AIMA Journal - Edition 115

Includes:

Arbitration

Driving diversity

AIFMD

Fed's challenges as it seeks neutral monetary policy

Capital requirements

Regulatory developments in the Cayman Islands

...and more

Message from AIMA's CEO

Jack Inglis

Jack Inglis

Welcome to the latest edition of the AIMA Journal, which now includes a number of videos alongside our usual compendium of articles.

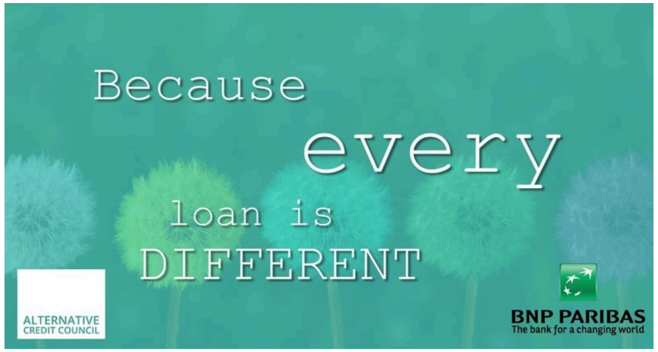
This edition contains a wide variety of commentary from across our membership. One article by Simmons & Simmons delves into the power of **arbitration**, as a more confidential and cost effective alternative to court proceedings. Among the regulatory pieces, includes an article by Maples and Calder on recent regulatory changes in the **Cayman Islands**, most notably around tax transparency. Elsewhere, we have a separate submission by Prestige Asset Management that focuses on **private debt and opportunities within the SME market**. And as the need to address **diversity** issues becomes widespread across all industries globally, KPMG discusses how best to address challenges the industry faces.

Momentum continues here at AIMA. Since our last edition, we have released two research papers - one covering responsible investment and the other, private debt.

The first of these, "From Niche to Mainstream: Responsible Investment and Hedge Funds" looks at how the hedge fund industry is responding to growth in demand for responsible investment. Among the key findings highlighted in the paper include that hedge funds globally have allocated at least $59 billion to responsible investment. Interestingly, around 40% of respondents to our survey say they are already investing using responsible investment principles, while 20% say they are committing 50% of their firms' assets to responsible investments.

Our other research paper titled "Enhancing the loan administration function highlights how firms that have the right operating infrastructure is integral to its success, but this is especially true for asset managers in growing markets such as private credit. Our paper demonstrates that the infrastructure behind credit funds is still maturing, although critical challenges remain. 90% of private credit managers face challenges with loan administration, with 45% of respondents saying that reporting to investors and regulators is challenging due to the bespoke nature of each and every loan. The video below highlights some of the key findings drawn from the paper.

As always, we hope you find this edition useful and illuminating.



AIMA

Confidential, quicker and cheaper dispute resolution: arbitration

Stuart Dutson, Partner and Alexander Sussman, Associate at Simmons & Simmons

Stuart Dutson

Alexander Sussman

Typical asset management disputes include allegations of breach of mandate, misselling, breach of duty, misstatements, misleading disclosures, negligent management and/or misreporting.

The asset management industry generally resolves its disputes via litigation, i.e. open court proceedings. Indeed, a recent survey by a leading arbitral institution (the International Chamber of Commerce, or 'ICC') suggests that arbitration is rarely used within the asset management industry. The ICC reports that in some instances, the existence of arbitration was completely unknown to survey participants.

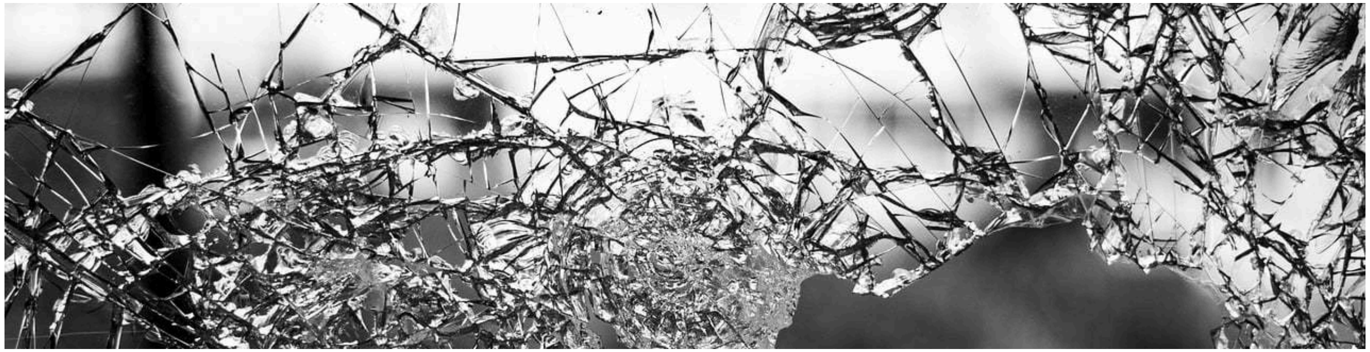
Arbitration is an alternative to court proceedings as a means of resolving disputes. It is based on the parties' agreement: instead of agreeing to submit their disputes to the courts of a specific jurisdiction in their contracts, parties agree to submit their disputes to a 'private' individual or tribunal. This usually forms part of the parties' main contract, although it is technically a separate agreement.

Rather than being bound by the rules of procedure applicable in a specific court system (including rules on disclosure or discovery of documents), parties who have opted for arbitration may choose the rules of one of the many arbitration institutions or set their own rules of procedure and determine, for example, the composition of the tribunal, the number of written submissions, applicable deadlines, the rules of disclosure and limitations on rights to appeal (to the extent permitted by law). One of the potential advantages of arbitration is that the opportunity to challenge or appeal an arbitral award can be heavily circumscribed, which means a quicker final determination.

A key benefit of arbitration is the ability to keep disputes confidential. This avoids the brand and reputation risks that open and public disputes with clients bring. A confidential process and outcome reduce the risk of a dispute being played out in a public forum and is the reason why we often see arbitration clauses included in partnership agreements in the asset management industry. Arbitration enables internal issues to be dealt with discreetly and confidentially without the publicity that public court proceedings entail. However, the publicity that litigation attracts is not a concern that is unique to internal disputes and the confidential nature of arbitration could be of significant strategic benefit to a wide range of disputes experienced by asset managers. For example, just the threat of publicising a dispute can often be used to apply pressure on asset managers to negotiate a settlement, and there is a perception in claimant litigation firms that asset managers can be a soft touch when the client can threaten public court proceedings – pressure that an arbitration clause can go a long way to alleviating.

Moreover, in arbitration there is only limited disclosure. Generally, parties need only disclose the documents upon which they rely and are not obliged to search for further documents or disclose adverse documents. Parties may make specific requests for further documents by application to the arbitral tribunal but this represents a significant hurdle to additional disclosure. Consequently, the large scale electronic disclosure exercises which are common in court litigation are almost unheard of in arbitration and the associated legal costs are avoided.

Arbitration would also allow the asset management industry to have its disputes heard by subject specialists. Allegations of breach of duty under English law, for example, need to be determined by reference to the opinions of reasonably informed and competent members of the investment



management profession, with allowances made for the difficulties in circumstances in which professional judgements have to be made. The relevant investment decisions may have been made against the background of voluminous and complex regulation applicable to alternative investment managers, for example, the EU Alternative Investment Fund Managers Directive.

With this in mind, parties may well prefer to have that dispute heard by someone with a background in investment management. Arbitration permits this flexibility: parties can opt to refer disputes to an arbitration institution which specialises in financial services, specify that the arbitrators must have experience of, or expertise in, investment management or opt for rules which allow them to nominate a member of the tribunal.

In addition, arbitration can offer a fast-track method of dispute resolution. The London Arbitration Club Financial Sector working group has developed an expedited dispute procedure. The procedure anticipates the handing down of an award within 6 months of the referral of the dispute to arbitration. It also requires that arbitrators nominated by the parties should have “experience and/or expertise related to financial services”.

Finally, arbitration awards are generally easier to enforce out of jurisdiction than English courts judgments. Over 140 countries have signed and ratified the 1958 New York Convention, which provides that signatory countries should, save in limited circumstances, enforce arbitral awards as if they are judgments of their own courts. There is no similar convention in place providing for the enforcement of English court judgments outside of the EU and there is uncertainty as to the position even within the EU post-Brexit. Therefore, parties seeking to enforce English court judgments abroad may find that they have to start fresh proceedings.

The adoption of arbitration clauses is, of course, not without its challenges. In particular, in order to benefit from the speed and simplicity offered by arbitration, it is important that all potential parties to typical asset management disputes are bound into the same process. For example, it is important to ensure that the dispute resolution clauses in contractual documents in place between a fund and its investors include consolidation provisions and mirror those in the contracts in place between the fund and the investment manager and other service providers in order that the disputes that may arise can be dealt with in a single forum. However these hurdles are by no means insurmountable, and comparatively easy to navigate for new fund start-ups, and the collective benefits of arbitration – confidentiality and a quicker, cheaper process with little or no disclosure/discovery – make it a very attractive proposition for the investment management industry to consider, particularly in a Brexit environment.

