it mainly revolves around Corporate Social Responsibility (CSR) or Corporate Sustainability where companies demonstrate accountability through environmental and social efforts that go beyond regulatory requirements. For entities in the sustainability research or investment space; Environmental, Social and Corporate Governance (ESG) research of companies could be a good proxy to better grasp and anticipate future financial risks and/or opportunities. This brings us to the broad concept of "Sustainable investment", an area which has been evolving rapidly for the past few decades.

Sustainable Investment has been described in many ways based on diverse cultural and historical interpretations of the term; a universally accepted definition is yet to be formulated. What started as an exclusionary approach of avoiding investments in tobacco or gambling companies has now matured into integrating ESG factors in the selection of stocks/securities to build up an investment portfolio.

Investors are "pragmatic"

In theory, it might be difficult for investors to apply this kind of strategy, as wealth maximization and protection are typically the main purpose of investing.

In truth, hedge funds (as other types of investors) have been very "sceptical" about ESG for various reasons (i.e. challenging their ethical, religious or philosophical roots / lack of commonly-agreed definition / lack of common set of indicators / cultural biases...). But the reality is now much different, as increasing transparency and recent controversies moved ESG to the center of investment-making decisions.

The rational of the global momentum around sustainable investment can be summarized as follows:

- the fiduciary duty principle,
- recognition that ESG factors play a "material" role in determining risk and return,
- rising concern about the impact of short-termism on company performance, investment returns and market behaviour,

- regulatory requirements (leading to more transparency),
- new appetite from end-investors to align convictions and investment ideas,
- the proven financial performance attached to those metrics,
- and finally, avoiding reputational risks from issues such as climate change, tax ethics...

From theory to practice: Leveraging on corporate governance to create financial outperformance

It seems (that) ESG gains more and more traction but how to demonstrate the value creation of adding ESG metrics in the investment process? And how to combine metrics the right way to demonstrate long-term value creation? At Société Generale Corporate & Investment Banking (SG CIB), we believe we have found a way to do this applying the following metrics which incorporates corporate governance as a differentiating factor (considering a mix of quantitative, qualitative financial parameters).

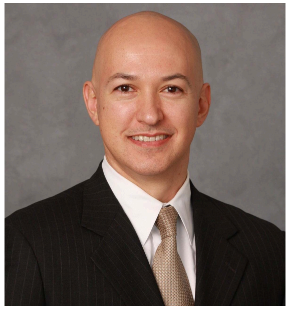
Investment philosophy: Underpinning our CEO Value stock selection is the idea that a company that has relatively sound corporate governance principles but that has underperformed peers over four years should see a turnaround in its share performance. Sound corporate governance principles should enable a company to address its weaknesses, or at least prevent deterioration, either by changing its strategy or management – or both.

Stock selection process: Our CEO Value proprietary screening tool (launched in April 2006) is built using a bottom-up approach. We apply this screening tool to the Stoxx 600 index to obtain a list of European companies that we think can deliver a positive message to investors over the following two years, and which are thereby likely to outperform – and in this we also have a clear large cap bias.

If you would like to know more about our product (that has more than ten years of a real track record), please do not hesitate to contact us.

Young, illiquid and…irresistible?

by Cesar Estrada, State Street



What do a busy airport, an offshore wind farm project and a city parking meter system have in common? All have garnered billions of dollars from institutional investors increasingly turning to a young, evolving asset class: infrastructure.

As stewards of long-term capital, institutional investors are wired to see opportunity. But it's not always easy to capture. State Street's annual Growth Readiness Study shows an industry caught between the push of opportunities for growth and the pull of factors threatening it. More than two-thirds (68 percent)[1] of institutional investors say they're concerned about hitting their growth objectives in the current market environment.

Against this backdrop, there has been a significant shift in how investors are adapting. Proponents of infrastructure assets note that the class, by and large, boasts yields high enough to be attractive in a low-interest rate environment, while also providing exposure to stable, predictable cash flows. This hasn't escaped the notice of fund managers as well as institutional investors who have been making generous infrastructure allocations as of late.

"The growth has been twofold," explains Kyle Alexander, a managing director focusing on infrastructure within State Street's Alternative Investment Solutions group. "Fund managers who have been working in the space for years are seeing more interest from investors and are successfully fundraising larger funds. Further, the biggest fund managers have adopted a more intensive focus on infrastructure assets, making headlines with record breaking fund launches."

The political environment is an important factor that's expected to help play a role in keeping this momentum going. With many differing feelings following the mid-term elections in the United States, Democrats and Republicans may finally begin to agree on something: infrastructure. In December, the U.S Department of Transportation announced that it will spend $1.5 billion to fund 91 infrastructure projects around the country.[2] It comes at a much needed time. In fact, in 2017, the American Society of Civil Engineers gave the country's infrastructure a grade of a D+.[3] With

Cesar Estrada
Senior Managing Director, Private Equity and Real Assets Services, State Street Corporation
cestrada@statestreet.com

bridges, roads, public transportation and more in need of major upgrades, bipartisan agreement will be especially beneficial to helping improve the country's infrastructure.

That being said, a government infrastructure bill is not the only way to keep capital moving into the asset class. 2018 is on pace to be a record for total fundraising. For the first three-quarters of the year, private equity firms have already raised $68.2 billion in infrastructure funds.[4] That compares to the record $66 billion set in 2016 and the $65 billion raised in 2017, according to the alternative asset data firm Preqin.[5] Unlocking private capital in greater scale will require the Federal government to be transparent, stay consistent in their process for awarding projects and maintain a strong push when permissioning those projects.

The rise of infrastructure in some ways mirrors the growth of the real estate asset class some two decades earlier. Whereas most buildings in metropolitan areas around the world were once owned by corporations, governments or universities, many are now in the hands of pension funds, insurance companies, foundations and other institutions. It's likely that in just a few years, much of the world's infrastructure - now mainly owned by municipalities, state and federal governments, and corporations - will also find new homes in the portfolios of institutional investors and infrastructure funds.

Arguably, a key difference between real estate and infrastructure is the remarkable diversity of the latter class. While infrastructure traditionally brings to mind images of toll roads and bridges, energy and telecom are two sectors that are in the midst of transformation. Oil and gas projects, like pipelines, once dominated investor dollars. Today, renewable energy has ruled the fundraising roost. In 2017, for the first time, investors poured more money into renewable energy funds than into their conventional energy counterparts, according to Preqin. The explosion of data is also quickly creating a more prominent need for telecom structures in areas such as social care, battery storage and InfraTech. This includes the infrastructure used in developing the Internet of Things, facial recognition technology and airports.

The buzz around infrastructure assets stem, in part, from the widespread understanding that global infrastructure needs are intensifying. The world will have to spend between $3 and $5 trillion a year on infrastructure to keep up with demand, according to Global Infrastructure Hub, a G20 initiative. On its own, need isn't enough to justify an investment. Funds only consider assets that are expected to meet targeted rates of return and many may not pass muster. For instance, Olympic host cities are known for infrastructure building booms ahead of the games, but funds mulling investments must question how assets will perform after the Olympic flame burns out.

This risk is particularly significant for infrastructure assets because they're mostly illiquid; a toll road can't just be traded away. Yet the assets' illiquidity is something institutional investors, like pension funds, are often willing to bear for the sake of long-term exposures that match their long-term liabilities. The lack of liquidity may also present opportunities for the largest infrastructure-focused funds, which can afford to take on bigger projects than smaller investors, especially when they form joint ventures with other funds. It's a valuable advantage, as investors today often must compete with one another for stakes in the most promising infrastructure assets.

The heated competition has naturally led to higher valuations, raising concerns that investors and funds might wind up overpaying for some of the most sought-after assets. But for now, institutional capital continues to chase infrastructure, with investors betting that assets like wind farms will keep blowing good returns their way.

Important Information

The views expressed in this material are the views of Cesar Estrada, through the period ended 31 December 2018 and are subject to change based on market and other conditions.

Investing involves risk including the risk of loss of principal.

The information provided does not constitute investment advice and it should not be relied on as such.

All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed.

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This document may contain certain statements deemed to be forward-looking statements. Please note that any such statements are not guarantees of any future performance and that actual results or developments may differ materially from those projected in the forward-looking statements.

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State Street Corporation, One Lincoln Street, Boston, MA 02111-2900

Footnotes

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Will artificial intelligence transform investment research?

By Rohit Kataria, Deloitte

Rohit Kataria
Senior analyst, Deloitte Support Services India Private Limited
rokataria@deloitte.com

Investment research and analysis are evolving rapidly, with proliferating data sources and expansion of artificial intelligence (AI) applications. Portfolio managers and analysts rely on financial statements, earnings call transcripts, press releases, investor presentations, blogs, news articles and sell-side reports for investment research. Synthesizing information originating from multiple sources and building proprietary quantitative models takes enormous human effort and time. AI tools not only enable large-scale data processing at a rapid rate but also integrate traditional data sources with new ones such as web traffic, web search trends, and social media data. Application of AI to these data helps portfolio managers and analysts save time and uncover hidden signals, contributing to improvements in forecasting, investment decision-making, and idea generation.

Natural language processing (NLP) and natural language generation (NLG) are the branches of machine learning that enable computers to understand and generate natural human language. NLP processes natural language by transforming text into structured data, while NLG interprets and analyzes structured data and converts it into readable format. Application of these technologies results in a machine-generated report that conveys insight from computation of the data.[1] It is able to make sense of spoken and written language. This approach overcomes some inherent limitations associated with rule-based algorithms, which struggle with processing unstructured data and lack the intelligence built from thousands of corrective iterations that machine learning conducts. Traditional rules-based algorithms don't self correct.

Augmenting research with NLP

Investment managers are integrating NLP capabilities into their analytics platforms. NLP tools can augment investment research in the following ways, among others:[2]

- By interpreting management sentiment during earnings calls to predict a company's future performance. By parsing sell-side reports for wording to gauge changes in analysts' projections.
- By sifting through volumes of unstructured data sources, such as blogs, news reports, and

social media and sentiment data to identify trends and potential investment ideas.

Some investment management (IM) firms are trialing NLP technology for investment decision-making. They are using NLP technology to score each piece of information a portfolio manager consumes into positive and negative groups. A positive score indicates the likelihood of a rise in company performance or corporate value, and a negative score means it is unlikely to rise. Trials also translate textual data from websites and blogs into quantitative scores. The goal is to augment the investment decision-making ability of portfolio managers by increasing throughput and reducing bias and other errors prone to humans.

Considerations before implementing NLP/NLG

NLP can also be used to generate investment ideas. Using NLP enables firms to reduce the time spent conducting initial research on one company the current average of four to five hours to 30 to 45 minutes.[3]

Margin compression and regulatory mandates are driving investment managers to pay for research directly, meaning the buy-side investment research landscape is likely to undergo a profound change.[4] Investment managers may expand in-house research and analysis capabilities by making long-term investments in advanced technologies like NLP and NLG to reduce their dependency on external research. The pace at which the natural language application of AI is accelerating. Automation of the investment research and analysis function at scale could soon be a possibility. Business leaders at IM firms may need to take the following factors into consideration before starting an NLP/NLG implementation:

Piloting - undertaking pilot projects/proofs of concept before full implementation to test whether desired results can be achieved.

Deployment - integrating NLP and NLG tools into the data analytics platforms accessed by analysts and portfolio managers to enable widespread deployment across the firm.

Data format - data sourced from a vendor in a structured form can be fed directly into an NLG process. while NLP is required as a preliminary step for unstructured data.

Talent - assigning a team of domain experts, or hiring external specialists to champion implementation.

In the coming years, computers will likely be able to process text and speech, enabling them to generate narratives about potential investments based on thousands of times more information than analysts alone can read. This development could completely transform the investment research and analysis function at IM firms.

Has your firm started exploring NLP and NLG-based tools or other forms of AI for investment decision making?

Footnotes

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Private fund side letters: common terms, themes and practical considerations

by Christopher Gardner and Mikhaelle Schiappacasse, Dechert

READ ON

Christopher Gardner

Partner, Financial Services and Investment Management

christopher.gardner@dechert.com

Mikhaelle Schiappacasse

Partner, Financial Services and Investment Management

mikhaelle.schiappacasse@dechert.com

Introduction

Side letters are an (increasingly) common way of formalising negotiated arrangements between a private fund and an investor.[1] Whilst used more widely in the closed-ended fund context (given the limited withdrawal rights associated with such funds, the typically higher level of negotiation and greater structural complexity), they are also a feature of open-ended funds, for instance where there is a seed or cornerstone investor investing significant capital or an investor subject to specific tax or regulatory regimes that require bespoke terms.

A side letter supplements and, where the fund takes contractual form (such as a partnership), can override the terms of the fund's constitutional documents and is typically required where an investor has specific commercial, legal, regulatory, taxation or operational concerns with respect to its investment in the fund. In many instances it is easier to agree concessions in these separate agreements rather than amend the fund's constituting documents (being the private placement memorandum and the constitutional documents such as the partnership agreement or articles), especially as the latter approach would mean the rights agreed would generally then be available to all investors. Some rights are also most practically recorded in a side letter (for example confirmation of an advisory committee seat for a closed-ended fund).[2]

This article provides an overview of common side letter terms and current themes in the private fund market. It also considers the regulatory context and practical points for managers navigating the restrictions and obligations of multiple side letters.

Common terms

Most favoured nations ("MFN") rights

Where a manager is willing to provide an MFN right, these rights are generally reserved for more significant investors as they can have wide-ranging implications for the fund, especially if they are not managed effectively.