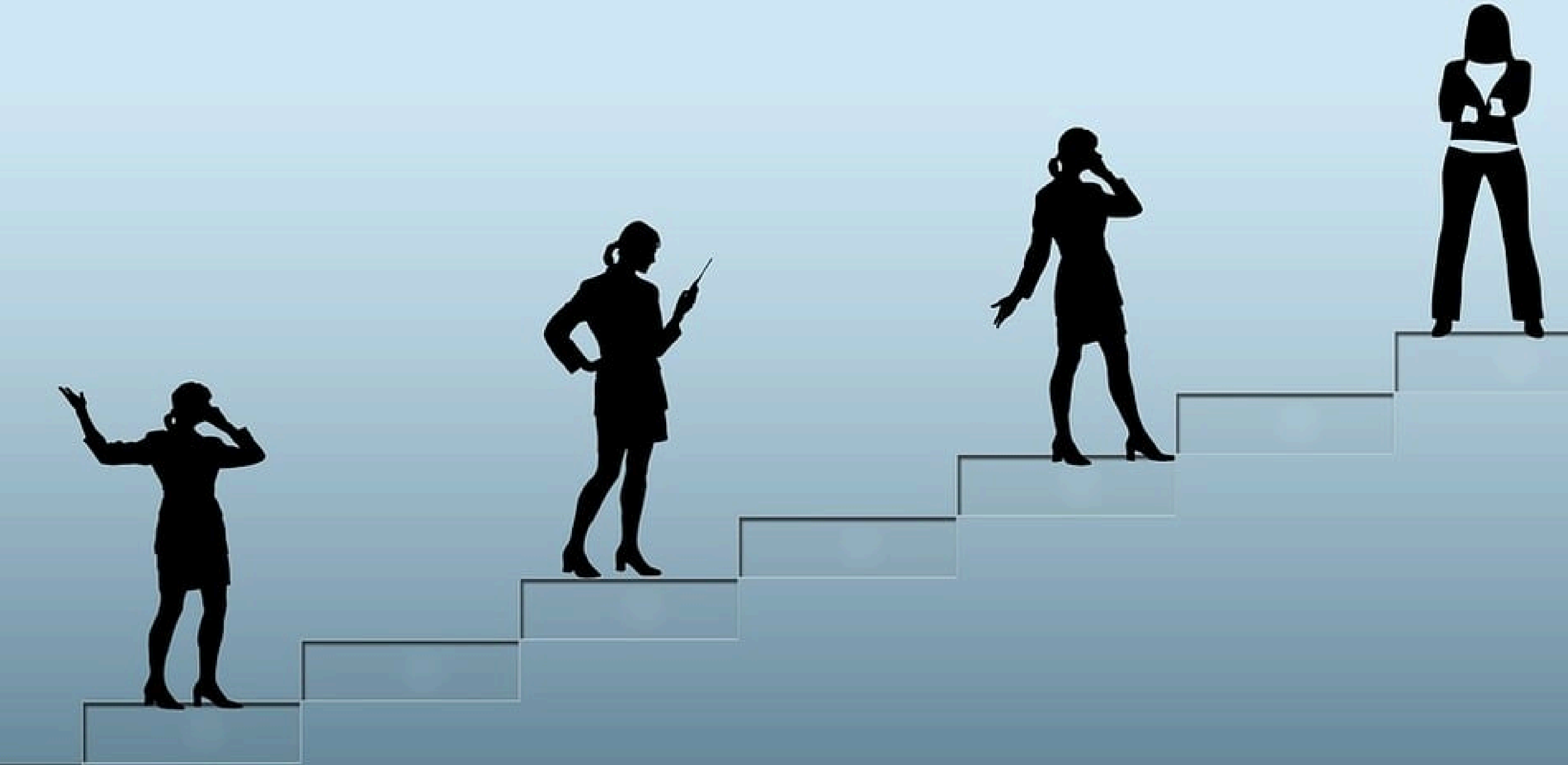
To contact the authors:

Alexander Sussman, Associate at Simmons & Simmons: Alexander.sussman@simmons-simmons.com

Stuart Dutson, Partner at Simmons & Simmons: Stuart.dutson@simmons-simmons.com

Driving diversity in alternative investments: The path to organizational success

Camille Asaro, Partner, Kelly Rau and Jacinta Munro at KPMG



Camille Asaro

Kelly Rau

Jacinta Munro

KPMG LLP has *launched its sixth annual Global Women in Alternative Investments Survey*. The conversation on gender and diversity is now mainstream with many discussing the issues and challenges facing women around the world. This year, our ambition is to elevate the conversation to a new level. We will not focus on what the issues are, but how we can collectively create a culture of change. To do so, we are seeking input across the industry, regardless of gender. Together, we can uncover how gender and diversity becomes a business imperative and what actions are required to get there. Please complete our survey today.

The conversation around diversity within the alternative investment industry is changing.

When we look back at KPMG's annual *Women in Alternative Investments Report* in 2014, it was an uphill battle to convince firms to discuss the role that diversity plays in organizational success. Responses, and the associated pushback, became all too familiar: firms were meritocracies, we were told, and pursuing diversity or targets for gender balance should not be considered as it took the focus off what was important, and that was investment performance.

Over time, it has been demonstrated that, contrary to popular belief, the push for greater diversity is not a distraction from business imperatives, but rather directly contributes to higher investment performance and overall profitability. In one recent study conducted across eight countries, researchers found that not only was there a "statistically significant relationship between diversity and innovation outcomes in all countries examined," but that the more diverse firms "had both 19% points higher innovation revenues and 9% points higher EBIT margins, on average." Other studies, as well as anecdotal evidence, confirm and reinforce these findings.

Pursuit of workforce diversity is now a business imperative. Across the industry, it has become more widely recognised that diversity of thought and opinion is critical to making better business decisions. This diversity can only be achieved by attracting, hiring and retaining a broader range of people across gender, race, sexuality, physical ability, and other areas. As a result, the conversation is now shifting from why diversity is important to how organizations can attract and retain a more diverse workforce.

Addressing challenges and barriers

While the value of workforce diversity has become more widely accepted, progress toward achieving a more equitable gender balance in asset management has nonetheless been slow. We do see greater female participation in the alternative investments space. However, many of these women work in support and other non-investment roles. It is especially positive to see an increase in the number of women in senior leadership roles, though these women are more likely to work as the Chief Marketing Officer or Chief Financial Officer rather than a Portfolio Manager or Chief Investment Officer.

Speaking to women, there are a number of factors that affect organisations' ability to attract and retain female employees. Some challenges exist in the entry stage of women's careers, especially the cultural and societal expectations that play a large role in directing women's choices in education and early job opportunities.

For some women, alternative investments was not an area that they heard about as a viable career option, pointing to the need to continue programs to raise university-level awareness of potential roles in asset management. For others, there is a perception—regardless of its accuracy—that asset management is a "boys' club" where women are not welcome or will face an especially challenging road to success. In the longer term, many women expressed concerns regarding the difficulty of managing a work/life balance an asset management firm. These latter issues point to the need for a shift in workplace culture in some instances, and measures to better dispel the myths in others.

Creating inclusivity from the top down

Though the recent shift in the conversation around diversity is a strong positive sign for change, we have to recognise that there is no quick fix for an imbalance stemming from decades of structural inequity. Greater inclusion, and the creation of an industry that actively attracts and more importantly retains a wide variety of people and backgrounds, will require time.

For individual organisations, change has to come from the top. Leaders not only set the tone but can also create the specific programs, goals and measurements that are required to create meaningful change. Successful approaches seen to date include setting measurable targets for diversity hiring and retention, as well as tying diversity to compensation and rewards, creating both a carrot and a stick for forward progress. Having women on the board of directors is another significant step that can have cascading effects not only in the composition of the executive team but also throughout the organisation as a whole.

When it comes to hiring and promotion, leaders need to push to see a diverse slate of candidates, especially for leadership roles. For example, if an organisation is launching a new vehicle or fund, it should ensure that female and other diverse candidates are considered. Ensuring that diverse candidates are considered for internal promotions also helps ensure that an inclusive mix of individuals within the organisation are given opportunities to excel.

Understandably, organisations that have made the greatest progress to date tend to be those that publicly champion or otherwise make a commitment to gender diversity. Not only are those that are participating in the discussion more likely to make advances, but those that have put a stake in the sand have a standard against which their progress can be publicly measured.

Individual actions for change

Even five years ago, women's voices were the ones pushing for greater gender diversity and inclusion. Now there are more men talking about the importance of a more balanced gender split, the necessity for an inclusive office culture and the uncomfortable truth that female co-workers may not have access to the same workplace opportunities. One important action that men are taking is helping support female talent in their organisations through sponsorships. Beyond mentorship, a sponsor can actively speak out on behalf of an individual in conversations surrounding promotion and advancement.

From the investment side, more investors are actively looking to invest in diverse organisations. Both male and female investors in pension funds, sovereigns and large endowments are starting to ask hard questions about organisational diversity as part of their investment-making decisions. In some situations, no longer is it enough for funds to show diversity in their investments: they must also demonstrate diversity in their organisations. If this trend continues, firms' increasing awareness that investment opportunities are being lost due to lack

of organisational diversity will provide an external motivator and competitive pressure for change.

Searching for solutions

As the business case for greater diversity and inclusion in the asset management space has already been made, the conversation can move on to more complex topics. In our upcoming *Women in Alternative Investments Report,* we turn the attention from why an organisation should pursue greater diversity to the thorny question of how firms can best create an inclusive work environment that attracts and retains diverse talent.

The alternative investments sector is a fast-paced, challenging and fiercely competitive part of the financial industry—but in the pursuit of greater organisational diversity we are all working together.

Through collaboration, mentorships and the sharing of ideas, together we can create a more profitable future where all can benefit.

To contact the authors:

Camille Asaro, Partner
KPMG in the US
T: +1 212 954 4610
E: casaro@kpmg.com

Kelly Rau, Partner
KPMG in the US
T: +1 212 872 3455
E: krau@kpmg.com

Jacinta Munro, Head of Compliance and Conduct
KPMG in Australia
T: +61 3 9288 5877
E: jacintamunro@kpmg.com.au

From real estate to real assets

Scott Carpenter, Global Head of Private Equity & Real Assets Fund Services for State Street's Alternative Investment Services Group

As the alternative investment industry environment transforms faster than ever before, alternative asset managers' ability to adapt their business models is being tested to the extreme. Driven by the need for better long-term returns and portfolio diversification, institutions have increased their allocations to alternative assets over the last two decades. Managers working to deliver a differentiated offering as the appetite for alternative strategies grows are finding that real assets are turning into a real opportunity.