An MFN right allows an investor to elect to receive the side letter provisions negotiated by other investors.[3] However, MFN provisions can be drafted in a number of ways, meaning that what the investor may actually be entitled to elect to receive can vary widely. For example, the drafting may vary in respect of: (i) whether the MFN applies to all side letter provisions or just, for example, to the fee provisions, (ii) the MFN only applying in respect of those provisions negotiated by other investors with an equal or smaller investment in the fund (typically affiliated investors will be aggregated), and (iii) whether the investor can see all side letter provisions negotiated (regardless of whether it is allowed to elect to receive them) or just those it may elect to receive. It is also common to carve out certain terms from the MFN, for example, rights granted to first closing or seed investors, rights granted due to an investor's specific legal, regulatory or taxation concerns and the right to an advisory committee seat. However, even with careful drafting, an MFN right can significantly extend the fund's (or the manager's) obligations; managers should therefore carefully consider which investors' terms are likely to be captured by the MFN when negotiating these (and other) side letter provisions.

Transfers

Transfer rights are particularly relevant in the closed-ended fund context where an investor cannot redeem from the fund should it wish to. Managers negotiating side letters on behalf of a fund should ensure that a transfer right provides them with sufficient comfort with respect to the identity and nature of the transferee (this is particularly the case where the fund has a credit facility and does not want to jeopardise its borrowing base) and that appropriate customer due diligence information will be provided in connection with any transfer. A blanket consent is therefore not advisable. Transferability is particularly important to certain investors, for example certain German pension funds,[4] who may need to be able to demonstrate free transferability (or as near to free transferability as the fund can practically offer) for regulatory reasons.

Excusal rights

The constitutional documents of closed-ended funds typically include a mechanism whereby an investor can be excused from participating in particular types of investments (generally due to regulatory or other internal constraints). Often an investor must notify the fund of any restrictions before it invests and/or require the opinion of external legal counsel to confirm that it is so restricted. If a fund is willing to negotiate excusal rights, it should try to limit the amount of investor discretion in determining what an excused investment is as the emphasis should be on using the investor's full commitment rather than allowing it to cherry pick deals. If the scope of the prohibited investments is stated in the side letter itself, it is generally helpful to state why they are prohibited in order to increase the chance that the provision is taken outside the scope of any relevant MFN right.
Enhanced reporting and information rights

These side letter requests can come in many guises, including requests to vary the frequency, format and content of reporting. Some investors may have genuine tax related concerns (for example, the need to be supplied with K-1 schedules in order to prepare their US tax returns) or regulatory reporting issues (such as the need to comply with the Solvency II Directive (2009/138/EC)). Any such terms should be both commercially appropriate and operationally practical for the fund and its manager. For example, a request for portfolio level information should not result in the investor holding information it could use to its competitive advantage or to the detriment of other investors. This is an area of particular sensitivity in the open-ended fund context where portfolio level information should generally only be provided when stale, e.g., after further trading of the portfolio so that its then-current composition is not selectively shared.

Other common provisions

The table is a summary of common side letter requests. Whether it is appropriate to grant such requests should be considered on a case by case basis.

Themes

Set out below are some current themes that are relevant to negotiating side letter terms.

Co-investments and other alternative ways of investing

In recent years there has been growing interest in co-investment vehicles, separately managed accounts and other alternatives to classic

Issue	Background
Fees	Fee provisions may be included in a side letter to reflect any commercial deal agreed (for example, in relation to the rate of management fees/performance fees/carried interest).
Redemption rights *(open-ended)*	Redemption rights may appear in side letters in various guises, including a waiver, or in the case of seed investors, imposition, of a lock-up period. Other common provisions may relate to redemption charges, gates, compulsory redemption terms, etc.
Notice of significant or key person redemptions *(open-ended)*	A side letter negotiated for an open-ended fund may include a notice provision in respect of significant or key person redemptions. Such provisions are often linked to enhanced liquidity rights (see 'redemption rights' above).
In specie redemptions	It is not uncommon to negotiate the making of in specie redemptions in a side letter. The exact terms depend upon the fund's documentation. Commonly a side letter provision will put the onus on the fund to dispose of illiquid assets if the investor so elects (particularly in respect of a fund dissolution).
Advisory Committee seat *(closed-ended)*	Where a fund operates an advisory committee, the committee members are typically confirmed in a side letter with the relevant investor. Certain information rights in respect of advisory committee meetings may also be set out in the side letter.
Alternative investment vehicles/parallel funds *(closed-ended)*	Certain investors may for legal or regulatory reasons have specific requirements in relation to the use of alternative investment vehicles and parallel funds. Typical side letter provisions may require the investor's consent prior to transferring its interest to such vehicles or certain information rights in relation to these vehicles/their constitutional documentation.
Use of placement agents *(closed-ended)*	Certain investors may require confirmation by side letter that no placement agent has been used or that the fund will not pay fees to a placement agent.
Representations and warranties	Various representations and warranties may be requested in a side letter, depending upon the investor's particular needs (for example, it would not be uncommon to see requests for representations stating that the fund and/or its general partner and/or its manager (i) is not subject to any material pending litigation, (ii) has all applicable registrations and licenses in place or (iii) is not insolvent). To the extent these are accepted, they should be appropriate and proportionate under the circumstances.
Opinions of counsel	Many funds' documentation require investors' counsel to provide an opinion in relation to certain matters. Accordingly, some investors ask that this requirement be modified in a side letter so that internal legal counsel may opine instead of external legal counsel.
Use of investor name and other confidentiality issues	As some investors are sensitive to their name being disclosed, they may ask that their consent is required to specifically name them when undertaking marketing activities. Conversely, an investor may request that certain confidentiality provisions in a fund's documentation be waived in a side letter in order to satisfy its own contractual obligations. This is a particularly common request from investors who are a fund of funds or otherwise have reporting obligations to beneficiaries.
Due diligence/visits and meetings	It is not uncommon for an investor to request a process for inspections by the investor by side letter.
FOIA requests	Certain investors that are public bodies (in the UK, the US and elsewhere) may be subject to freedom of information laws or regulations. They may therefore request a side letter provision allowing them to disclose certain information about the fund following a valid freedom of information request.
Taxation	A variety of tax obligations and confirmations may be requested by investors due to their specific circumstances. Provisions might include enhanced reporting rights and confirmations that the fund will be managed so as to avoid certain taxation consequences (such as the need for investors to file taxation returns in certain jurisdictions).

commingled funds. While investors commonly seek an acknowledgement in a side letter that they are interested in co-investment opportunities (or a similar election right), the range of alternative investment structures currently in vogue introduces new side letter concerns, particularly in relation to strategy and allocation issues (for example strategy caps and successor fund provisions). Typically it is more appropriate for the manager rather than the fund to sign up to these requests. If these issues arise, managers should ensure that the concessions are achievable, do not unduly limit their firm's growth and development strategy and that they can be effectively monitored.

Use of credit facilities

Credit facilities are an increasingly popular tool used by closed-ended funds to satisfy short-term bridging needs and smooth the capital call process. However, they pose certain distinct issues with respect to side letters which can be problematic, particularly where the lender's ability to take security is compromised or the borrowing base is otherwise restricted. Examples of this include where excusal or transfer rights affect the existing credit assessment on the borrowing base.

To the extent a fund has a credit facility and any of the provisions described above are also covered by an MFN right, these issues can be exacerbated because multiple investors may be able to elect to receive the problematic provisions. Managers may therefore wish to include a carve-out in their standard MFN clause in respect of side letter provisions which affect the fund's credit facility.

Key person issues

Key person terms are common in the closed-ended fund context (where a key person event is likely to trigger the suspension of the investment period). Their use in the open-ended funds context is increasing, particularly to tie in certain key persons financially, including required investment levels and notification rights where a key person submits a significant redemption request (which could potentially be linked to favourable liquidity rights). Provisions regarding no bad acts are also common, especially in seed arrangements or where significant investments are made and are often particularly relevant for smaller managers where the conduct of a key person is more likely to impact performance of a fund.

Pooling of UK local government pension schemes

Certain UK local government pension schemes have recently pooled their investment assets into eight distinct pools to improve the efficiency of the management of their assets. From a side letter perspective, this effectively increases their negotiating power, particularly if one of the schemes is granted an MFN which is extended to all members of its pool. However, the schemes have not pooled using a consistent structure so, as it stands, requests should be considered on a case by case basis – it may be that the various schemes do not necessarily fall within a fund's definition of affiliate (which is generally how entities are grouped together for the purposes of an MFN clause). The pooling of these entities continues to evolve and a standard approach may develop over time.

Environmental, Social and Governance ("ESG") concerns

Investors are increasingly looking to funds to make ESG commitments with respect to their investments. ESG provisions may include a confirmation that the fund will comply with the UN Principles for Responsible Investment when making investments or that investee companies comply with the ten principles of the United Nations Global Compact or other guidelines that are more specifically tailored to the investor in question, including restrictions on making investments in companies engaged in certain lines of business. If such a provision is contemplated by a fund, it should ensure it is able to comply with these provisions and, from a practical perspective, to provide any reporting agreed.

Regulatory context

Aside from the commercial and practical considerations relevant to agreeing to a side letter provision, there are certain regulatory issues that managers should also bear in mind.

Managers that are subject to the Alternative Investment Fund Managers Directive (2011/61/EU; "AIFMD") (whether as a European Economic Area ("EEA") based alternative investment fund manager ("AIFM"), managing an EEA alternative investment fund ("AIF") or through marketing an AIF to investors located in the EEA) must comply with the AIFMD rules on preferential treatment. Under the AIFMD, investors must be provided with a "description of how the AIFM ensures a fair treatment of investors and, whenever an investor obtains preferential treatment or the right to obtain preferential treatment, a description of that preferential treatment, the type of investors who obtain such preferential treatment and, where relevant, their legal or economic links with the AIF or AIFM." This disclosure obligation applies prior to investment and following any material changes to such preferential treatments. The introductory recitals of AIFMD also require that any preferential treatment is disclosed in the AIF's rules or instruments of incorporation – this can be achieved through broad disclosure in the private placement memorandum or partnership agreement (although some managers prefer to include more tailored terms to ensure investors are not provided with too much of a 'shopping list'). The ability to request further information from the manager is also commonly included in the private placement memorandum, with summaries of side letter rights typically made available.

EEA based AIFMs are also subject to an additional requirement to ensure the fair treatment of investors. In particular, any preferential treatment accorded to one or more investors must not result in an overall material disadvantage to other investors. EEA managers should bear this requirement in mind when deciding whether to agree to a particular side letter provision.

From a U.S. Securities and Exchange Commission ("SEC") perspective, there is concern about an investor being given preferential treatment in a side letter that may have a negative impact on other investors, such as preferred liquidity and information rights. However, such provisions may be acceptable if sufficiently disclosed to the other investors who are able to take the information into account when making their investment decision. The more acute the conflict or significant the potential impact on other investors, the more detailed and extensive the disclosure should be. The SEC staff on examination has been known to review side letters to test whether they are being adhered to and whether proper disclosure was made. Deficiencies in this area can result in negative written findings at the conclusion of an examination and, in sufficiently serious cases, could result in an enforcement referral.

Practical Considerations

Below are some practical considerations that could be relevant when managing a fund with side letters:

- Side letters supplement the terms of a fund's constituting documents, so they should be considered whenever these documents are consulted.
- It is better to be consistent in agreeing side letter terms, for example, having a 'house' provision that is stuck to. This allows continuity of application.
- Managers with a number of side letters should consider keeping a centralised record of all side letters agreed for the fund, allowing compliance to be monitored on an ongoing basis. Annual (or more frequently if appropriate) certifications from the teams responsible for compliance with individual provisions can support this process.
- Managers managing open-ended funds can simplify monitoring and compliance by keeping a clear record of when an investor has redeemed (such that the side letter is no longer relevant).
- While it is tempting to immediately move on to the next project after a closed-ended fund's final closing, it is important to ensure the MFN exercise is handled immediately in order to avoid any technical breaches. The MFN

exercise ensures that all investors who are allowed to see/elect to receive other investors' side letter provisions are presented with their options within the agreed timeframe. This is typically achieved through an election form and can take some time to coordinate if a significant number of side letters are involved and/or if a complex set of carve outs apply. The need for consistency between side letter terms (including any MFN rights granted) becomes particularly apparent when conducting this exercise.

Conclusion

Side letters are becoming an increasingly significant part of a fundraise. Managers should be alive to the implications of agreeing to side letter provisions, considering each term from a commercial, legal, regulatory and operational perspective. Issues are amplified where any MFN rights are involved. The themes identified in this note also demonstrate that the private fund space continues to evolve and that managers also need to adapt in order to ensure that they move with the times, rather than getting caught out by a term that is hastily agreed to without the overall implications receiving proper attention.

This document is not legal advice and should not be relied on as such. Parties to a side letter negotiation should seek advice on the particular transaction in light of their circumstances.

Footnotes

1. In certain circumstances the manager may also be a party. As a general matter, to avoid any enforceability issues, care should be taken to ensure that the correct parties are parties to the side letter and in the right capacity. For example, there have been cases in the Cayman Islands where it has been held that a side letter is not enforceable because the beneficiary rather than the registered interest holder was a party to a side letter and because a manager had entered into a side letter on behalf of the fund (and did not have sufficient authority to bind the fund).
2. Conversely, certain rights generally should not be included in a side letter, notably those that would create a new class of interests from a local law perspective or restrict the fund as a whole (such as tighter investment restrictions than those described in the fund's constituting documentation).
3. In some circumstances an MFN is included in the fund's constituting documentation rather than being agreed separately by side letter.
4. These are commonly referred to as so-called 'VAG' investors, i.e., those which are either a

German insurance company, pension pool, pension fund or other pension scheme which is directly or indirectly subject to the provisions of the German Insurance Supervision Law or the Ordinance on the investment of restricted assets of pension schemes, funeral expenses funds and small insurance companies or the Ordinance on the investment of restricted assets of pension funds regarding the investment of their restricted assets.

Computer Vision Technology and Autonomous Learning Investment Strategies

by Michael Weinberg and Emily L. Spratt, Mov37

Michael Weinberg
Chief Investment Officer, Mov37
mow@mov37.com

Emily L. Spratt
Fellow, The Frick Collection and Art Reference Library
espratt@alumni.princeton.edu

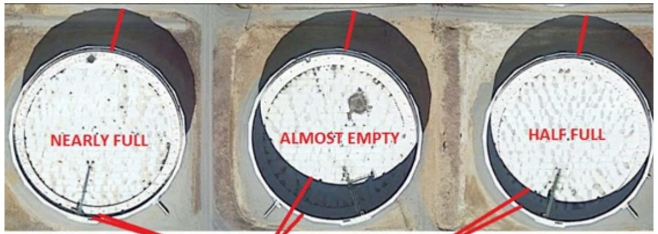
In the last five years, developments in computer vision technology have reached a critical turning point largely on account of the successful incorporation of machine learning techniques into the analysis of digital images. Uses of this AI-driven technology have become ubiquitous, aiding everything from the smart searches online advertising companies offer consumers to the empowerment of self-driving vehicles. While computer vision science has begun to seamlessly influence a wide swath of industries, its potential for use in the financial sector has yet to be optimized. In this article, we consider the burgeoning role that computer vision technology, both with and without the latest AI techniques, is already serving in financial services and situate this trend within the larger movement toward computer automation in investment practices. As artificial intelligence is increasingly utilized to help navigate the plethora of data we now regularly harness to inform better business practices, we aim to bring attention to this change in the traditional methodologies employed to analyze investment information. This method we have termed Autonomous Learning Investment Strategies, or ALIS, and the use of computer vision technology is one increasingly significant tool that we can utilize in our approach to money management.

Now that information of every variety is digitally available to companies on an unprecedented scale at ever-lowering storage costs, one of the most significant problems businesses today face is effective data management and interpretation. As the sheer quantity of information requiring oversight has grown well beyond the bounds of human reach alone, data analytics has been transformed to include the now indispensable fields of computer science and statistics, which fall under the umbrella category of data science. Propelling this change in approach to information analysis has been the successful application of one AI technique in particular, deep learning, to complexly analyze structured and/or unstructured data through the use of training models that teach the machine how to complete tasks of varying levels of difficulty by way of learned examples. The application of this technique for vision technology is already having a significant influence on the interpretation of digital images and videos, and we anticipate that this will catalyze interest in the use of images to harvest information pertinent to the investment sector.

To date, the exponential growth in data, the breakthroughs in data science, the manifold applications of machine learning in business, and the record low costs of data storage and processing are reshaping the investment landscape. In the following five examples we examine current applications of computer vision technology in light of these convening factors to underscore its burgeoning market potential.

Oil: How full are the tanks? Only a few decades ago, it was not uncommon for large portfolio management companies to employ people in the Middle East to monitor and quantify the level of oil in the tanks, and to count the oil tankers and track their movement. This would then be reported back by telephone and/or fax machine. Although this was a slow process for obtaining information, it was all based on public information and anyone could have hired people to do the same thing, though few had the resources for this type of information gathering.

Fast-forwarding to our online world of digital images that record so many of our actions, we have the ability to see instantly the evidence for oil production through satellite imagery. Today, anyone can go to a tanker-tracking site and monitor daily crude oil shipments, supplies, and storage levels. Based on the satellite imagery, one can calculate the ratio of the length of the shadow inside a given tank versus the length of the shadow outside of the tank to determine how full the tank is, as exemplified in the accompanying images. With computers and satellites making these calculations, the images can be near-real time. This is an excellent example of how basic computer vision technology has replaced and disrupted the prior human role that was required for monitoring crude oil globally. ALIS managers can therefore use this computer imagery to help inform trades in crude oil and related securities.



The length of the shadow within the tank vs the length outside the tank indicates how full it is.
TankerTrackers.com #OOTT

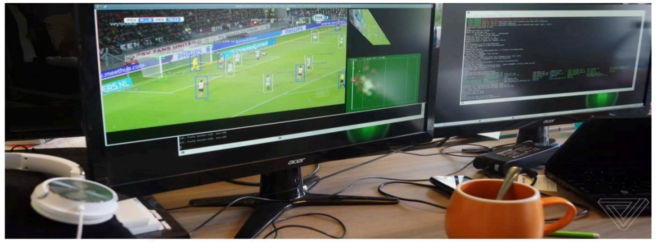
Retail: Will a company meet, beat, or miss expectations? In the past, it was often the case that portfolio managers would hire outside firms to count cars in parking lots to gather insight on the retail market. They would do this in concert with a team of people around the country. By contrast, today many of those teams have been disintermediated by the information that we derive from satellite imagery and camera surveillance of those parking lots and stores. In the image below, the large rectangular grey area represented is a big box retailer. The turquoise circles represent shoppers' (or potential shoppers') vehicles.

Again, depending on the periodicity of the satellite photography, one can get this information updated on a nearly constant basis. With enough historic data, ALIS managers may use this data to determine whether store traffic—and sales, which are likely a derivative of that information—are likely to meet, beat, or miss their market expectations, and invest (or divest) in the retailers' securities accordingly. As general imaging improves, especially in regard to granularity and the frequency of image outputs, computer vision technology will allow for assessment of not only the cars in parking lots, but also the people entering stores. Consequentially, more precise forecasts of business, revenues, profitability, and security prices will be enabled.

Weather: Can we use it to forecast commodity prices? While weather forecasting is still far from infallible, improvements are also possible through the analysis of highly dimensional datasets with low signal-to-noise ratios. For example, ALIS managers may monitor the weather at what were previously inconceivable levels of granularity and frequency. While public forecasts may have certain biases that are intentional, such as the underreporting of the probability of rain occurring (for the reason of not depressing the populace), ALIS managers have the ability to directly make weather predictions given the availability of weather data from the two key providers of this information. Furthermore, they may combine these forecasts with other satellite imagery and computer vision data to gain more precise answers to pertinent investment questions relating to environmental conditions.

Let us consider the example of one's approach to trading energy futures. If one uses satellite imagery and determines that there is a massive snow cover on the solar panels in a certain region that may diminish the output of solar energy, one can by extension predict higher prices for fossil fuels. In addition, one may use satellite imagery to discern equipment failures on wind-driven turbines, which may similarly have an adverse impact on the supply of that power source and the resultant impact on the pricing of alternative power sources. Consequently, these ALIS managers may be able to predict commodity yields and prices ranging from agriculture to energy more accurately than previously possible or based on public weather forecasts. This record level of data and imagery is unprecedented and a boon to ALIS managers' data arsenals, which could potentially generate outsized returns and alpha.

Sports Images: Can we use them in betting? ALIS funds in Europe are using machine learning techniques to analyze digital imagery of games to generate returns and alpha in sports betting. These ALIS managers are not expressing personal preferences; instead, they are systematically using machine learning, data, data science, and record low processing and storage costs to try to gain an edge to predict which teams are likely to win and lose and where the odds are mispriced, just as an investor might do when investing in companies and commodities.



Two monitors show feeds from the company's neural networks, currently analyzing an archive game. | Photo by James

The upper image shows two monitors from a company's neural network analyzing an archived soccer game. Other computer vision programs examine the 3-D images of bodies in videos to enhance content analysis and even to predict the percentage likelihood of a goal by estimating the poses of the figures relative to each other.

Heart Rates: Predicting prevarication from video analysis Through supervised learning and off-the-shelf web cameras, it is possible to estimate the heart rates of persons from videos focused on faces. Imagine a public company executive on a webcast, at a conference, or on television. Examining the forecasted data of the executive's heart rate based on video of that individual, it is possible to hypothesize whether the person was prevaricating. This might have implications on the veracity of the executive's statements and result in buy, sell, or hold recommendations on the company. With further diminished cloud-driven processing and storage costs, an ALIS manager could not only analyze the current imagery but also compare it to prior imagery of the same person for greater accuracy. Recurring patterns of dishonesty may also be discerned by tracking videos of certain persons.

Overall, digital technology, the increased resolution of digital photographs, and the declining cost of camera hardware and software will in turn further the ability to use computer vision technology, which is also being propelled by the advances in machine learning, as an ALIS tool. Further declines in the storage of photographs and videos will similarly facilitate the increased usage of photos and videos. Especially considering the data consumptive nature of videos to date, we do not believe that this medium for the dissemination of information has been adequately considered, let alone exploited, for ALIS, and that this will quickly change with better data storage solutions.

What Is the Future of Computer Vision Technology as an ALIS Tool?

We would like to suggest that computer vision science is one of the most promising fields of study regarding the analysis of our increasingly digital visual world. While processing and storage costs of image-related data need to fall even further to meet their fullest potential for ALIS, we see much potential in the use-value of digital image analysis in finance, and predict that this area of data analytics will grow significantly. As our society becomes as fluent in image-based information exchanges as in text-based communications, the way we analyze our world of digital images has the potential to become a fast and effective way to measure our behaviors and their socio-economic impact.

For instance, by utilizing image recognition technologies empowered by deep learning techniques, the incidence of the appearance of images on social media related to particular products or company brands could be tracked over time as one useful signal, amongst others, as an indicator of market sentiment. It is important to highlight, however, that the visual landscape of our digital world is not a neutral indicator of the behavior of markets, as visual replication, biases, and outright fraud create noise in the data, which require much disambiguation. (The use of bots to amplify the dissemination and seeming influence of a given set of information is but one reason for trepidation.) We therefore predict that the most successful applications of computer vision technology in this environment will be tempered with management strategies that effectively account for intentional and unintentional skewing of a given dataset. We also would note that as with all data usage, ALIS managers must ensure that they behave responsibly and have the right to collect any given dataset and use it with due respect for information rights and digital privacy.

In conclusion, as ALIS managers harness the value provided by alternative, unstructured, nonfinancial data, including image data, the value of the effective and accurate interpretation of it is becoming more apparent. As more capital, and, consequently, research and development are invested in directing the growth of image recognition technology, its return as an investment tool will also become more apparent. Given the notable developments in computer vision technology, it is possible to navigate the investment landscape with machine-empowered eyes of the world. The better we can decipher our digital world of images, the greater transparency we will find in our analysis of the markets.

The changing nature of event risk

by Blu Putnam, CME Group

READ ON

Blu Putnam
Chief Economist, CME Group
bluford.putnam@cmegroup.com

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

The nature of event risk is changing and in very important ways for risk managers to appreciate. We have transitioned through two distinct phases of event risk and have now entered a new and different phase. The first phase, 2010-2015, was the "central bank put" where Federal Reserve (Fed) asset purchases cushioned the impact of any negative events. The second phase from 2016 to 2017 focused on political events with known dates and unknown binary outcomes – think Brexit, U.S. Presidential elections and UK "snap" Parliamentary election. We have now entered a new phase, which is all about extended policy debates where the date of the final resolution is unknown but there is significant event risk embedded in the "back and forth" of the policy debate – think U.S.-China trade war, Brexit negotiations, oil production decisions by the Organization of Petroleum Exporting Countries (OPEC).

In this article we first describe in greater detail these three phases of event risk – (1) central bank put, (2) known dates and unknown outcomes, and the current (3) extended binary policy debates. We examine the different risk management challenges presented by each phase of event risk. Looking forward, we will analyze different event risk debates that are currently in the forefront of market attention. Our conclusions are that risk managers have little choice but to adopt dynamic risk management strategies incorporating a mix of direction-based hedges and volatility regime shifts or price-gapping hedges to manage through an extremely complex set of potentially divergent market outcomes.

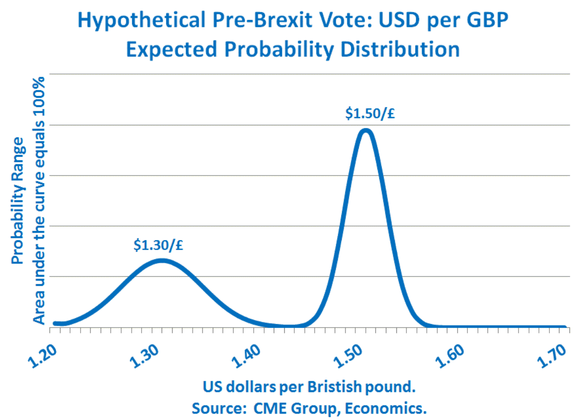
Phase 1: The Central Bank Put (2010-2015)

During the early stages of economic recovery from the Great Recession of 2008-2009, the introduction of massive asset purchases (i.e., quantitative easing or QE) from the Fed while economic growth was modest worked to lower bond yields, support rising equity prices and dampen equity and bond market volatility during this 2010-2015 period. There were episodes of event risk during this period, such as the credit downgrade of U.S. Treasuries in August 2011, various episodes in the European sovereign debt crisis, the unexpected timing of then Fed Chair Ben Bernanke's "taper tantrum" in May 2013 when he proclaimed that QE would eventually be withdrawn, and the OPEC decision in November 2014 not to cut production even as oil prices were under considerable downward pressure. What mitigated against event risk market repercussions in equity markets, though, was the expectation that quantitative easing would cushion any impact, and a "buy the dips" mentality became the norm.