Adding Infrastructure to the Mix

Real assets are a combination of all types of physical assets held by funds, including real estate and infrastructure. It's this mix of investments that's playing an increasingly important role in our clients' portfolios. The unique characteristics of infrastructure investments – being stable through times of macroeconomic downturn, reliable, growing cash flows – contribute to risk-adjusted returns and portfolio diversification.

Infrastructure remains at the early stages of development and its needs are massive. In 2017,

the Global Infrastructure Outlook from Oxford Economics[1] forecasted that infrastructure investment needs to reach $94 trillion by 2040 to keep up with profound economic and demographic changes across the globe. This makes infrastructure one of the largest opportunities for institutional investors and private fund managers for the next couple of decades.

Understanding the Opportunities

Infrastructure assets range from transportation and energy, to water and communications, and enable economic activity across the globe. They also offer a broad spectrum of risk/reward profiles and strategy options: US, Europe or Asia-Pacific, emerging versus developing markets. Brownfield versus greenfield, and equity versus debt.

Recent data from Preqin suggests that more than 60 percent of institutional investors in infrastructure are still below their target allocations. A whopping 93 percent of surveyed investors said their infrastructure investments have met or exceeded their expectations.[2] But as competition for attractive deals intensifies, the challenge can be to find high-quality opportunities. With investor demand outstripping supply in some cases, investors who are looking for more exposure in the infrastructure space may find that collaborating with larger managers will give them their desired exposure to infrastructure. We're also seeing larger managers establish open-ended fund

products to help investors enter and exit the space as it fits with their growth plans and available capital.

Structuring Infrastructure

Our 2017 *Growth Readiness Study* highlighted a strong growth trajectory for investments into alternative assets, but also showed that many firms are turning to third-party service providers to help scale operations at the necessary pace and perform functions more efficiently.

One area that's really heating up is the battle for talent. It's a piece of the puzzle that newcomers to the space should not overlook. The highly technical infrastructure field mixes engineering and financial expertise. Its complex deals require considerable execution expertise and typically demand a hands-on approach led by a dedicated asset management team that can support the transition into a strong, standalone business. Subject-matter experts who speak the language of infrastructure assets and understand investors' needs in the market are critical.

Supporting our Clients

In our evolution from real estate to real assets, we remain fully committed to supporting the needs of real estate managers. For clients who are considering adding infrastructure in their real asset portfolio, we offer the support of our industry expertise and dedicated fund administration office. We're enhancing our real assets platform and reporting to support the diverse nature of infrastructure investments and their specific attributes as well as the variety of closed- and open-end fund structures. By servicing a wide range of fund managers, we're well positioned for funds just entering this growing space as well as funds with existing portfolios focused on infrastructure.

In addition to delivering a dedicated infrastructure fund services offering, we offer credit services and FX solutions. Given the growing needs for transparency and oversight, and the diversity of sub-asset classes within infrastructure, we're also looking at how we can incorporate asset-level data analytics solutions for both asset managers and asset owners.

The alternative asset manager sector has seen tremendous growth in recent years. With infrastructure needs climbing globally and investors looking for new routes that will help them meet growth goals, investments in infrastructure look to be a real opportunity.

For additional information, please contact:

- **Scott Carpenter** 617-664-6156 scott.carpenter@statestreet.com
- **Amos J. Rogers III** 617-664-7424 ajrogersiii@statestreet.com
- **Kyle Alexander** 212-258-1824 kalexander1@statestreet.com

Footnotes

[1] Global Infrastructure Outlook, Oxford Economics © 2017 Global Infrastructure Hub
[2] 2018 Preqin Global Infrastructure Report

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

More than a token risk – ICO trading platforms and promoters in SEC crosshairs

Steven Gatti, Partner and David Adams, Associate at Clifford Chance

Steven Gatti

David Adams

Since issuing its "DAO Report" in July 2017,[1] the US Securities and Exchange Commission ("SEC") has aggressively asserted jurisdiction over the products sold through initial coin offerings ("ICOs").[2] Last March, the SEC issued a "Public Statement" cautioning investors and operators of online platforms that facilitate ICO offerings and trading that many platforms may be operating unlawfully.[3] And with increasing frequency, the SEC has brought enforcement actions in the digital asset space. These actions have focused principally on violations of the securities offering registration and disclosure requirements of the Securities Act of 1933 ("1933 Act") in the context of primary market ICOs.[4] The DAO Report and Public Statement underscore a second front in the SEC's push to regulate the digital asset markets – enforcement actions against intermediaries that distribute or provide a marketplace to trade instruments issued in ICOs, but fail to register as broker-dealers and/or securities exchanges under the Securities Exchange Act of 1934 ("1934 Act").

For example, earlier this year, the SEC and US Department of Justice ("DOJ") filed civil and criminal complaints against an exchange operator.[5]ICO trading platforms and other digital asset market participants, including hedge fund managers, also received SEC subpoenas earlier this year requesting information about ICO structures, investors, and transactional activity. We expect the regulatory and enforcement focus in this area to continue unabated, which has important implications for fund managers who want to invest in this emerging asset class.

1934 Act Registration Risks for Securities Token Trading Platforms and ICO Promoters

A foundational requirement for SEC jurisdiction over ICOs is the existence of a "security." Whether a digital asset is a security depends on its specific characteristics and the economic rights it represents. The SEC generally ignores "coin," "token," or other designations when assessing an asset's status.[7]The SEC considered the tokens described in the DAO Report to be securities because they met the so-called Howey "investment contract" test of being: (i) an investment of money; (ii) in a common enterprise; (iii) with an expectation of profit; (iv) due solely to the efforts of others.[8] We refer in this briefing to cryptocurrencies, coins, tokens, and other digital assets exhibiting the same or substantially similar characteristics as the DAO Report tokens as "securities tokens."

Exchange Registration

A securities token trading platform is likely to satisfy the definition of an "exchange," requiring either registration under the 1934 Act or reliance on an exemption. A platform will be deemed an "exchange" if it: (i) brings together the orders for securities of multiple buyers and sellers; and (ii) uses established, non-discretionary methods (e.g., an electronic trade matching engine) under which orders interact with each other, and the buyers and sellers entering such orders agree to the terms of the trade.[9] The SEC is closely examining the assets traded on platforms to determine if they are securities and ignoring "currency exchange" or "coin exchange" self-designations intended to avoid classification as a securities exchange.[10] The SEC has broad jurisdiction under Section 5 of the 1934 Act over exchanges that use, directly or indirectly, "any means or instrumentality of interstate commerce" to effect transactions on the exchange. Thus, the SEC is likely to assert that the 1934 Act exchange registration requirements apply to US securities token trading platforms and to non-US platforms available to US persons.[11]

Broker-Dealer Registration

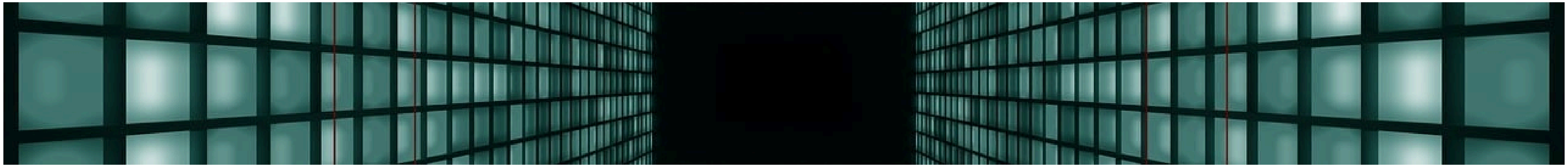
Securities token promoters, intermediaries, and exchanges may also need to register with the SEC as broker-dealers.[12] Under Section 15 of the 1934 Act, absent an exemption, any person engaged in the business of effecting transactions in securities using US jurisdictional means must register with the SEC as a broker-dealer. The SEC interprets the meaning of "effecting transactions in securities" broadly to include activities beyond transaction execution. The SEC and US courts have found persons to be broker-dealers where they participate at key points in the chain of a securities transaction or distribution, such as maintaining custody of funds and securities, structuring securities transactions, engaging in transaction negotiation, solicitation, purchase or sale activities, or receiving commission-based compensation.[13]

Key SEC Enforcement Actions Involving Securities Token Exchange Operators

Much of the SEC's activity related to ICOs has necessarily been reactive, i.e., enforcement and policy statements vs. rule making, due to the speed of technological development and the rapid growth of the digital asset market. We review below key enforcement developments involving securities token platforms, and then discuss the impact on investment managers.

BTC Trading Corp.

In December 2014, the SEC took enforcement action against a California-based computer programmer and his online platforms ("BTC Trading") for failing to register as a securities exchange and broker-dealer under the 1934 Act.[14] The SEC found that BTC Trading operated a virtual stock exchange by, among other things: (i)



providing 52 securities issuers the ability to create and list initial and secondary offerings; (ii) permitting users to electronically execute more than 400,000 trades in uncertificated digital securities by posting "bids" and "asks" to an online order book where trades were automatically executed according to non-discretionary price and time priority rules; and (iii) enabling issuers to advertise listings by posting a prospectus or business plan on a BTC Trading platform and to communicate with their investors.

The SEC also concluded that BTC Trading operated as an unregistered broker-dealer because it, among other things:(i) actively solicited the public to open trading accounts by advertising on virtual currency websites; (ii) opened over 10,000 online accounts for investors through the websites and maintained custody of users' virtual currency in a virtual currency wallet; and (iii) collected litecoin and bitcoin-denominated commissions based on each user's trading activity.

The DAO Report

The DAO Report found that tokens offered and sold by a "virtual" organisation known as "The DAO" were securities and therefore subject to the federal securities laws, including the requirement that issuers register the offer of distributed ledger or blockchain technology-based securities tokens under the 1933 Act, or utilise an exemption.

The DAO Report also discussed platforms that facilitated transactions in the DAO's securities tokens. These platforms publicly displayed their quotes, trades, and daily trading volume in DAO tokens, and executed transactions using non-discretionary methods.The SEC explained that the platforms where DAO tokens were listed and traded appear to have satisfied the 1934 Act definition of an "exchange."Chairman Clayton later confirmed that platform operators may also need to register as broker-dealers.[15]

On February 21, 2018, the SEC and the DOJ filed complaints against BitFunder, a bitcoin-denominated exchange and its founder ("BitFunder").[16]The SEC's civil complaint alleges that BitFunder operated as an unregistered online securities exchange for virtual "shares" of currency-related enterprises (e.g., virtual currency mining operations) (the "virtual assets"), and defrauded exchange users by misappropriating their bitcoins and failing to disclose a cyber attack that resulted in the theft of more than 6,000 bitcoins.The virtual "shares" at issue were uncertificated and many paid dividends in bitcoins.Online account statements provided by BitFunder to users reflected their ownership of virtual assets and bitcoins. Purchasing virtual assets and trading on the BitFunder platform also required users to deposit bitcoins in a single wallet controlled by BitFunder, a factor that made the cyber attack and theft experienced by BitFunder possible.

In identifying the unregistered exchange activity, the SEC complaint states that BitFunder: (i) required users to deposit the bitcoins used to purchase and sell shares in virtual assets in a wallet that it controlled; (ii) allowed users to buy and sell shares of virtual assets using bitcoins through an electronic matching system based on price and time priority; (iii) automatically executed buy and sell orders; (iv) publicly displayed all of its quotes, trades, and daily trading volumes in the listed shares of virtual assets; and (v) charged transaction-based fees when virtual asset shares were sold.

Consequences of Operating an Unregistered Exchange or Broker-Dealer

Unregistered securities token platform operators are subject to the full SEC arsenal of penalties. Although the SEC did not assess penalties against the platforms selling DAO tokens, in BTC Trading, the SEC required disgorgement of profits and interest, imposed a monetary penalty, and barred the founder from participating in the securities industry for at least two years. The SEC complaint against BitFunder seeks civil penalties including monetary fines and disgorgement with interest.Moreover, the SEC and other US authorities have imposed significant monetary penalties in recent years on both US and non-US entities for operating unregistered broker-dealers. Unregistered securities token exchanges and broker-dealers are also exposed to private claims under US laws including the 1934 Act.

Key Implications for Investment Managers

ICOs continued generating significant investment capital in the first quarter of 2018 despite intense regulatory scrutiny.[17] A fund manager interested in digital asset investments should be aware, however, that the regulatory classification of each asset depends on a highly facts and circumstances-based analysis. A recent speech by Mr. William Hinman, the Director of the SEC's Division of Corporation Finance, outlined the analysis.[18] While Mr. Hinman stated that he does not view Bitcoin and Ether as they exist today as "securities," he did not address the thousands of other "cryptocurrencies" currently in existence, or the thousands of "tokens" found on the Ethereum blockchain.

Given this continuing uncertainty, fund managers should assume that any instrument sold through an ICO is a "security" under applicable US law and take proactive steps to ensure that they meet their regulatory obligations.The SEC and other regulators regularly express concern about the ability of terrorist organisations and others to exploit the anonymity inherent in public blockchains to engage in money laundering.The SEC has also expressed concern about the ability of investment funds to effectively value digital asset investments, to ensure that the assets are securely custodied, and to avoid fraudulent schemes.[19]The liquidity of securities tokens is also of concern to the SEC, given the lack of exchanges on which they can be legally traded.

In response to the evolving regulatory landscape, existing platforms[20] are acquiring or establishing alternative trading systems ("ATS") to provide legal venues for securities token offerings and trading.[21]Moreover, at least one market participant recently announced a joint venture with the US-registered securities exchange to develop a first-of-its-kind platform that integrates blockchain-driven capital markets into the current US National Market System.[22]

Fund managers should closely monitor developments in the US and abroad as the regulatory landscape is constantly and rapidly evolving. While efforts to establish a functioning SEC-compliant securities token exchange remain ongoing, the success of these efforts, coupled with additional guidance from the SEC on custody and other issues, may help securities tokens quickly transition from fringe investments and curiosities to appealing opportunities for institutional investment.

To contact the author:

Steven Gatti, Partner at Clifford Chance: steven.gatti@cliffordchance.com

David Adams, Associate at Clifford Chance: david.adams@cliffordchance.com

Footnotes

[1] Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, SEC Rel. No. 81207 (July 25, 2017) (the "DAO Report").

[2] See, e.g., SEC Chairman Jay Clayton, Statement on Cryptocurrencies and Initial Coin Offerings (Dec. 11, 2017) (the "December 2017 Statement") (explaining that "[b]y and large, the structures of initial coin offerings . . . involve the offer and sale of securities and directly implicate the securities registration requirements and other investor protection provisions of our federal securities laws").

[3] SEC Divisions of Enforcement and Trading and Markets, Statement on Potentially Unlawful Online Platforms for Trading Digital Assets (Mar. 7, 2018).

[4] See, e.g., SEC v. AriseBank et al., No. 3:18-CV-00186 (N.D. Tex., Jan. 25, 2018) (halting allegedly fraudulent ICO); SEC v. Plexcorps et al., No. 1:17-CV-07007 (E.D. NY, Dec. 1, 2017) (ordering emergency asset freeze to halt an alleged ICO fraud).

[5] SEC v. Jon E. Montroll and BitFunder, No. 1:18-CV-01582 (S.D.N.Y. Feb. 21, 2018); US v. Jon E Montroll, No. 18 MAG 1372 (S.D.N.Y Feb. 21, 2018) (the "BitFunder Complaints").

[6] See, e.g., NASAA, State and Provincial Securities Regulators Conduct Coordinated International Crypto Crackdown, Press Release (May 21, 2018) available at http://www.nasaa.org/45121/state-and-pro...

[7] Some legal practitioners have urged the SEC to acknowledge that certain products distributed through ICOs do not exhibit the characteristics of a security (so-called "utility tokens"). Chairman Clayton has expressed skepticism, stating "I have yet to see an ICO that doesn't have a sufficient number of hallmarks of a security." Dave Michaels & Paul Vigna, SEC Chief Fires Warning Shot Against Coin Offerings, Wall Street Journal (Nov. 9, 2017) available at https://www.wsj.com/articles/sec-chief-f...

[8] DAO Report at Section B.1. (citing SEC v. W.J. Howey Co., 328

U.S. 293, 301 (1946)).

[9] See 1934 Act Rule 3b-16(a).

[10] See, SEC Chairman Jay Clayton, Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission (Feb. 6, 2018) (stating that the "currently applicable [state money transmitter] regulatory framework for cryptocurrency trading was not designed with trading of the type we are witnessing in mind").

[11] For non-US persons, the use of US jurisdictional means is typically inferred where a non-US person provides securities-related exchange, brokerage, or dealer services to US persons through a website accessible to US persons.

[12] The 1934 Act generally defines a "broker" as a person engaged in the business of (i.e., regularly participating in) effecting transactions in securities for others. A "dealer" is a person engaged in the business of buying and selling securities for its own account. The distinction between the broker and dealer definitions often becomes blurred and securities firms are referred to as "broker-dealers."

[13] Securities token trading platforms may trigger other US regulatory requirements. Platforms that offer digital wallet services may trigger transfer agent or clearing agency registration requirements. Platforms that exchange fiat currency for platform currency or cryptocurrency (e.g., bitcoin) must also consider money transmitter licensing requirements. These issues are beyond the scope of this article.

[14] In the Matter of BTC Trading Corp. and Ethan Burnside, SEC Rel. No. 34-73783 (Dec. 8, 2014).

[15] See December 2017 Statement (stressing that "those who operate systems and platforms that effect or facilitate transactions in these products . . . may be operating unregistered exchanges or broker-dealers in violation of the [1934 Act]").

[16] See generally the BitFunder Complaints. The DOJ BitFunder Complaint focuses on non-securities criminal claims.

[17] See, e.g., Coindesk, State of Blockchain Q1 2018 (May 14, 2018) available at https://www.coindesk.com/research/state-...

[18] Digital Asset Transactions: When Howey Met Gary (Plastic), speech by William Hinman, Director, SEC Division of Corporation Finance

available at https://www.sec.gov/news/speech/speech-h...

[19] See generally, SEC Staff Letter, Engaging on Fund Innovation and Cryptocurrency-related Holdings (Jan. 18, 2018) available at

https://www.sec.gov/divisions/investment...

[20] See, e.g., Nikhilesh De, Token Trader Templum Just Bought a Broker-Dealer, Coindesk (Feb. 7, 2018) available at https://www.coindesk.com/templum-acquire...

[21] ATS's are exempt from the 1934 Act's definition of an "exchange" if they meet the requirements set forth in SEC Regulation ATS. These requirements include registering with the SEC as a broker-dealer, filing an ATS registration form with the SEC, and abiding by market transparency and market access requirements for certain securities.

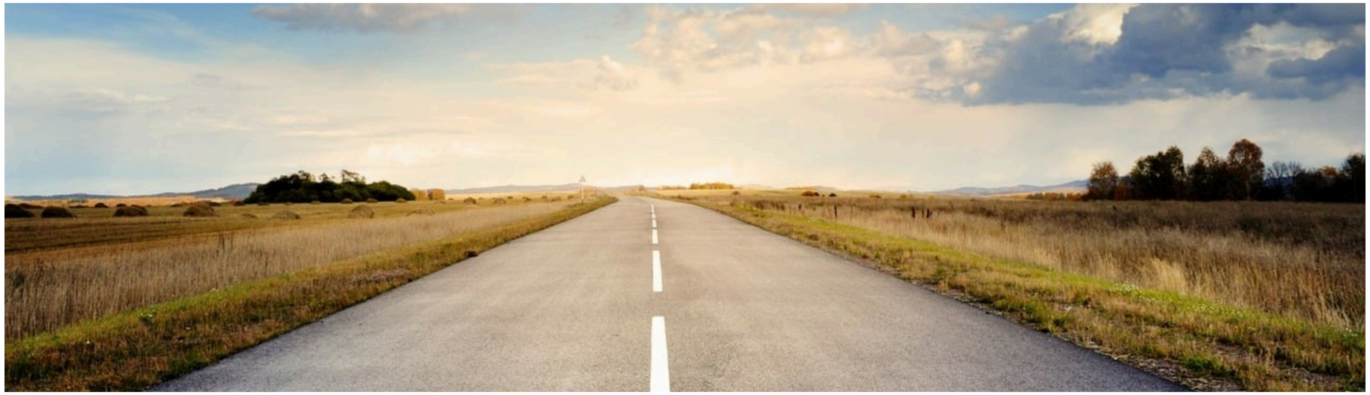
[22] tZERO and BOX Digital Markets Sign Deal to Create Joint Venture, Business Wire (June 19, 2018) available at

https://www.businesswire.com/news/home/2...