Phase 2: Known Dates and Unknown Outcomes (2016-2017)

About the time the Fed started raising rates above the near-zero levels held since Q4/2008 - the first hike was in December 2015, not necessarily causal yet coincidental - event risk entered a new phase. There were specific political or policy events that had binary choices with very different implications. The Brexit referendum of 23 June 2016, the U.S. Presidential election of 6 November 2016, and even the OPEC decision of 27 November 2014, toward the end of the previous phase, are examples of "known date" events in which the outcomes had a huge impact on the direction of certain markets.

Let's look specifically at Brexit as a classic case study of "known date, unknown outcome" event risk. We analyzed in detail in "Describing the Dynamic Nature of Transaction Costs During Political Event Risk Episodes" published in the April 2018 issue of High Frequency. In that analysis, we characterized this type of event risk as a binary choice that is expected to move markets almost instantaneously in one direction or the other as soon as the outcome becomes known.



In the Brexit referendum in June 2016, the choice for the UK to "Leave" the European Union (EU) was widely expected to be associated with a sharp drop in the value of the British pound, while a vote for the UK to "Remain" in the EU was expected to be associated with a relief rally that would see the pound appreciate. These kind of pre-event relatively extreme binary expectations are quite rare, but when they do occur they reflect what statisticians call a bi-modal probability distribution. What is important for market participants is that the pre-event market is pricing the probability weighted average of the two very different potential outcomes. Once the outcome is known, then the price is expected to move in a sharp price break (that is, technically speaking, a price discontinuity) to a new level with a more traditional single-mode, bell-shaped probability distribution.

The key outcome for the Brexit referendum was that a majority voted to "Leave" the EU, and the British pound immediately declined from the low $1.40s per pound to below $1.30/pound without passing Go. The key outcome for equity markets in the U.S. Presidential election was whether corporate taxes would be cut. When the outcome became known that the Republican Party had swept the Presidency, the U.S. Senate, and House of Representatives, then the odds of a substantial corporate tax cut being passed into law went up substantially, and U.S. equities staged a major overnight rally.

Phase 3: Extended Debates over Binary Policy Decisions

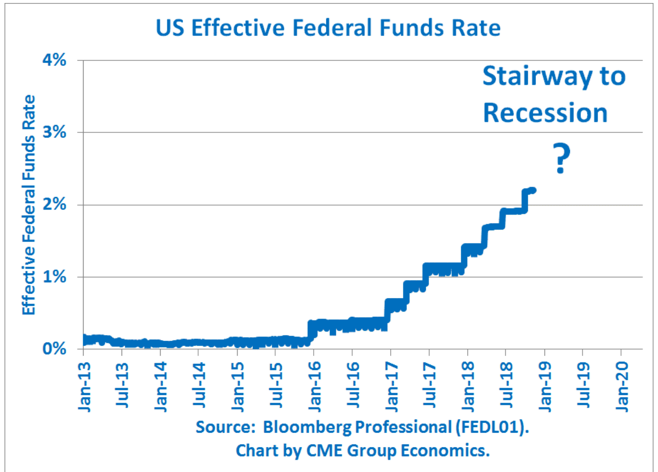
What 2018 brought was a new phase of event risk in which the dates were no longer specific and known in advance, and the focus shifted to handicapping policy debates and digesting the possibility of vastly different outcomes. Will the UK leave the EU with no-deal or a soft-exit deal? What will be the next shoe to drop in the U.S. trade war against China? Will OPEC cut production enough to offset rising U.S. shale oil production or not? Having pushed rates up and flattened the yield curve, will the Fed push rates ever higher in 2019 and risk a 2020 recession, or not? This latest phase of event risk means that there is no one specific date on which the outcome is announced to the world as happens with a vote. Instead, there is an extended period of debate, with news flashes that change probabilities, sometimes dramatically in an instant and then back again in short order, as world leaders make pronouncements and then walk them back or see the other side retaliate in some form or another.

What appears to be occurring in this new phase of extended debates about binary policy outcomes is that the frequency of price breaks or price gapping is becoming more of a risk for market participants. As noted earlier, what is meant by a price break or gap is that an almost instantaneous shift in the price level occurs, up or down, in which there is virtually no trading between the old price level and the new price level. Economists call this a price discontinuity, and when economists are building their models and want to vastly simplify the mathematics, they often assume this type of price action does not exist. The Black-Scholes-Merton option pricing models of the early 1970s are a classic example of assuming that there are no price discontinuities, or price breaks or gaps. There are highly critical risk management implications of this restrictive assumption.

Think about the implied volatility calculated from options prices using a Black-Scholes-Merton type of options valuation model. If there is a reasonable expectation from many market participants that a price break could occur due to event risk, such as described here, then the option price in the market will contain joint expectations of both expected volatility and the one-off impact of an expected price break. The existence of expectations of a price break works to raise the calculated implied volatility if one is using an options model that assumes price breaks do not occur. If one is managing the risk of a volatility regime shift, appreciating the possibility of joint expectations embedded in the implied volatility calculation can be very important. Also, if one is using a delta hedging approach to managing the risks associated with options positions, there are huge risks if unforeseen price breaks occur, as the success of delta hedging depends in no small way on the assumption of price continuity and the absence of price breaks.

Perspectives on Current Event Risk Debates and Risk Management Implications

There are several policy debates with potentially binary outcomes that are currently in an unsettled state. We have examples from the Fed, the trade war and from oil markets, among others. The U.S. yield curve has flattened, which suggests to some analysts that pushing rates ever higher in 2019 could risk a recession in 2020, with big implications for U.S. equity and bond markets. On the trade war front, will a comprehensive tariff reduction package be agreed between the US and China, or will there be further tit-for-tat retaliation? U.S. equities seem to bounce with every news flash about the trade war. Oil markets have event risk, too. Will OPEC be both willing and able to cut production enough to offset the fast rise in U.S. shale oil production? Brexit continues to provide drama as the deadline for a divorce agreement looms large at the end of March 2019. Will there be a soft-Brexit deal or maybe no deal at all? The fate of the British pound hangs in the balance. 2019 is going to be a fascinating year as some of these policy debates get resolved one way or the other.



Bottom Line

What is clear is that risk management strategies need to adapt to the changing nature of event risk. The current challenge is one of more frequent large price breaks (price discontinuities as outcomes becomes known) which can occur when a news flash alters the probabilities of one outcome versus another. That is, with the "to and fro" of the news cycle, important probability shifts occur more frequently and over an extended period. Dynamic, multi-legged hedging approaches have come to the forefront where price-gap and volatility-based risk management strategies using options may often be linked to directional hedging involving futures.

Will EMIR and MiFIR delegated reporting for Asset Managers survive Brexit?

by Ron Finberg, Cappitech

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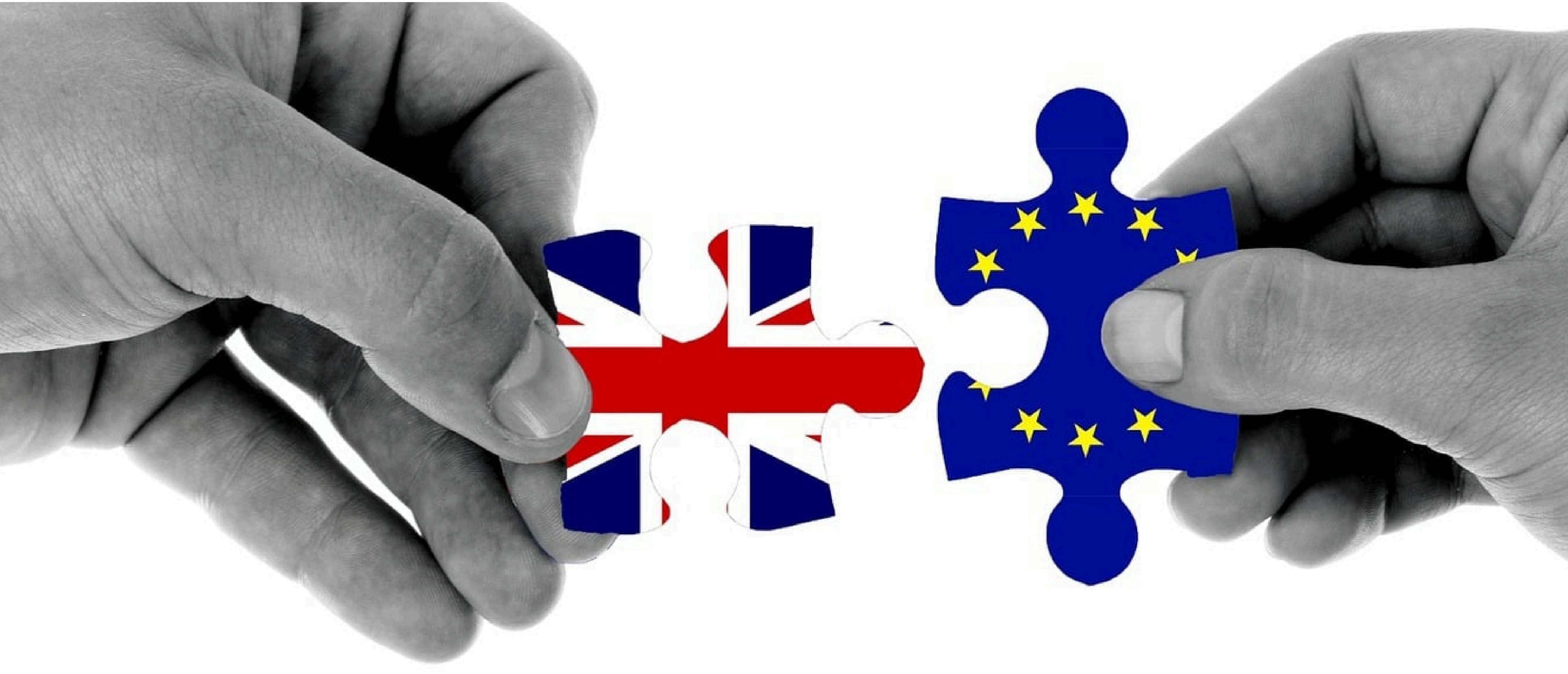


Ron Finberg
Product Specialist - Regulation, Cappitech
ron.finberg@cappitech.com
www.cappitech.com

At some time in 2019, as early as 29 March, Brexit is going to happen. One of the floating questions in 2018 has been the future of EMIR and MIFIR reporting after Brexit. The FCA answered that in October when they released their first Consultation Papers of technical standards and regulatory frameworks after Brexit. The paper included mention of EMIR and MIFIR and that the FCA would adopt similar regulation as UK standalone law.

Soft vs Hard Brexit

Before delving too much into the effects of Brexit, it is important to point out that there are two outcomes: 'Soft' or 'Hard'. Under a soft Brexit, which is the most favoured by the UK financial industry, a two-year window would be put in place for implementing the new standards and regulation. Under this situation, there would be no immediate needs for format or Trade Repository/ Approved Reporting Mechanism (TR/ARM) changes to comply with EMIR and MiFIR.

Excerpt: *The FCA has stated that a UK version of EMIR and MiFIR reporting will continue after Brexit. But, due to the UK/EU split, some aspects of EMIR such as delegated reporting are being affected.*

Where things get tricky is a hard Brexit. Under this scenario, the EU/UK split would occur immediately. EU investment firms would only be able to report via an EU authorized TR and ARMs with UK companies reporting to UK TRs and ARMs. Also, UK TRs and ARMs will need to open an EU entity and become authorized there post-Brexit to support EU based clients, and vice versa.

Separate EU and UK TRs and ARMs

Regardless of a soft versus hard Brexit, TRs and ARMs will ultimately have to open dual EU/UK entities to support their current clients under EMIR and MiFIR. For the most part, this is already taking place. Most ARMs and TRs have moved forward under the assumption that a hard Brexit may well take place and have registered and opened dual UK and EU entities as of Q4 2018.

In terms of investment firms, this puts the burden on them to make sure they are reporting their data to an ARM or TR that is authorized to receive their submissions. TRs and ARMs have already started the process of notifying clients that they should alert them of whether they will need to submit to their UK or EU entity post-Brexit.

If a jurisdiction change is needed, companies will be required to sign a new contract with the ARM or TR as well as gain access to a new sFTP location that supports their country. For most firms, this isn't expected to be much of a big deal. But, companies that are currently reporting trades for both UK and EU branches will have more to prepare for. Existing report files will need to be split by jurisdiction and sent to the appropriate submission folders. Specifically, EMIR reports that can support multiple Reporting Entities from both EU and UK firms in a single file will need to be split.

But... Similar formats

In regards to the field formats of the UK versions of EMIR and MiFIR, according to feedback from TRs and ARMs, the FCA isn't expected to make major changes. Also, multiple TRs and ARMs have notified clients that as long as FCA changes are minor, they will handle the reformatting. This reduces any new data required from customers.

Delegated reporting for EMIR is harder

While field format changes aren't expected to be a problem, delegated reporting provided by sell-side firms under the FCA's new EMIR framework could be.

One of the unique aspects of EMIR is that it is a 'double-sided' reporting regime. Each EU counterparty to a trade reports their side of the transaction. Both parties are required to use the same unique transaction identifier (UTI) on the report in order that the data can be matched. In a sell-side to buy-side firm trade, the sell-side counterparty is responsible for generating and distributing the UTI within enough time for the buy-side firm to report their EMIR obligation in T+1.

Unlike transaction reference numbers that are distributed in near real time at the point of trade confirmation, a trade's UTI is often not created until later. For buy-side firms, this has made it difficult for them to report under EMIR as they may not receive UTI information to submit reports within the T+1 obligations.

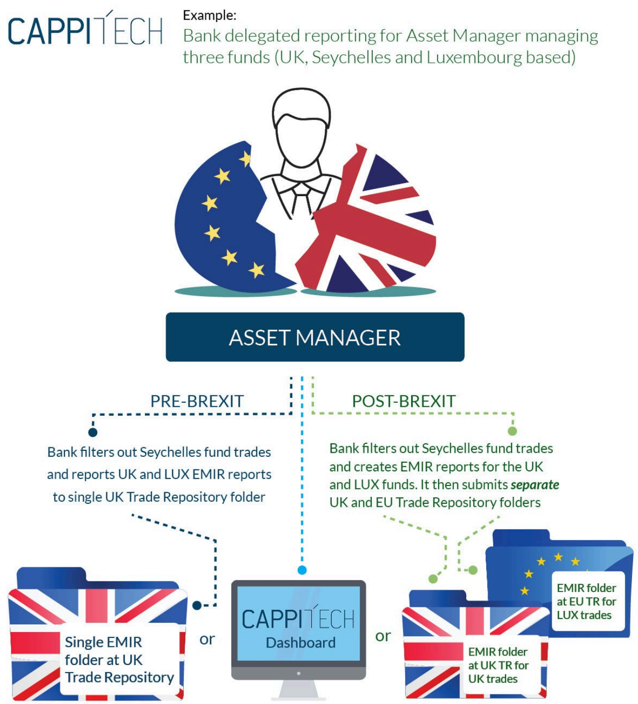
Due to their inability to share UTI information, most EU based sell-side firms that support the fund industry provide delegated reporting to their customers. When a sell-side bank or broker reports their side of an EMIR report, they also prepare a counter report for their customers. The report is then submitted to their respective TR, typically the DTCC.

While delegated reporting from banks makes it easier for investment funds and non-financial companies to comply with EMIR, it reduces transparency if a bank or broker doesn't explain to their customers how they report. Also, due to costs involved and responsibilities, sell-side firms would prefer not to provide delegated reporting. As such, delegated reporting has become more of an accepted reality due to the double-sided nature of EMIR rather than a desired outcome.

Under Brexit, the complexities of delegated reporting become even more challenging.

Split reports and jurisdiction recognition

As stated above, under a split EU/UK EMIR scenario, reports need to be sent to the authorized jurisdiction of the reporting entity. This is the case currently with MiFIR reporting, and one of the main reasons very few firms offer delegated reporting for this regulation.



To support delegated reporting, sell-side firms need to have in place a process to both identify whether their counterparty is EU or UK based, and be able to split reports depending on jurisdiction. For example, under EMIR, the reporting counterparty is the underlying fund and not the investment manager. Therefore, an investment manager may trade with a bank on behalf of say four funds. Two of those are domiciled in Luxembourg, one in the UK and the fourth in Seychelles.

In regards to EMIR compliance, the two Luxembourg funds and the UK entity will need to report their side of the trade. In this situation, to provide delegated reporting, the bank needs to identify the Seychelles positions that don't need delegated reporting, the Luxembourg trades that are reported to an EU authorized TR and the UK fund's trades to a FCA licensed TR. This contrasts with the current process where the investment manager sets up one submitting folder at a TR on behalf of all the funds needing EMIR reporting.

Due to the new complexity, this is expected to cause sell-side firms to once again evaluate the viability of providing delegated reporting for their customers. Some may decide not to provide it at all, while others may charge a fee for the service. It will also make compliance monitoring difficult as reports may go to different trade repositories.

Two TR/ARMs, two accounts

Regardless of whether sell-side banks and brokers tack on new fees for EMIR delegated reporting, buy-side firms may experience higher expenses if they need two submission accounts with both a UK and EU authorized TR and ARM. Until final FCA EMIR and MiFIR framework is passed, pricing structures for UK reporting is unknown. However, some TRs and ARMs have begun to have discussions with clients about pricing on a non-official basis. In those talks, some firms related that they plan to keep costs uniform while others have mentioned price increases of 20% higher than they are now. Even if prices remain the same, investment firms may need to pay separate minimum yearly fees for each of their UK and EU accounts.

FCA/ESMA sharing of data

Another lingering question is if there will be any cooperation between the FCA, ESMA and European NCAs to reconcile UK and EU based EMIR and MiFIR reports. Currently, as a dual reporting regime, ESMA and local NCAs review EMIR data for inconsistencies of data between reporting parties. However, in cases of trades between a UK and EU entity, this would require the FCA to share data with its European counterparts.

At the moment, there is no clarity on whether there will be future cooperation to monitor reports of cross UK/EU trades. For at least the short-term future, EMIR and MiFIR reports sent to the FCA aren't expected to be shared with EU NCAs and vice versa.

Planning for Brexit

With Brexit on the horizon, the main preparation for asset managers is answering which of their related entities needs to report and to where. Once this is established, firms should speak with their existing TRs, ARMs and sell-side partners to understand what their options are post-Brexit. These two items should allow companies to know whether Brexit will cause a gap in their current EMIR and MiFIR reporting process.

Firms with a gap should then decide if changing their TR and or ARM can solve their submission gaps. Also, companies may want to use a 3rd party vendor to help create and submit reports if their current delegated reporting options change.

To contact the author or for any other questions regarding the impact of Brexit on EMIR and MiFIR and preparation for changes, please click here.

Rising to the repapering challenges of IM

by Nick Railton-Edwards, DRS

Nick Railton-Edwards
Head of Research, DRS
nick.railton-edwards@drsllp.com

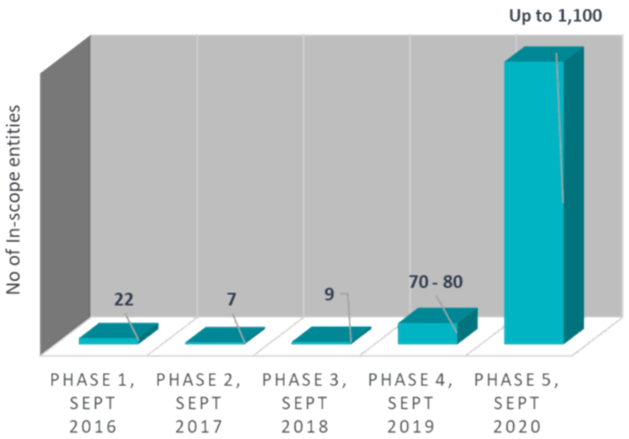
Introduction

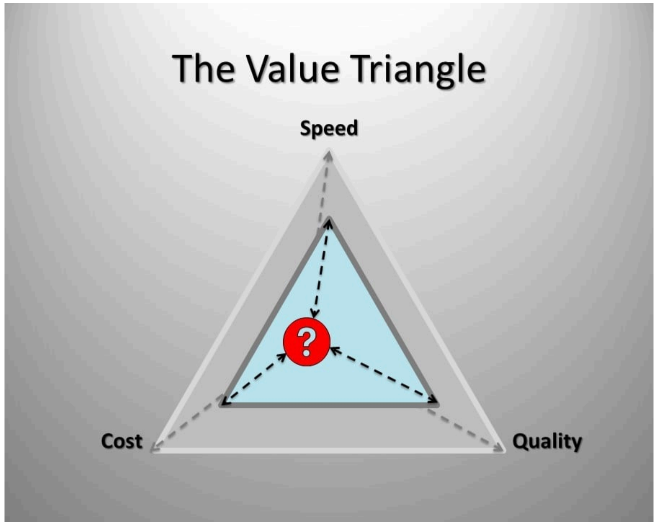
Broaching the topic of upcoming initial margin regulations, the typical response (often from a smiling lawyer) is “there aren’t going to be enough lawyers”. Still swamped by the ongoing regulatory tsunami and with a Brexit storm brewing, AIMA members might be forgiven for putting initial margin regulations somewhere down their “must do now” list. This article will briefly explain why this may be a costly mistake.

Initial margin (IM) requirements form part of post-crisis rules intended to mitigate the build-up of credit risk via bilateral swaps exposures. While variation margin (VM) accounts for daily credit risk, the exchange of initial margin provides a buffer for the time between a VM default and termination of the swap. IM is phased-in over five periods, starting and ending in September of each year, culminating in 2020. The in-scope population for each phase is determined by the notional size of an entity’s derivative portfolio, calculated as an annual average of month end totals during March to May (AANA). To date, the IM obligation has been confined to the sellside, with only Brevan Howard joining Phase 3. Of the approximately 80 entities expected to be Phase 4 (deadline September 2019), up to 20 may be buyside. It is anticipated that Phase 4 will include at least five of the largest hedge funds: BlueCrest Capital Management, Capula Investment Management, Citadel, Millennium Capital Partners and Rokos Capital Management. By contrast, in Phase 5 the AANA threshold gaps down disproportionately from Phase 4’s $750bn to include all entities with a derivatives portfolio over $8bn. As illustrated by the graph on page 2, an order of magnitude increase in affected population.

Why now?

The “magic” project management triangle mandates that there is always a compromise to be made between time, cost and quality. Each antagonising the other, the simultaneous performance of all three is problematic. Failure to finalise the operational and legal arrangements required by the IM rules by the deadline will preclude an entity from transacting OTC derivatives. The deadline-imposed time factor combines with an IM knowledge gap and a requirement for high-quality execution, perfectly highlighting the triple constraints.





Large in scope and complex to execute

From a documentation point of view, IM repapering represents a significant challenge in both magnitude and complexity. In response to the challenge posed by the population increase, the industry is engaged in ongoing advocacy, ranging from increasing the AANA threshold to $100bn to exempting physically-settled FX swaps from the calculation. While the latter recommendation seems to have the tacit support of the CFTC, a reduction in Phase 5 numbers will require unprecedented international adjustment to primary legislation on a short time-scale. The possibility also exists that Phase 5 may itself be broken into "mini phases" by a series of threshold-dependent extensions to the deadline. Market participants should not confuse wishful thinking with a concrete solution.

While it is technically possible to amend existing credit support agreements to achieve compliance, this is far more complex and time-consuming than beginning afresh with industry-approved IM-compliant documentation. In contrast to VM's single CSA, IM repapering will usually require the negotiation of four documents per counterparty pairing. In addition to an eligible collateral schedule (detailing the type of collateral which counterparties can post to each other) you will also have to negotiate:

An IM CSA/CSD (or a CTA and Security Agreement):
The DNA of an IM CSA is inherently more complex than that of a VM CSA. IM CSAs calculate collateral requirements separately with respect to each "Regime" in accordance with a defined "Method" (usually, but not always, ISDA SIMM). They are also much more complex in the way they define and handle 'defaults' by the provider of collateral, the holder of collateral, and the custodian – all of which can result in the liquidation (or return) of the collateral.

Alternatively, you may prefer to negotiate a Collateral Transfer Agreement ("CTA") instead of a CSA/CSD. The CTA essentially mirrors the operational mechanics of the CSA, but does not include a security interest. It requires the execution of separate Security Agreements (one for each party when acting in the capacity of a provider of security).

Account Control Agreements

Initial margin is typically held in a segregated account by a third party custodian. This necessitates the execution of an Account Control Agreement – a document which details the circumstances in which the Custodian may release the collateral to the secured party (or return it to the provider). Usually, two Account Control Agreements are required – one for each party when acting as the provider of collateral.

It's more time-consuming

The number and interdependent complexity of IM documents mandates a markedly longer lead-time than VM. Seven days after the original VM deadline (1 March 2017) average VM CSA execution rates were reported to be 40.72% (a surprising increase from the 8% of 22 February) with only 10.45% of documents having been loaded into bank reference data systems by the deadline. The industry's failure to substantively comply by the deadline forced regulators to grant a six month extension. Regulatory forbearance is rare and any a prior reliance on this for IM would be reckless at best.

The skills are there but rare

The scarcity in sourcing experienced derivatives documentation negotiators was evident throughout VM 'big bang'. When it comes to IM, the talent pool is a puddle, a shallowness exacerbated by the fact that many of these documents are brand new or at an early stage of evolution. Scarcity translates to expense.

Where to start?

Assess and monitor your AANA numbers early and use them as a guide. Taking any portfolio compression into account, if it looks likely that you will breach the Phase 5 $8bn threshold- start planning now. Two basic questions: "where will I get the resources I need?" and "how many people do I require?"

Where will I get the resources I need?

Use in-house resource

Assess whether this is a realistic option. Can you afford to divert legal staff from 'business as usual' workstreams? If so, do you have the necessary level of experience to execute an IM repapering project properly? Many firms have already answered these questions in the negative.

Law firms

Law firms justify their relatively high cost base by the provision of legal advice. They are not set up to deliver large-scale, specialised documentation projects. As large as they are, they have limited numbers of lawyers with significant IM experience – many of whom are already effectively retained by the Phase 1 and 2 banks.

Access the temp market

The IM knowledge that does exist sits almost exclusively within Phase 1 and 2 banks. Those banks are not only taking steps to retain their existing IM knowledge, but they are actively acquiring additional IM experience in anticipation of Phases 4 and 5. If you can access the resource at all, the cost is likely to increase significantly as the Phase 4 and Phase 5 deadlines loom.