Fed's challenges as it seeks a neutral monetary policy

Blu Putnam, Chief Economist at CME Group

Blu Putnam



The Federal Reserve (Fed) now appears determined to seek a neutral monetary policy. It is raising rates and shrinking its balance sheet as it unwinds the Bernanke-era emergency policies of the Great Recession. So far, this well-telegraphed approach to unwinding quantitative easing (QE) and raising rates has had no discernible impact on the pattern of real GDP, inflation or the labour markets. The next task is finding the neutral gear for interest rate policy, which may not be as easy as it might sound. Even the definition of a neutral interest rate policy is not so clear and depends on one's views on inflation. In addition, one is led to an important examination of how to enforce a given short-term interest rate target. In turn, a discussion follows on the way the Fed pays interest on reserves which puts an emphasis on the inadequacies of the federal funds rate as the primary policy target rate. It is going to be a very interesting debate.

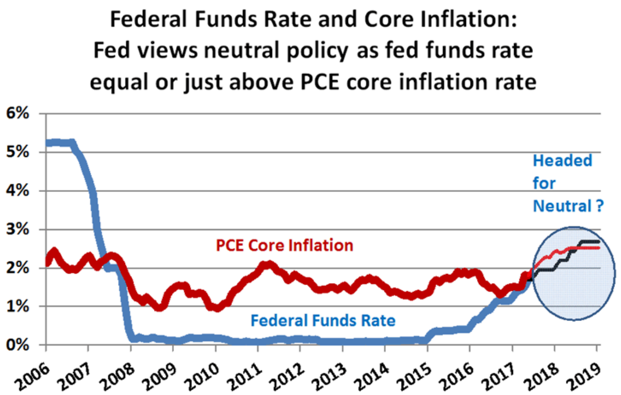
What is Neutral?

Immediately after the September 2008 financial panic triggered by the Lehman Brothers bankruptcy and the AIG bailout, the Fed quickly lowered the effective federal funds rate to close to zero. For the full six years between 2009 and 2014, the effective federal funds rate averaged just 0.13%. The first rate rise came in December 2015, and then the Fed got cautious and delayed the next rate increase until December 2016. Since then, the Fed has been on a steady pattern of "skip an FOMC meeting, raise rates, skip a meeting, raise rates," wash, rinse and repeat.

The Fed now seems on a path to steer the effective federal funds rate to a level that is equal to or just modestly higher (25 to 50 basis points) than the prevailing rate of core inflation, which we take to be the Fed's new definition of a neutral short-term interest rate policy. Of course, the definition of a neutral policy is not universally agreed. Pre-2008, the prevailing view was that a neutral policy reflected an inflation risk premium of maybe 2% above the prevailing core inflation rate. The Janet Yellen view was that the neutral inflation risk premium was now close to zero or just incrementally positive, and that view appears to have been accepted by many FOMC members.

Then, there is the issue of estimating the path of inflation. If the FOMC members' collective wisdom on inflation develops as estimated, then core inflation might rise to 2.5%. The Fed remains extremely data dependent, so if the inflation path changes, one can count on the anticipated rate path being changed as well.

Figure 1.



Source: Federal Reserve Bank of St. Louis FRED Database (FEDFUNDS, PCEPILFE), Estimates from CME Economics.

The Shape of the Yield Curve matters, too

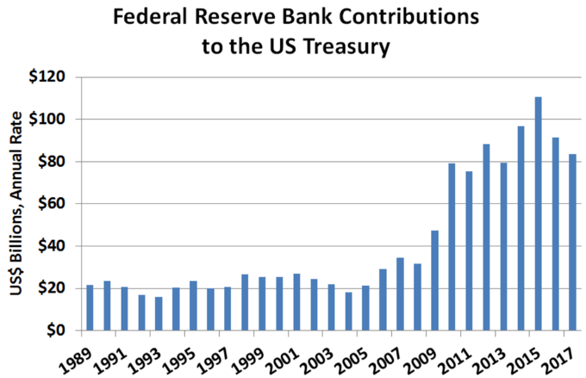
The story, however, gets much more complicated. One constraint on the Fed's rate rise ambitions is the yield curve's shape. Flat or inverted yield curves historically have been excellent predictors of both coming equity volatility and future recessions. A flat or inverted yield curve indicates the Fed has gone too far and pushed rates too high. It has only taken six decades of history for the Fed to elevate this statistical correlation into the rate policy debate. And, who knows? The yield curve may not be applicable this time around, but the Fed is paying the shape of the yield curve considerable attention. If bond yields do not rise in parallel with short-term rate increases (that is, a flattening yield curve), the Fed most probably will delay future rate increases while it observes inflation data and bond market activity.

Enforcing the Fed Funds Target and Payment of Interest on Reserves

The Fed currently enforces its federal funds rate target range by paying interest on reserves it holds at the upper bound of the target range. The Fed only started paying interest on required and excess reserves at the end of 2008 as part of its emergency response to the 2008 panic. By paying interest on reserves at the ceiling of the new approach to setting a federal funds target range, the Fed was effectively providing a very nice income stream with no credit risk to the banking system in 2009 when it really mattered.

As short-term rates have been pushed higher, the Fed has increased the interest rate it pays on required and excess reserves in lock step with increases in the federal funds target range. This works to increase the Fed's own costs of funding its balance sheet and serves as a drag on the Fed's earnings, most of which are paid to the U.S. Treasury. Even with incrementally rising short-term rates, the Fed is in no danger of losing money. Prior to 2008, the Fed typically contributed around $20 billion or a little more to the U.S. Treasury each year. Once QE ramped-up the Fed's balance sheet, annual contributions in the 2013-2017 period soared to the $80-$100 billion range. The Fed's earnings are now expected to decrease modestly year-on-year as rates rise further and as the Fed shrinks its balance sheet and holds fewer assets.

Figure 2.

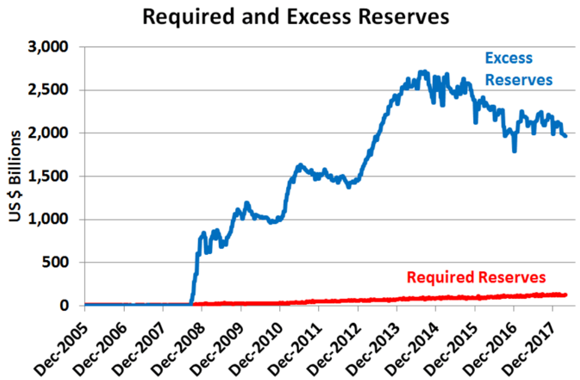


Source: Federal Reserve Bank of St. Louis FRED Database (B677RC1A027NBEA).

As Fed earnings decline with higher rates and a smaller portfolio, we expect the Fed to evaluate different ways of exerting influence over short-term rates to break the link between the payment of interest on reserves and decisions to encourage short-term rates to move higher or lower. This possibly means the Fed may consider moving away from federal funds as the target for Fed interest rate policy.

Before the 2008 crisis and subsequent expansion of the Fed's balance sheet, excess reserves were much smaller. It was not uncommon for banks that had strong corporate lending franchises and weak core deposit bases to need to borrow reserves to meet their reserve requirements. Similarly, banks with a strong consumer deposit base would have an excess of reserves over their requirements, and they would lend federal funds (deposits with the Fed) to banks in need of reserves to meet their requirements. By using repurchase (repo and reverse-repo) transactions the Fed could temporarily add or withdraw reserves (fed funds) from the banking system and influence the federal funds rate – the overnight rate at which one bank lent its deposits at the Fed to another bank.

Figure 3.



Source: Federal Reserve Bank of St. Louis FRED Database (RESBALREQW, EXCSRESNW).

Once excess reserves ballooned after 2008, few banks needed additional funds to meet their reserve requirements. And, Fed repo transactions that added or withdrew excess reserves made little difference since the overhang of excess reserves was so large. While the Fed still does (reverse) repurchase agreements, the impact on the federal funds rate is fleeting at best. The primary means of enforcing a higher target range for the federal funds rate has been to raise the interest rate paid on reserves to the target range's ceiling. If a depositary institution needed to borrow federal funds, it would pay a discounted interest rate or higher price for the federal funds. The result is that federal funds have tended to trade very steadily (except for the last few days of any given month) at around 7 – 13 basis points (annual rate) lower than the ceiling, which has kept the federal funds rate comfortably inside the target range. The volume of transaction, however, is generally not very high – around $75 billion a day in April 2018, for example.

The point is that the federal funds rate no longer trades as a truly representative rate for overnight lending. If the Fed chose a new broader-based and much more representative rate to target, then the

Fed would gain the freedom and flexibility to set a rate of payment of interest on reserves that might be lower than the new target short-term interest rate.

Will the Fed eventually choose to target some other rate than federal funds? We do not know. We do know that there are very strong incentives in place in the post-2008, post-QE environment to consider replacing the target rate with something more representative of market conditions than federal funds. And we also believe the Fed may very well see advantages in delinking its target rate from the interest rate it sets to pay on reserves. We expect the debate within the FOMC to commence very soon, although it may last a year or more. There is considerable research to be done. To paraphrase the former member of the Bank of England's Monetary Policy Committee, Charles A. E. Goodhart, "when a central bank targets a specific metric, the nature of the metric is forever changed". This observation in various forms is now known as Goodhart's Law and can be viewed as a derivative of German theoretical physicist Werner Heisenberg's uncertainty principle. It provides a cautionary message, yet our view is that change is coming for Fed rate targeting and for how interest is paid on reserves and change may come sooner than one might expect, given that the debate has yet to commence.

To contact the author:

Bluford Putnam, Managing Director & Chief Economist at CME Group:
bluford.putnam@cmegroup.com

Disclosure

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

Cayman Islands regulatory developments – Is your fund compliant?

Harjit Kaur, Partner at Maples and Calder

Harjit Kaur

The Cayman Islands has recently changed a number of regulatory provisions as part of its ongoing commitment to international standards, most notably with respect to tax transparency. Given the prevalence of the Cayman Islands as a jurisdiction for offshore hedge funds, managers and boards of such funds will need to take certain steps by specified deadlines to ensure their funds remain compliant with the various regulatory requirements.

These changes include enhancements to the Cayman anti-money laundering (AML) regime, revisions to certain aspects of the Cayman beneficial ownership register (BOR) regime, the issue of revised Guidance Notes relating to the implementation of the OECD's Common Reporting Standard (CRS) in Cayman and the introduction of Country-by-Country Reporting (CbCR) regulations to implement in Cayman the model legislation published pursuant to the OECD's BEPS Action 13 Report. Each of these developments, together with the applicable deadlines for compliance, is outlined below.

AML regime

At the end of last year the Cayman AML regime was enhanced to keep it closely aligned with the Financial Action Task Force (FATF) Recommendations and global practice. These changes, among other things, expand the scope of entities that are subject to the Cayman AML regime and expand the list of mandatory AML procedures entities in scope are required to maintain.

Expansion of scope

The recent changes mean that any entity conducting the business of "investing, administering or managing funds or money on behalf of other persons" in or from the Cayman Islands is now in scope. This term reflects wording used under FATCA and CRS in the definition of "Investment Entity", so any entity that may have been classified as an "Investment Entity" under FATCA or CRS will likely now be subject to the Cayman AML regime. As a result, Cayman unregulated investment entities previously out of scope of the AML regime are now in scope and must take steps to maintain AML procedures in accordance with the Cayman AML regulations (for example, by delegating the maintenance of their AML procedures to a third party, such as the fund administrator). The grace period for such entities to take the necessary steps to become compliant ended on 31 May 2018, so managers and boards of any such entities that have not yet addressed their AML obligations should do so as a priority.

Expansion of mandatory criteria

Cayman funds registered with the Cayman Islands Monetary Authority ("CIMA") will have been subject to the Cayman AML regime since their launch. Such funds normally satisfy their AML obligations by delegating the maintenance of AML procedures to their fund administrators. The expansion of the mandatory AML procedures entities in scope are required to maintain means that such funds will

need to review, and where necessary, adjust, their existing AML delegation arrangements to ensure they remain compliant with the new requirements.

Requirement to appoint individuals as AML Officers

CIMA issued a notice in April clarifying that all Cayman entities in scope of the AML regime (including investment funds that have otherwise delegated the maintenance of their AML procedures to their fund administrator) must designate/appoint natural persons as AML Compliance Officer (AMLCO), Money Laundering Reporting Officer (MLRO) and Deputy MLRO (DMLRO and together with the AMLCO and the MLRO, the AML Officers). The same individual can act both as the AMLCO and one of the MLRO and DMLRO, so each fund will need to designate at least two individuals.

CIMA expects to release FAQs and revised AML Guidance Notes addressing the requirement to appoint AML Officers in due course. However, all existing entities in scope are required to appoint AML Officers by 30 September 2018, while all new funds launching on or after 1 June 2018 are expected to have designated AML Officers at launch. Regulated funds will be required to notify CIMA of the details of their AML Officers.

There are no particular restrictions in terms of who can be designated as an AML Officer - the principal question is whether the person performing any one of those roles is autonomous in carrying out their function. As such, employees of the fund administrator or the investment manager, members of the board, or a third party service provider can be designated as an AML Officer.

BOR Regime

The Cayman BOR regime which first came into force on 1 July 2017 requires certain Cayman companies and limited liability companies ("LLCs") to maintain a beneficial ownership register that records details of the individuals who ultimately own or control more than 25% of the equity interests or voting rights, or who have rights to appoint or remove a majority of the company directors/LLC managers at their Cayman registered office. Most investment fund entities are able to rely on an exemption, meaning they are out of scope of the BOR regime and are not required to maintain such a register. However, other non-fund entities in a fund structure such as general partner entities, Cayman management entities and holding vehicles may be in scope if no relevant exemption applies.

The BOR regime was amended at the end of last year to introduce a requirement for all entities (including Cayman funds) that are exempt to file a written confirmation prior to 30 June 2018, which must (a) identify the grounds for its exemption; and (b) provide certain additional information regarding any regulated entity or approved person upon whom the exemption relies. Managers and boards of Cayman investment funds should liaise with their registered office provider to ensure the relevant written confirmation is filed prior to the 30 June 2018 deadline. A revised confirmation is required to be filed within 30 days of any changes resulting in a change to the exemption relied on.

In addition, some exemptions available under the BOR regime have been removed and some new exemptions have been introduced. Accordingly, Cayman companies and LLCs should review any existing exemption criteria prior to 30 June 2018.

CRS

In March, certain revisions were made to the Cayman CRS Guidance Notes. The most significant change was the lowering of the threshold for the determination of "Controlling Persons" from 25% to 10%. This brings it in line with the threshold applicable under the AML regime but diverges from the 25% threshold that still applies under FATCA. Cayman funds with account holders/investors that are Passive NFEs or Financial Institutions in Non-Participating Jurisdictions (for example, Delaware feeder funds into Cayman master funds) need to collect information for "Controlling Persons" of such investors by reference to the 10% threshold with effect from 1 April 2018. An updated version of the self-certification form was issued at the same time and should be used for investors admitted on or after 1 April 2018. In addition, funds have until 31 December 2018 to conduct a back fill exercise for any pre-existing investors impacted by the change.

The revised CRS Guidance Notes also clarify that (a) an account should be closed if a self-certification is not obtained within 90 days of account opening; and (b) Cayman financial institutions being liquidated or wound up should arrange for a third party to perform any obligations under CRS which arise prior to final dissolution and which cannot be completed prior to such final dissolution. At the end of May it was announced that Cayman entities will have until 31 July 2018 (extended from 31 May 2018) to complete their FATCA and CRS reporting for the 2017 financial year without attracting any compliance measures for late filing.

Under CRS there is a requirement for all Reporting Financial Institutions to have in place written policies and procedures, and such policies and procedures should also be updated to reflect the changes made to the CRS Guidance Notes.

CbCR

The Cayman CbCR regulations were issued in December last year, with the related Guidance Notes being issued in March (together, the CbCR Laws). Investment funds are not exempt from CbCR requirements. It is therefore essential that funds undertake an analysis to determine if they are in scope.

It is expected that the CbCR Laws will impact a subset of Cayman funds, namely, funds that are part of a multinational enterprise group (MNE Group). In summary, an MNE Group is a collection of enterprises related through ownership or control such that it is required to prepare consolidated financial statements under applicable accounting principles (or would be so required if equity interests in any of the enterprises were publicly traded) that (i) includes two or more enterprises which are "tax resident" in at least two different jurisdictions or includes an enterprise that is tax resident in one jurisdiction and is subject to tax via a permanent establishment in another jurisdiction, and (ii) has a total consolidated group revenue of at least US$850 million in the preceding fiscal year. A group of entities which are tax resident in the same country will not constitute an MNE Group even if preparing consolidated financial statements. As such, managers and boards of Cayman funds that form part of a group of entities which are resident in different jurisdictions should take steps to conduct an analysis of whether the fund or any of other Cayman entities in a structure are in scope.

Summary of Key Dates

Summary of Key Dates

Deadline	Action
22 May 2018	CbCR notification deadline for Cayman entities forming part of an MNE Group where the reporting entity is resident in Cayman
31 May 2018	End of the grace period for entities previously out of scope of the AML regime to comply with their AML obligations
31 May 2018	Deadline for filing of CbCR report for MNE Groups where the reporting entity is resident in Cayman
1 June 2018	New Cayman funds launched on or after this date will need to appoint AML Officers on launch
30 June 2018	End of the grace period under the BOR regime
31 July 2018	Deadline for completing FATCA and CRS reporting for the financial year 2017 without attracting enforcement action
30 September 2018	Deadline for appointment of AML Officers by existing funds
30 September 2018	CbCR notification deadline for Cayman entities forming part of an MNE Group where the reporting entity is not resident in Cayman
31 December 2018	Deadline for remediation of pre-existing investors impacted by the change in threshold for the determination of "Controlling Persons" from 25% to 10%

To contact the author:

[1]**Harjit Kaur**, Partner at Maples and Calder:
harjit.kaur@maplesandcalder.com

[1] Our thanks also to Matthew Bloomfield for his assistance in writing this piece.

A brave new world – new capital requirements for investment firms

Harpartap Singh, Managing Consultant at Bovill

Harpartap Singh

Recent European Commission proposals for a tailored prudential regime for investment firms represent a significant change from the current approach to capital and liquidity.

Current rules and the road ahead

The current prudential rules, the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD IV) were introduced in June 2013 in the wake of the global financial crisis (the Regulation and Directive are together colloquially known as CRD IV). Despite being developed with banks in mind, CRD IV also applies to investment firms (albeit with some national exemptions for certain investment managers and advisers). For investment managers and advisers, capital requirements are usually driven by either the composition of their balance sheet, their fixed cost base or, in many cases, a minimum base requirement.