Other vendors

For many, third-party document outsourcers will represent the only real option, but vendor choice should be undertaken carefully. Practical IM experience is limited to a handful of firms. An outsourced vendor may achieve a desired price point and a tightly-controlled process, but too-frequent recourse to in-house resource will introduce inefficiencies.

How many people do I require?

The answer will specific to your own circumstances and hostage to a number of variables. It's helpful to look at two inter-related questions – "How many negotiations can one person handle?" and "How long will a negotiation take?"

How many negotiations can one person handle?

Estimates vary widely. Our practical experience suggests that, with full focus and the right support, one experienced negotiator can simultaneously handle between 25 and 30 negotiations.

How long will a negotiation take?

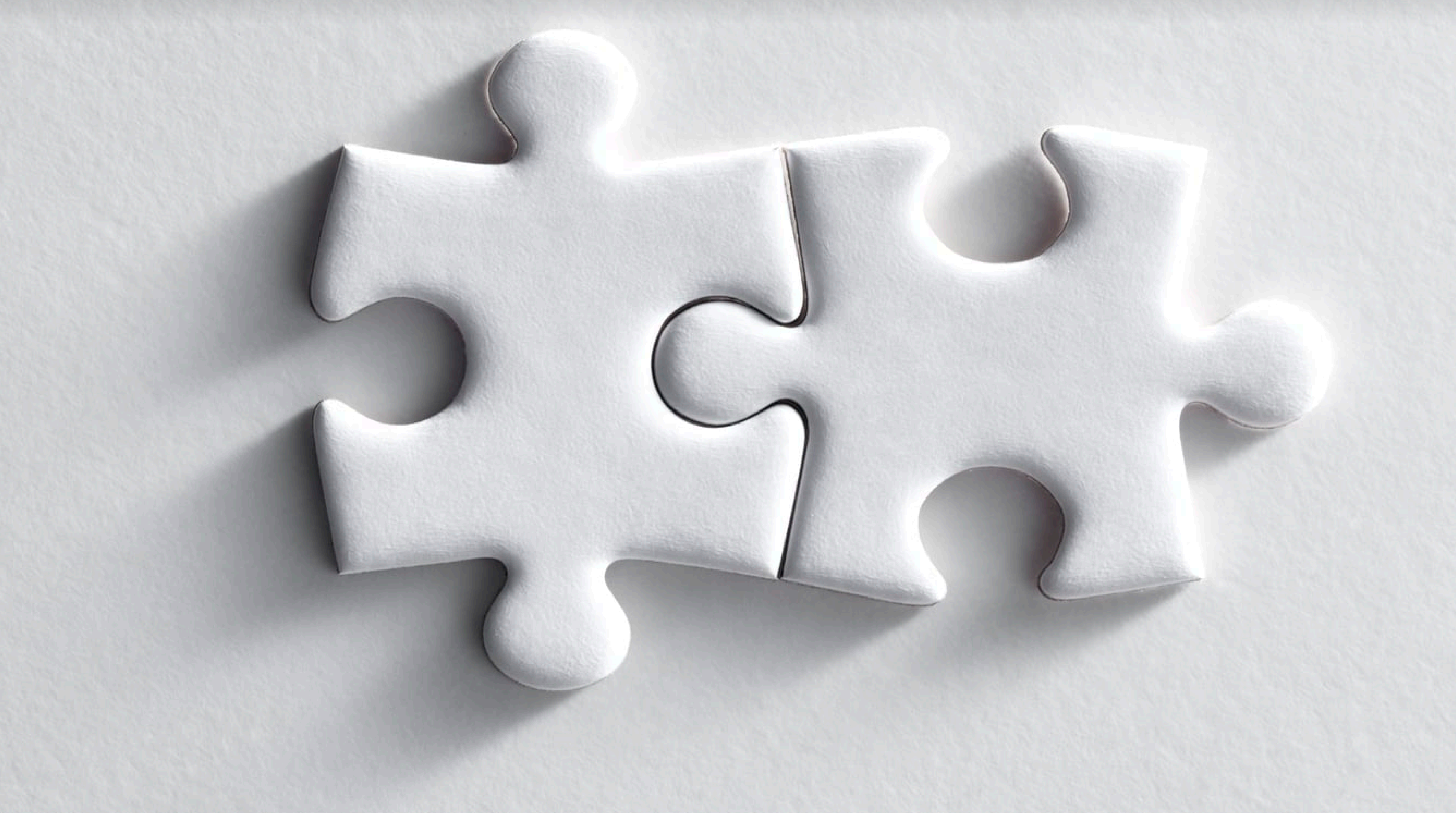
Again, Phase 1-3 experience indicates that a single suite of IM documentation can be negotiated and executed within four months. Phases 4 and 5 - market resources will be stretched by volume and a decrease in counterparty education, a delay potentially amplified by the need to familiarise with the new breed of documentation. To the contrary, a number of factors may mitigate the time required. Increased buyside participation will comprise more replications and umbrella agreements, a clear per document efficiency saving. Technology solutions are currently in development, assisting with first draft production, data extraction from executed documents and the upload to relevant systems. Time savings will result, but these solutions will not be a replacement for IM experience and their operation will require a high degree of knowledge.
Given the above, how many people might you need? There is a Rubik's cube of variables. One year, one entity to execute with 200 counterparties would equate to approximately three experienced negotiators. If you have only six months left, the number will double. If you (and your counterparties) were negotiating on behalf of multiple group entities the number will increase. This estimate assumes that all of your counterparties are as organised, motivated and well-resourced as you are. It also assumes perfect initial data and no unforeseen delays- experience does not accord. The vital process of onboarding at custodians was one of the main bottlenecks for Phases 1 and 2. The introduction for Phases 4 and 5 of more (and smaller) custodians with little (or less) IM experience IM is unlikely to accelerate the process. Other considerations include: team management and supervision, location and physical resources, and provision for resource absence or failure.

Conclusion

Assess your AANA numbers early, if you might be in scope - take action now. Nobody has unlimited IM expertise. Mike Tyson was right when he said that 'everyone has a plan until they get punched in the mouth'. If your plan is to rely on possible regulatory forbearance and pick up the necessary negotiation resource nearer the event, then the punch may be coming and you do not even have a plan. The work may need to be done, but you will have little to no control over cost, timeframe or quality.

Co-investments in the hedge fund space

by Kelly E. Zelezen and Rita Fitch, Kleinberg Kaplan




Kelly E. Zelezen
Partner, Kleinberg Kaplan
kzelezen@kkwc.com

Rita Fitch
Associate, Kleinberg Kaplan
rfitch@kkwc.com

In line with investor demand, hedge fund managers have been increasingly utilizing co-investment vehicles, structures traditionally associated with the private equity industry. Co-investment vehicles are typically used to participate in single ("best idea") investments, usually alongside a manager's "main fund." Co-investment vehicles not only offer hedge fund managers an opportunity to meet investor demand and build relationships, but also to invest in less liquid assets or different strategies than may be permitted under their main fund's investment strategy, to further invest in an attractive opportunity when their main fund has reached capacity, to create a track record with another vehicle, and to offer more products to differentiate themselves. Below we will address some of the various considerations in raising co-investment vehicles, including (i) structuring, (ii) key terms, (iii) offering issues and (iv) other conflicts and regulatory issues.

Structure

One standard co-investment structure is an "one-off" Delaware or Cayman Islands limited partnership (LP) or limited liability company (LLC). However, if a manger is expecting to participate in numerous co-investment opportunities with different investors, then this structure, which requires a new entity and related documentation for each separate investment, can create an administrative burden.

An alternative structure is a Delaware Series LLC or Cayman Islands segregated portfolio company (collectively, "Series Structures"), which allows a manager to simply create a new series within the same entity for each new co-investment opportunity. Under Delaware and Cayman Islands law, each series/portfolio in these Series Structures is treated as a separate legal entity, so the assets and liabilities of each series/portfolio are segregated from the assets and liabilities of other series/portfolios.[1] No formation filings are required to create a new series in a Series Structure, however, because each series is treated as a separate legal entity, there are regulatory and administrative requirements associated with each new series, as managers generally make separate tax (e.g., EIN), Form D and blue sky filings etc. for each series. Thus, while a Series Structure is beneficial because the actual entity and framework (e.g., term sheet with the core terms) is already established, the time and cost savings are not as great as may initially appear.

A manager can always just add a series or class to an LP or LLC (without utilizing a Series Structure) for each subsequent investment it makes, but if there are different investors participating in different investments this may be unattractive to investors because they would potentially have exposure to the liabilities of other series/classes/assets (unless, for example, the different series/classes just hold different tranches of shares of the same company).

Another alternative is to have a co-investor invest directly in the asset and potentially give a proxy or power of attorney to the manager. However, this is more common in the private equity context where managers sometimes need co-investors in order to consummate a deal.

Key Terms

Co-investment vehicles often use certain private equity style terms since underlying assets tend to be less liquid and harder to value. For example, the term of a co-investment vehicle holding an illiquid asset will often match the life of that investment, and investors will usually have limited (or no) withdrawal rights.

Additionally, the incentive allocation will often be a private equity style waterfall, where carried interest distributions are made upon the disposition of the asset, with or without a preferred return to investors.

Management fees rates are often lower than rates charged by a manager's main fund(s), and managers sometimes waive management fees altogether (especially if co-investors are investors in the main fund). Management fees can be calculated based on net asset value, but sometimes, because of the hard to value nature of an illiquid co-investment asset, they are based on the lower of cost and net asset value.

When a co-investment asset has reduced liquidity or is restricted, managers must also use alternative means to "pay" for the management fee, such as setting up "reserves" funded by initial contributions or using capital calls which would force investors to make additional contributions to cover management fees. Similar issues arise in paying ongoing expenses, and the foregoing solutions (reserves or capital calls) can also be utilized to cover expenses.

Offering and Selecting Co-Investors

An early stage decision, along with structure and terms, is to consider who will be offered the opportunity to participate in the investment. Managers often offer co-investment opportunities to investors in an existing main fund, but may also approach third parties depending on the size of the co-investment opportunity, the investors' level of sophistication and ability to act quickly, the manager's desire to build a relationship with and/or attract certain investors, tax/regulatory or legal considerations and other concerns such as side letter arrangements.

The offering of co-investment opportunities can raise fiduciary concerns along with issues of favoritism and conflicts of interest. This has been an area of particular focus for the Securities and Exchange Commission (SEC), which has specifically cited co-investment allocations as an example of favoritism and noted that "Rule 206(4)-8 of the

Investment Advisers Act of 1940, as amended (1940 Act), and other antifraud provisions might be violated without adequate disclosure."[2] The SEC has recommended that managers let investors know when, and on what basis, co-investment opportunities will be offered, so that investors are able to "complain" about a manager's process.[3]

Importantly, the SEC has not required managers to allocate co-investment opportunities among investors pro rata or in any particular manner, but rather to carefully disclose to investors "where they stand in the co-investment priority stack."[4] Based on this guidance, standard practice is to establish a co-investment allocation policy (listing factors a manger will consider when making allocations) and include detailed disclosure on such policy in the fund documents.

Other Conflicts and Regulatory Issues

Expense allocation also raises conflicts of interest concerns, but, similar to the conflict discussed above, can generally be cleansed through a formal policy and sufficient disclosure. For example, when expenses relate to an investment held by both a main fund and a co-investment vehicle, especially broken deal expenses, the default rule is to allocate expenses pro rata (or, if a co-investment vehicle's operative documents do not permit certain expenses, have the manager bear the vehicle's pro rata share of such expenses). However, a manager should be able to allocate in a different manner so long as it is sufficiently disclosed to investors.

Managers that are registered investment advisers (RIAs) should also be aware of certain additional regulatory considerations. Co-investment vehicles are typically considered "clients", so an RIA will generally need to disclose these vehicles on its Form ADV. Furthermore, an RIA must comply with the Custody Rule (Rule 206(4)-2 under the 1940 Act), including the requirement for the vehicle to undergo an annual audit (or otherwise be subject to surprise examination).

Final Thoughts

While certain elements of co-investment vehicles mirror those of traditional hedge funds, there are many unique issues and considerations that managers need to address, including unique conflicts, not all of which are covered in this article. In addition, given the often bespoke nature of co-investment opportunities, assets and participants, it is not clear that "market" terms will develop for co-investment vehicles in the same way they often do for traditional hedge funds. The issues discussed above regarding options for structuring co-investment vehicles, negotiating key terms, offering and selecting co-investors, conflicts of interests and regulatory considerations should therefore be considered carefully with respect to any new co-investment opportunity. Managers are encouraged to consult with their tax and legal advisers throughout the co-investment process.

Footnotes

1. Note, however, that there is little to no precedent available on the treatment of Series Structures by Delaware, Cayman Islands and other foreign courts, so there is no guarantee that such segregation would be upheld in all instances.
2. https://www.sec.gov/news/otherwebcasts/2014/complianceoutreachns013014.shtml
3. See FN 2.
4. https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html

Operational due diligence 'Down Under'; why does it appear 'upside down'?

by Grant Harslett, Maritime Super

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Grant Harslett
General Manager, Maritime Super
granth@maritimesuper.com.au

Overview

In response to the regulatory requirements in Australia, a representative working group of superannuation fund investors and consultants concluded that the most efficient way to improve the breadth and quality of ODD being carried out by investors was to encourage investment managers to commission an ODD report from an independent ODD firm (in the same manner as they commission external audits and controls reports) and provide that annual report to current and prospective investors (the 'manager' model).