It was clear that the differing business models and risk profiles of investment firms simply didn't fit well with CRD IV and resulted in a disproportionate regulatory burden being imposed on non-banks. As a result, the CRD IV mandated a review of the prudential treatment of investment firms. The EBA drafted recommendations for the European Commission in 2017 which then issued a draft Regulation on the prudential treatment of investment firms (IFR) and a Directive on the prudential supervision of investment firms (IFD) in December 2017.

Once the proposals have been discussed and accepted by the European Parliament and the European Council, they are expected to take another 18 months to come into force. This means the new regime may come into effect in Q1 2020

Wider scope

The new prudential regime will apply to all MiFID II firms. This is in contrast to CRD IV which only applies to MiFID firms that hold client money, operate a Multilateral Trading Facility (MTF), deal on own account, conduct underwriting or have opted in to MiFID.

Over a thousand firms in the UK (currently called exempt CAD firms, commodity investment firms and local firms) will for the first time become subject to many new prudential requirements.

Class

The current rules differentiate between 12 different categories of firm. The categories will be radically simplified to just three and be a function of firms' size and activity, not just the regulatory activities it undertakes.

Class 1 firms will be those that are bank like or pose a systemic risk. These firms, which are all in the UK, will continue under CRD IV.

Class 2 firms will be those that conduct certain activities (for example, dealing on own account, hold client money or assets) or which exceed certain size limits (AUM > €1.2bn, handling client orders > €100m per day for cash trade or €1bn for derivatives, balance sheet > €100m, gross revenues > €30m). This is the class which will experience a fundamental shift in the method for calculating prudential requirements.

Class 3 firms will by default be those falling outside the Class 2 criteria. These firms will be subject to a stripped-down version of the new regime due to their lower levels of risk and complexity.

There are also provisions which enable firms to be re categorised.

How much capital will be required?

Class 2 firms will have to hold capital which amounts to the higher of three metrics:

- Permanent Minimum Capital (PMC),
- fixed overhead requirement (FOR) and
- the K-factor requirement.

PMC will be either €75k, €150k or €750k. It is simply dependent on the regulated activities of the firm

and is not risk sensitive.

The FOR is based on 25% of a firm's fixed annual expenditure. It is a proxy for the costs of winding down a firm and scales with it's cost base.

The K-factor requirement is calculated using a risk-weighted formula for each type of activity the firm undertakes. It is calculated as the sum of the applicable K-factors - assets under management, client money held, assets safeguarded and administered, client orders handled, daily trading flows, net position risk, trading counterparty default and concentration risk. The last three factors only apply to firms which deal on their own account. The formula differentiates between cash trades and derivatives and also includes market risk, counterparty-credit risk and concentration risk elements.

The K-factor of most relevance to investment managers / advisers is the K-AUM factor. This applies at a rate of 0.02% of the monthly average of assets under management. For those firms which are AIFMs (Alternative Investment Fund Managers), that also perform MiFID activities or have AIFMs in their group, this will sound familiar. However, there are two key differences from AIFM prudential requirements. First, there is no upper cap on the amount of the K-AUM risk factor. Second, the preamble to the IFR states that the rationale for K-AUM is the "risk of harm to clients from…ongoing portfolio management and advice" which is wider in scope than under AIFMD. The next most relevant

K-factor would be K-COH (client orders handled) which covers transactions executed by firms providing portfolio management on behalf of investment funds.

Class 3 firms will only have to apply the higher of the PMC and FOR and don't have to worry about the K-factor formula at all.

Securitisations

At present, firms which want to invest in securitisations can only do so if the originator, sponsor or original lender discloses to the firm that it has retained an ongoing net material interest of at least 5%. This restriction does not appear to apply under the IFR.

Firms which invest in securitisations on their own behalf or are themselves originators or sponsors, will no longer have to apply any haircuts to such positions under IFR. This may present an opportunity to free up capital.

Mandatory liquidity requirements

Both Class 2 and 3 firms will have to maintain liquid assets of at least one third of their fixed overhead requirements. Liquid assets are limited to unencumbered cash and Level 1, 2A and 2B liquid assets as defined for the purposes of the Liquidity Coverage Ratio under CRR.

Class 3 firms will, however be able to cover up to a third of their liquidity requirement with trade debtors and fees and commissions receivable, subject to a 50% haircut.

Additional reporting and public disclosures?

Class 2 firms will have new annual reporting requirements on a range of matters beyond their existing capital reports covering capital requirement calculations, activity levels in respect of the Class 2 conditions, concentration risk and liquidity requirement. Class 3 firms will have it slightly easier because they will not have to report on concentration risk or liquidity.

The annual frequency will be a welcome relief for many firms used to quarterly or half yearly reporting but the detailed requirements of what has to be reported are yet to be developed by the EBA and ESMA.

Turning to public disclosures (Pillar 3), Class 2 firms will have disclose information on six areas:

- risk management policies,
- governance,
- own funds,
- capital requirements,
- return on assets and

- remuneration policy.

Some of these disclosures are the same as now but there are some differences such as disclosure of a firm's FOR and, if requested by the regulator, results of the ICAAP (firm's own capital assessment) and any additional capital requirement imposed by the regulator as part of a supervisory review process. Class 3 firms will have a much easier ride, since they will not have to make Pillar 3 disclosures.

What should you do?

Fortunately, there will be a five-year transitional period to provide some temporary relief. During this time, many firms will still see changes by steps in their regulatory capital burden along with the need to cope with the more complex calculations.

Firms should carefully consider what category they are likely to fall into, taking into account current and future business plans and the consequential effects on their capital adequacy and prudential obligations. Now is the time for firms to plan for the potential impact, which could be significant.

Of course, you might ask if this is something to worry about with Brexit on the horizon. In our view, yes, absolutely; the UK will want to meet equivalence standards and therefore, you should expect UK regulation to be the same or at least very similar to that in Europe.

To contact the author:
Harpartap Singh, Managing Consultant at Bovill: hSingh@bovill.com

Pre-marketing - Proposed changes to AIFMD

Cathy Pitt, funds partner at CMS

Cathy Pitt

On 12 March 2018, the European Commission published a proposed directive and a proposed regulation amending the AIFMD and UCITS IV to facilitate cross-border marketing of funds. Importantly, these proposals cover pre-marketing under AIFMD which is an area managers typically ask about.

Directive

Planned to be adopted in May 2019 and implemented in May 2021. Proposals include:

- A definition of "pre-marketing": broadly providing information to professional investors before the fund (AIF) is established; and
- Pre-marketing by an EU AIFM must be allowed by Member States as long as it does not relate to or refer to an established fund (see further below).

Regulation

Planned to be adopted in May 2019. Proposals include:

- AIFMs will need to facilitate subscriptions and redemptions by retail investors.
- Marketing communications should present the risks and rewards of investing in AIFs and UCITS.
- Fund marketing rules must be published by national regulators and maintained centrally by ESMA.
- Verification of compliance with national provisions, if required, must be decided within 10 working days.
- Local levies, fees or charges must be proportionate to supervisory tasks carried out and published on regulators' websites.
- ESMA must maintain a central database on all AIFMs, UCITS management companies, AIFs and UCITS.
- The EuVECA and EuSEF Regulations will allow managers to test investors' appetite for opportunities or strategies through pre-marketing.

Pre-marketing under AIFMD

The AIFMD does not contain a definition of "marketing" and there is no harmonised approach in the EU. This means local regulators have taken different approaches as to what "pre-marketing" activity is permitted before a formal regulatory notification is needed under the AIFMD. For example, discussing fund strategy with potential investors before the fund is established may be allowed in certain EU states, but require regulatory notifications in other. The proposed amendments to the AIFMD are intended to solve this through a new definition of pre-marketing.

New definition of pre-marketing

The proposal sets out a new definition of "pre-marketing":

"pre-marketing' means a direct or indirect provision of information on investment strategies or investment ideas by an AIFM or on its behalf to professional investors domiciled or registered in the Union in order to test their interest in an AIF which is not yet established.'"

New article on pre-marketing

It also states that EU member states shall ensure that an authorised EU AIFM may engage in pre-marketing in the Union, "excluding where the information presented to potential professional investors:

1. Relates to an established AIF;
2. Contains reference to an established AIF;
3. Enables investors to commit to acquiring units or shares of a particular AIF;
4. Amounts to a prospectus, constitutional documents of a not-yet-established AIF, offering documents, subscription forms or similar documents whether in a draft or a final form allowing investors to take an investment decision.

EU member states shall ensure that no requirement to notify the competent authorities of pre-marketing activities is necessary for an EU AIFM to engage in pre-marketing activities."

According to the recitals, draft offering documents should not be sent to potential investors during the pre-marketing stage. This differs from current practice, for example in the UK, where draft fund terms may be sent to cornerstone investors before the fund is established, without triggering regulatory notification requirements.

To contact the author:
Cathy Pitt, Funds Partner at CMS: cathy.pitt@cms-cmno.com

The challenge for UK SMEs is an opportunity for the new breed of lenders

Craig Reeves, Founder, Prestige Asset Management / Prestige Funds

Craig Reeves

Regulation, red tape, Brexit – clouds with silver linings for private debt?

Owners and managers of small and medium-sized enterprises (SMEs) in the UK may feel that the world is out to get them. Running a small business is tough enough without the panoply of obstacles that have been inadvertently created for them over the past few years with the generation of mountains of post-2008 'red tape'.

There are political and economic clouds that continue to swirl over the future of the UK. The stream of bad news seems never-ending. As a fund manager that manages a dedicated UK centric investment strategy, we are often asked by investors to address this news flow. How, they ask, will private debt as an asset class be able to flourish with all this going on?

The banks beat a retreat

A week does not seem to go past without issues being thrown up around one or more marquee names in the banking industry. Yet all this bad news comes in the wake of the introduction of some of the toughest banking and capital adequacy regimes the industry has ever seen. We have seen a massive transition in the way banks are lending to business.