This process provides the foundation for investors to make their operational risk assessment and saves substantial duplication of the ODD groundwork that is common to all investors. Both investors and investment managers benefit from this approach because it reduces the time, resources and cost spent on ODD.

In aggregate, the reduced total cost burden on the industry will ultimately improve the retirement outcomes for the members of superannuation funds. And the quality of ODD being done by investors should increase, and the operational processes of some managers may also improve.

Advantages of the 'manager' model

For investment managers, savings of time and resources should be experienced from reducing the quantity of investor due diligence engagement, which is often repetitive and time consuming (and would only have increased from Australian investors or their ODD providers under the old 'investor model').

There should also be value for investment managers from the direct engagement with the ODD provider. Compared to the 'investor model', the manager 'owns' the report and can therefore engage directly with the ODD provider over their findings, and ultimately provide the manager's responses in the report for the investors to read and review.

Using an experienced ODD provider will also provide the investment manager with regular insights into best practices across the industry. And may even lead to improvements in the manager's operational processes.

It should provide a marketing advantage in seeking new investors; already some Australian investors see it as a necessity before considering a new manager appointment. And a manager ODD report may well lead to an investor's due diligence being completed sooner, which means the mandate can commence sooner and so deliver fees to the manager earlier.

While the manager 'writes the cheque' for the ODD report, investors expect to ultimately pay their share of the report costs incurred by managers through fee scales and/or trust costs (where feasible).

A counter argument sometimes put forward to the 'manager model' is that the appointment by the manager, rather than the investor, reduces the independence of the provider and creates a potential conflict. But as noted above, there are precedents of manager-appointed external service providers (external audits; controls reports). And the professional reputation of the ODD providers should mitigate against a 'soft' report.

Finally, we note that investors can, and should, dig deeper on any aspect of the initial ODD assessment on which they might have concerns or questions, as the ultimate responsibility for the ODD risk assessment resides with the investor.

So why did the 'manager ODD' model appear in Australia? Firstly some background on due diligence in the Australian marketplace.

The investment due diligence process in Australia

In Australia, like most other countries, due diligence of an investment manager (or manager's fund/product) has two broad components; investment capability and operational capability.

The initial investment capability assessment (IDD) is typically carried out by an asset consultant, or increasingly by the internal investment staff of the larger superannuation funds. The scope of the assessment depends on the particular mandate and the needs of the super fund client and hence is quite individual to each client/manager situation.

The operational risk assessment (ODD) is rarely carried out in Australia by an asset consulting firm as the required skill set is very different and, although important prior to appointment, it is also an ongoing assessment process. It is also more firm-related than mandate-related; many core operational elements relate to the investment firm and do not vary by investor. So while equally as important, the nature and timing of ODD is different to IDD.

And there is a growing view that investors shouldn't have to undertake all of this operational risk assessment responsibility; arguably an investment manager should be able to provide independent support for their assertion that they can run their business sufficiently soundly to be able to deliver their investment proposition. Following this thesis, investors arguably should be provided with a manager-initiated report to assist the investors with their operational risk assessment.

Why the manager ODD model appeared in Australia

The 'manager ODD' model was driven in Australia by market forces; primarily the prudential regulator's standards and guidance, coupled with the relatively large number of superannuation funds operating in the market.

APRA, the prudential regulator for superannuation funds, established a number of prudential standards in 2013 which all Australian superannuation funds must follow. 'Investment Governance', 'Outsourcing' and 'Risk Management' are three of these prudential standards which are relevant when appointing an investment manager. APRA has also issued explanatory guidance on ODD expectations in various forums; the key documents are articles in APRA's Insights publication in 2014 and 2018.

These articles clearly set out APRA's expectations of all superannuation funds in relation to the initial and ongoing ODD of outsourced investment arrangements.

And "all superannuation funds" is the key here because the Australian superannuation industry, despite a significant contraction in the number of superannuation funds over recent years, still has over 100 sizable funds. And to date, not all superannuation funds had been carrying out adequate ODD.

So for all superannuation funds to reach APRA's required level of operational risk assessment, which to be fair is nothing more than sound practice anyway, the previous delivery model simply did not scale up efficiently to handle the necessarily greater volume of ODD that needed to be carried out by investors.

Some global support

Relative to the more common overseas ODD model where the investor contracts the ODD provider, or does all the assessment work themselves, in a sense the Australian approach might appear 'upside down'!
But Australia is not alone in seeing the merits of the manager ODD model. Two global providers have expressed their support for the model; including Laven Partners (offices in the UK and US) and Prism Alternatives (located in the US).

What is the scope of the ODD report?

The working group mentioned earlier, was established by the Australian Institute of Superannuation Trustees (AIST) which represents superannuation funds in the 'profits-to-members' sector (industry, public sector and corporate funds). An AIST working group of investor members, and asset consulting firms, canvassed the issues outlined above and engaged with peak investment manager bodies (FSC, AIMA) and the prudential regulator (APRA).

To implement the 'manager model', AIST launched a Guidance Note in 2016 which outlines the approach and sets out nine areas that should be

Laven Partners
"Fund Managers who assess their own operational controls are equipped to proactively address any deficiency before an investor due diligence raises the matter at the bottom of the sales funnel. The AIST guidance for manager-led operational due diligence provides an excellent model to ensure operational best practice standards are followed and to help assist fund managers in providing assurances to investors as to the quality of their operations."

With permission, we quote from a recent PRISM Alternative Investments newsletter:

FUND PAY MODEL VERSUS INVESTOR PAY MODEL – WHY HASN'T THIS HAPPENED YET?

Around the world, ODD is paid for and mandated by the institutional investor, and not the fund, like the case is for GAAP audits. Why would this be, when this creates a significant cost burden for the manager and for the investors? Why should each pension, endowment, wealth management platform, or FOF have different levels of ODD information, expertise, and take on different levels of fraud risk and operational costs? So, today managers sometimes host hundreds of ODD meetings a year, and investors do varying levels of ODD work, resulting in tens of millions of dollars in duplicative costs. Some spending 100 hours on ODD using non-experts, and some spending 30 hours a year using ODD specialists. Simply put, it is not an efficient frontier. Australia is one of the first countries to make the move and treat each investor equally by recently putting out regulatory guidelines recommending that managers/funds obtain a periodic ODD opinion from a reputable ODD firm. When or will the rest of the world follow?

covered in an ODD review. These areas cover all elements of an ODD review which any best practice process would cover and they are consistent with the guidelines set out by APRA.

The nine areas are: Organisation structure, Personnel, Governance and risk management, Trading processes and operational functions, Valuation processes, IT systems and security, Business continuity, Service provider oversight, Reporting.

It is critical to note what the ODD report is not! It is not an extended controls report (SOC, SSAE18, GS007). It has a much broader scope and is more forward looking than a controls report.

Most importantly the style of the ODD report is 'advisory' in nature and approach; it is not 'assurance' in the audit sense. It provides expert advice and commentary on areas of potential operational risk and on the manager's operations relative to best practice.

Investors retain responsibility for risk assessment and decision

The independent ODD report provided by the investment manager is a foundational contribution to the risk assessment process by the investor, but the investor must make the overall assessment on the likely operational risk of using the investment manager, assessed against the investor's risk management framework and the circumstances of the mandate.

Consequently, the investor may need/want to do more analysis and enquire on some matters before reaching their conclusion. But the aim is that investors only supplement, but not duplicate, the core ODD review work carried out, and reported on, in the independent report.

Progress

So the 'down under' model should enable costs savings from less duplication of ODD activities and also improve the breadth and depth of ODD assessments and the quality of operational processes.

Progress with the implementation is good. Many Australian managers are on board and the number of international managers is growing. Benefits are already being observed by both investors and investment managers.

AIST is continuing to work closely with investment manager representative bodies, FSC and AIMA, the regulator APRA, and other stakeholders, in evolving and refining the model.

Conduct unbecoming: the hidden challenges of SMCR

by Robert Quinn, Robert Quinn Consulting

Robert Quinn

Managing Director, Robert Quinn Consulting

Robert@robertquinnconsulting.com

The extension of the Senior Managers and Certification Regime (SMCR) to FCA regulated firms in December 2019 presents AIMA members with the opportunity to use this key regulatory change as a catalyst to implement improved management practices across the board. Firms should consider taking a robust approach in their application of SMCR in order to articulate reporting lines, identify the required management information to supervise properly and empower senior managers.

The UK Parliament enacted SMCR legislation in response to the 2008 banking crisis and significant conduct failings such as the manipulation of LIBOR. The FCA's increased focus on 'culture' and individual conduct and personal accountability goes beyond the SMCR legislation and represents a key shift for them. Viewed through the SMCR lens, this includes:

- Encouraging a culture whereby staff at all levels take personal responsibility for their actions
- Ensuring firms and staff clearly understand and can demonstrate where responsibility and accountability lies

The New Regime

SMCR will supersede the Approved Persons Regime on 9 December 2019. At a high level, firms will need to:

- Identify Senior Managers who are personally responsible for the areas of business that they manage
- Identify employees undertaking Certification Functions, which includes those employees who interact with clients, are material risk takers, are proprietary or algorithmic traders or who perform a significant management or supervisory role
- Implement a formal fitness and propriety assessment that requires a number of due diligence checks on an initial and ongoing basis for both Senior Managers and Certified Function holders
- Introduce new Conduct Rules, which are similar to the previous FCA Statements of Principle for Approved Persons, that apply

directly to most (if not all) employees within a firm
- Develop and apply a more formal training programme
- Ensure timely reporting to the FCA for Senior Manager appointments and any conduct rule breaches by employees
- Ensure accurate and timely information is posted on the new FCA Directory
- Implement a suite of new written policies and procedures that document a significant number of new requirements that SMCR brings into play

Creating a Road Map

Unlike aspects of - say - AIFMD and MiFID II which contained certain complexities and ambiguities, SMCR is more straightforward. However, firms should not underestimate the new regime as an "HR re-papering exercise". SMCR is a significant piece of change management legislation that cuts across compliance, legal, human resources and senior management. Managers should appoint the right individuals who can foresee the potential sensitivities this legislation might create and allow sufficient time for implementation. The banks learned this lesson in 2016 when they implemented SMCR.

Firms should be prepared to expect questions and respond to potential concerns from employees with respect to their role, responsibilities and accountability under the new regime, insurance coverage, employment contracts, compensation, regulatory references, background checks and a whole host of other issues. Proper consideration and handling of these issues in order to achieve amicable resolution will take time. It is therefore important to start your SMCR project as early as possible and allow that time in order to not negatively impact company morale with a rushed, heavy-handed approach.

Creating a road map now that identifies action items in 2019 will give your firm the tools to succeed.

Identify the "Surprises"

This article is not going to recite what's required by the new legislation. Rather, it helps you identify five key areas which may put time-consuming bumps in your road map.

<u>1. Partners of LLPs</u>

The FCA expects that most partners in a firm will be a Senior Manager. Junior partners and partners with no involvement in the management of the firm will not need to be appointed as Senior Managers.

This creates a conflict with the HMRC tax rules. In order for a limited liability partnership to receive beneficial tax treatment, it is assumed that the partner would have significant influence over the affairs of the LLP. Firms who have partners who are not Senior Managers may face HMRC aggressively seeking to apply a less favourable tax treatment to such partners.

LLPs should review this area carefully.

<u>2. Overseas Employees</u>

There is no territorial limitation to the Senior Managers Regime. SMCR applies to anyone who undertakes a Senior Manager Function anywhere in the world. For Senior Managers based outside the UK who may occupy a senior management role within a group context, but who otherwise are not impacted by the UK regulatory environment or have a detailed understanding of the application of FCA rules, this may present a challenge. Senior Managers will be personally liable to the FCA if they do not take “reasonable steps” to supervise their area of the business – showing competency in FCA rules is a key measure in demonstrating reasonable steps.

With many global firms having overseas principals nominally supervising the UK entity, firms should assess whether they have the right Senior Managers in place and whether implementing a UK-specific continuing education programme is warranted.

Similarly, the Certification Regime has an extra-territorial element as well. Certification applies globally to all employees who are deemed to be material risk takers. Certification also applies to all employees performing Certified Functions who are dealing with, or have contact with, UK clients.

Decisions about which overseas employees fall into these categories may take some time. Keep in mind that firms are required to assign the responsibility of implementation and oversight of both the Senior Managers Regime and the Certification Regime to one or more Senior Managers.

3. Formal Training

SMCR requires firms to provide training on the Conduct Rules at least annually. Fitness and propriety assessments of employees undertaking a Certified Function also lend themselves to using continuing education as a tool to demonstrate competency.

However, firms should also be aware of specific documents they will need to provide to the FCA when appointing a new Senior Manager. These important requirements have not been fully covered in recent FCA publications.

When appointing a new Senior Manager, firms will need to provide:

- A description or copy of the candidate’s Induction Programme
- A description or copy of the candidate’s Skills Gap Analysis
- A description or copy of the candidate’s Learning and Development Plan (including the name of the individual responsible for monitoring the candidate’s progress against the development points and the time frame for completion)
- A description or documentation setting out how the competency was assessed (demonstrating competence and suitability mapped to the specific role and responsibilities of the role)

Most firms will not currently have such a granular formal training programme in place. They will therefore need to spend some time assessing how best to address the gaps at all levels of the business and ensure implementation in good time.

4. Individual Accountability versus Collective Accountability

The regulatory shift from collective responsibility to individual accountability will create many challenges. With the appointment of Senior Managers who are now personally liable for properly managing their area of the business, there may be concerns raised about what is going on in a certain department, or how management information is provided to the Senior Manager. The adoption of this framework is not without moral hazard. There is, for example, the potential for Senior Managers to make decisions in order to reduce their personal liability i.e. protect their 'fiefdom', as opposed to considering the needs of the firm as a whole.

It may be prudent to arrange for an independent assessment or health check of the business, to give confidence to that Senior Manager that the firm is compliant with industry standards and in step with its peer group, as well as ensuring that policies and procedures are up to date and tailored to the business.

<u>5. Conduct Rule Breaches and the Parameters of "Acceptable Behaviour"</u>

The FCA has been explicit that Approved Persons must act with honesty and integrity at all times. The regulator has successfully brought several high-profile enforcement cases of individuals in senior positions, who have been banned for behaviour both within and outside the workplace - conduct that was deemed to demonstrate a lack of fitness and propriety. A challenge for firms is that the concepts of 'honesty' and 'integrity' can be subjective; firms must remember that they are not necessarily seeking to make moral judgements on individuals.

Under SMCR, not only must firms report conduct breaches to the FCA, they are also obliged to include such breaches in regulatory references requested from a potential new employer. This heightens the risk for employees that are found to be in breach, and this could create a myriad of HR/ employment law challenges. Firms should - inter alia - consider what types of employee behaviour within and outside the workplace might be considered a breach of the Conduct Rules and how that might be communicated to employees.

Taking Your Firm to the Next Level

SMCR is coming and it is here to stay. By investing the time and resources into understanding the changes and empowering Senior Managers with the right tools to succeed, firms can successfully embed a culture of corporate governance that will both improve the controls within the business and impress institutional investors.

Securing the cloud

by Kulvinder Gill, Eze Castle Integration

READ ON

Kulvinder Gill

Associate Director, International Marketing, Eze Castle Integration

kgill@eci.com

A Risk-Free Approach to Securing the Cloud

Cloud products continue to evolve as adoption has increased rapidly over recent years. Top vendors such as Microsoft offer feature-rich cloud platforms, with transformational potentials for the global workforce. However, due to the perceived data security risks accompanying cloud usage, there are still many firms that have decided against 'going cloud'. A report on cloud security published by Crowd Research Partners in 2018 highlights that 91% of cybersecurity professionals share these concerns. Fears around cloud security are not uncommon, and, unfortunately these fears do have a basis. An estimated 25% of public cloud users have suffered data loss, as per security software company McAfee's 'Navigating a Cloudy Sky 2018' report. All things considered, businesses are still encouraged to leverage a cloud-based platform to accelerate the modernisation of their IT. And, trust that with a strong security net in place, applications and assets stored on these solutions can effectively be protected. Businesses are advised to embrace the following cloud data security best practices to secure their network.

Security Comes First, Always

A security-first approach to planning and implementation is the foundation to successful cloud migration. Firms will find it is more effective to move to a cloud solution with the necessary security layers in place right from the start. With a firm foundation in place, additional layers can always be added as required.

A security-first approach entails a lot of planning on behalf of the business looking to move its assets and applications to the cloud. Firms are encouraged to carefully consider the different cybercriminals and malicious entities it may face.

Another integral component of the migration process that falls under planning is research. In-house IT teams are encouraged to research cloud service providers and evaluate their respective data security protections to ensure complete security. It's good practice to know how any partners work with clients, as the most secure cloud platforms result from both parties sharing the responsibility for protecting customer and employee data.

Handle Access Control Effectively

Unauthorised access is amongst the top cloud security threats. Reputable telecommunications entity, Verizon, reported that 28% of more than 53,000 system attacks recorded in 2017 involved malicious insiders. Cloud adopting firms are urged to mitigate the risk that comes with granting employees access to cloud-hosted applications or the architecture itself by putting into place strict access controls. Preconfigured access management features are included with most enterprise cloud services, allowing firms to govern system access control on a granular level.

Credentialed members of staff with good intentions can also pose a risk since many maintain poor login management practices. Therefore, for an added measure of security, firms and any IT partners are also advised to have strict guidelines for granting access, where permissions are matched to job duties.

Bulletproof Your Network with Digital Defences

It takes several protective layers to create a bulletproof cloud data security strategy. For instance, the system-level defences, which constitute the outermost layer, secure the so-called plumbing of the cloud, or the compute containers, networks, operating systems and the other overarching components that facilitate cloud-based connectivity.

Next, you have application-level security features, which encompass the above-mentioned access control policies explored instead of technical components. And, data-level protections form the final layer, as the last line of defence against cybercriminals on the technology front. Not forgetting the end users, who require training to ensure the security strategy is not compromised.

In terms of sharing the responsibility, cloud-computing vendors are responsible for developing and deploying the data security features that make up the first layer, whilst internal IT teams or managed service providers must build out the two remaining layers.

Cloud adopting firms must take full responsibility when it comes to establishing data-level defences, and the vast majority start by employing encryption services. McAfee has reported that over 65% of data security experts agree that encryption is the best method for protecting sensitive information. Some firms have leveraged tokenization, which involves transforming valuable decipherable data into strings of random plaintext called tokens, and only users with access to token vaults can view the protected information in its unscrambled form.

Some established data security tools that have proven effective in addressing small-scale data security issues before they develop into disastrous flaws, include:

- **Access auditing** – This backend protection software allows system administrators to view user network activity to pinpoint potential threats.
- **URL scanning** – These data security modules evaluate active links embedded in emails to determine any malicious content.
- **Web filtering** – Programs of this sort review webpages in real time and block any dangerous or unsanctioned assets.
- **Email protection** – These applications integrate with industry-standard email clients and scanning incoming messages for potential

viruses.

- **Multifactor authentication** – This login method which requires users to employ multiple identify verification methods.
- **System environment monitoring** – This technology enables IT departments or managed IT providers to scan enterprise computing environments in real time.

Overall, businesses must devote considerable resources in order to establishing system-, application- and data-level defences, as well as training staff on critical data security best practices.

Partner with Only the Best

Top cloud providers are increasingly providing add-on features to their offerings to be the single source of all things cloud for clients. Whilst the idea of working with a single service provider may seem appealing, this is seldom feasible or realistic in addressing all security and feature requirements. A single vendor cannot be everything to everyone, which is significantly impactful to firms that have unique application, availability and security requirements. Additionally, firms should also consider that a single source strategy can result in increased risk due to a single point of failure.

Hence, businesses are advised to follow a best-of-breed approach to utilise the best feature sets from an array of solutions and ensure high levels of security. Working with a managed service provider (MSP) is worth considering for firms looking to bundle cloud features with other best of breed solutions (i.e. multifactor, end point protection, next-generation firewalls), and get the best of both worlds. With this approach, firms can rely on their MSP to carry out the necessary product testing to select the best vendor for each security layer and then manage the environment. MSPs also often provide 24x7x365 help desks that can provide personalised support to businesses, meaning firms can rest assured knowing their infrastructure is always supported.

Take the Leap

Migrating to the cloud can be daunting, especially in the context of today's ever-evolving digital threat landscape. However, the global marketplace demands the scalability available through the cloud, making migration almost essential for firms looking to stay ahead of the growth curb. The benefits of 'going cloud' are countless including; reduced IT costs, improved ability to align IT to business needs such as more frequent release of business features and the capacity to host all files and applications in one secure location, to name a few. Putting fears and reservations aside, businesses are encouraged to take the leap, and avoid risks by adopting the data security strategies explored in this article.

Change is the only constant: a career in financial services

by Bernadette King, haysmacintyre

Bernadette King
Partner, haysmacintyre
bking@haysmacintyre.com

Accountancy doesn't run in my family and it wasn't where I expected I'd end up.

My education has undoubtedly been one of the biggest influences on my journey into financial services. At school, I discovered Economics at A-level and as it combined my enthusiasm for business and statistics, it was only right that I went on to study the subject at UCL. That joint interest then influenced my career choice following graduation, and I joined accountancy firm Hays Allan in 1995 (later renamed haysmacintyre after a merger in 2001) – and I am still at the firm 23 years later.

From a young age, my teachers and family instilled in me the importance of hard work and ambition, and encouraged me to always strive to do well and grasp the opportunities that came my way with both hands – values that have supported my career development and trajectory at haysmacintyre.

Having qualified as a chartered accountant in 1999, I was quickly promoted to an assistant manager. This coincided with the volume of work from a new sector focus for the firm – working with hedge fund managers – increasing rapidly. I was keen to support the new initiative and had gaps to fill in my work portfolio, so I was the obvious choice to support the new financial services (FS) clients and that is where I have maintained my focus.

The accounting industry, and FS sector as a whole, has transformed from when I started – from what we wear to where we find our information, to the number of female leaders in the sector, to the expectations and demands that working life has on our personal lives.

It's hard to believe but when I was applying for my training contract in London, I attended a presentation by one of the few female partners at a top accountancy firm, who was celebrating that, merely one week earlier, women at that firm had finally been permitted to wear trousers at work – something that wouldn't cross the minds of professionals today. Also, without the benefit of Google, as a trainee accountant, I taught myself the regulatory rules of IMRO (today's FCA)!

When I was starting out in the 90s, female partners were not common. Seven years on from qualifying, however, I was appointed as haysmacintyre's first internally promoted female partner and now, almost a third of haysmacintyre's partners are women. Throughout my career, I have never considered my aspirations or job requirements to be any different to male counterparts; we all have commitments and other interests and we are better advisers for having these differences.
The nature of the regulatory calendar for FS clients means we tend to have seasonal peaks in activity; the beginning of the year is my busiest period (given businesses' requirements to submit annual reports and accounts 80 days after the regulatory year-end). That works well for me and my other business and personal commitments.

Luckily perhaps, I do find the work I do with FS clients the most rewarding. They are typically business minded entrepreneurs, who tend to have at least a basic understanding of their accounts. This allows for a more collaborative working relationship, as our expertise as accountants is valued and appreciated.

I also particularly enjoy advising clients who are just starting up a business. Supporting the growth of the business as well as seeing the individuals themselves grow throughout the process, and being part of their success, is particularly satisfying. Today, the majority of graduate accountants, including those at haysmacintyre, are given the opportunity to work across all their firms' sectors before choosing any specialism. By the time they become managers, they are able to choose their preferred sector, having already become well acquainted with the clients in that space.

I enjoy the immediate and direct relationship between the FS sector and the political and macro-economic landscape. Looking to the future, with the FS sector's reputation arguably still suffering from the 2008 financial crash, and with Brexit on the horizon, the sector needs to respond head on to the unavoidable change that is coming our way. As a sector we can expect to see regulatory processes become more time-consuming and expensive – a necessity if we want to maintain London's reputation as the financial centre of the world. The sector simply can't survive another reputational crisis like that of 2008. Therefore, it's important we continuously develop our regulation so that both companies and individuals are well protected. When looking ahead to Brexit, the FCA's European passporting rules will cause complications as the deadline draws closer. When the UK leaves the EU (and possibly the EEA as well), the market could shrink, and HFMs may consider relocating to Europe.

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Global Head of Hedge Funds Practice
Matthias Feldmann
Partner
T: +852 2825 8859
E: matthias.feldmann@cliffordchance.com
Business Development Lead, Global Funds & Investment Management
Fiona Grafton
Senior Business Development Manager
T: +1 212 880 5602
E: fiona.grafton@cliffordchance.com
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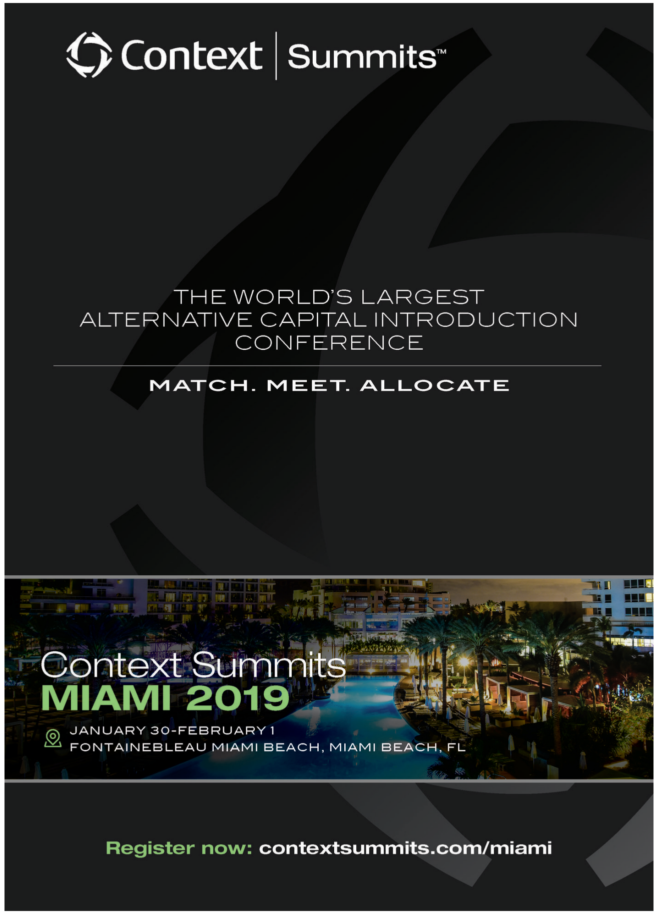
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Contact us

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

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

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

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

Toronto
120 Adelaide Street West, Suite 2500, Toronto, Canada
+1 416 364 8420
cvanwykallan@aima.org

Singapore
12 Marina View, #21-01 Asia Square Tower 2, Singapore 018961
+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

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