M4 net lending to small and medium enterprises in the UK (and it is a pattern that is reflected in other markets) fell off a cliff in 2009-10 and has never returned to what it was. Beyond that, however, banks also look less profitable due to the introduction of IFRS 9 accounting standards which apply to institutions in more than 120 countries. The standards which came into force on 1 January of this year mean banks have to increase their provisions against credit losses. We believe this may further restrict or delay lending to SMEs, leaving private lenders including private debt funds to play a more important role in this market.

On top of this the UK government has also required its largest banks (those with a three-year average of more than £25 billion in core deposits) to ring fence their essential banking services (e.g. plain vanilla retail banking activity) from their other banking activities.

The overall impact on business lending in the UK is going to be significant. Forty per cent of the UK's bank branch network has closed over the last five years, with over 1000 branches shuttered in the last two. This is choking a traditional artery of essential business finance into the UK economy, particularly in rural areas.

This is also increasing the opportunity set for non-commoditised lending to smaller businesses.

Regulatory and fiscal challenges

Another area of valuable financial assistance for many SMEs in the rural economy in the UK has been renewable energy subsidies. They have now been excluded from Enterprise Investment Schemes (EIS) and Venture Capital Trusts (VCTs). Tax-based investment schemes that benefited from initiatives like the Renewables Obligation Certificates (ROCs) were removed in 2014 and have impacted the closed-ended EIS and VCT vehicles that were investing in renewable energy projects and were starting to mature. These funds will now need to sell complete and incomplete projects in order to raise cash. In addition, renewables projects that are so essential if the UK is going to achieve its clean energy targets, will not be able to source the funding they will need in the future from these sources.

The introduction of both MiFID II and the accompanying MiFIR directive, which also arrived on the scene in January this year, have expanded the scope of MiFID to cover a broader range of companies and financial products. These directives are starting to create additional costs and bureaucracy for SMEs across Europe, as well as considerably raising the cost of capital for traditional bank lenders that offer wealth management or lending. We think this development will either restrict or delay the provision of finance to smaller European businesses.

The economic picture

You might not see all this doom and gloom reflected in the economic outlook for the UK. It currently has some of the lowest unemployment in Europe with levels not seen since the 1970s. Indeed, there has been a marked increase in overall productivity and there is still a significant flow of net inbound migration which the economy continues to absorb. According to Migration Watch UK, while numbers have dropped since the Brexit vote, net migration into the UK is still over 200,000 per annum (based on 2017 figures).

In short, the UK economy is still a good place to be if you are a private debt manager. The threat of increased inflation seems to have been contained, with the Bank of England stepping away from a rate hike and UK 10-year government bond yields are currently lower than Australia, Canada, Italy, Spain, New Zealand or the USA. Additionally, a weaker British Pound makes UK / Sterling-denominated assets more attractive to Euro and USD based investors.

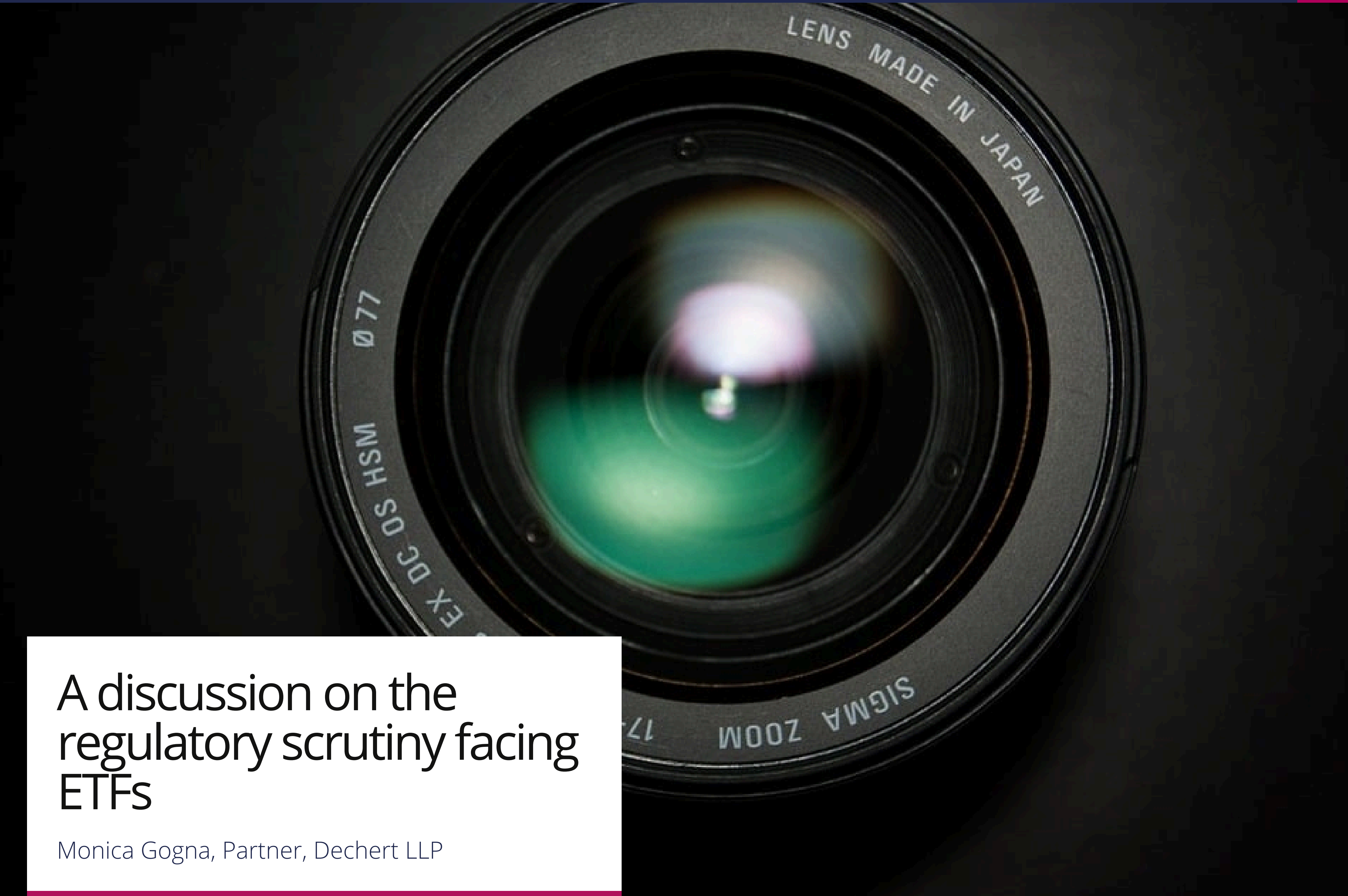
Conclusion

Private debt is playing a more critical role than ever before within the UK economy. Britain is more reliant on its SMEs for employment and productivity at a time when traditional forms of lending are evaporating. Prestige is just one of a number of specialist private lending fund operations in Europe, and we have not seen a wider opportunity set than what we see today within the industries that we are focused on, such as agriculture, construction, engineering, manufacturing, renewable energy and many other old economy sectors.

Both closed and open-ended funds in Europe are reporting considerable fund raising for private debt this year, from European investors and those further afield, as allocators become more aware of the asset class and its widening opportunity. We continue to see significant interest in UK-directed lending from across the global investor base, from wealth managers and IFAs through to sovereign wealth funds. We don't expect the banks to return to this market for a range of reasons cited above. It means private debt providers will play an important role for some time to come.

To contact the author:

Craig Reeves, Founder, Prestige Asset Management / Prestige Funds:
Craig.reeves@prestigefunds.com



A discussion on the regulatory scrutiny facing ETFs

Monica Gogna, Partner, Dechert LLP

Monica Gogna

Other than GDPR, exchange traded funds (ETFs) has been the buzzword for the first half of 2018. The year-on-year increased inflows into European ETFs is something which is being discussed at every conference or seminar where product development is on the agenda. Given I am not a statistician, I will not spend any more time on this aspect. However, an area which continues to generate interest is the increased level of scrutiny applied to ETFs by regulators across the globe.

Regulatory scrutiny of ETFs

I am sure by now we have all read the Central Bank of Ireland's (CBI) discussion paper on ETFs. For those of you who haven't I suggest you do; it is an excellent way to get know (in only 100 pages) how an ETF operates. As any good regulator should, the CBI has set out its stall on what it considers are the key risk factors for ETFs that concern them the most. These include questions over:

- The design of ETFs.
- Their use of primary dealing and secondary trading.
- The impact of ETFs on market liquidity.
- Disclosure requirements surrounding ETFs.

At first glance, on their own, such remarks seem very valid and sincere questions that should be asked of a growing sector, but when put together with additional calls for "the assessment of the risks inherent in the ETF structure" and a reminder that national, international and supranational securities regulators have embarked on work that is focused on ETFs, it is certainly time for the industry to pay attention.

In recent months, discussions have taken place to explain how ETFs operate and to address the question regarding how the ETF sector faces up to challenges during periods of market stress, for instance in the aftermath of the financial crisis or after the sell-off of volatility ETFs.

In general, the ETF sector has come out strong, making its case for how individual ETFs and the ETF market deal with potential liquidity pinch-points. Linked to this discussion is the emphasis being placed on the role of the authorised participant (AP) and the perceived potential lack of accountability held between the ETF sponsor and an AP, other than through their terms of business. While I am generally sceptical of sweeping statements that infer that one must look at an entire sector just as they are increasing in popularity, I do understand why regulators may wish to see a more evolved process surrounding the appointment of APs. With this in mind, an increased level of consistency of AP terms across the industry and dare I say it, robustness, within AP documentation is likely to be a good starting point.

The risk of contagion is another factor where regulators have expressed their concern and the potential "ripple effect" of any liquidity crisis within the ETF sector. My observation is that ETF providers across the industry have been requesting additional methods to increase market transparency, including schemes such as the use of consolidated tape under the initial MiFID II proposals (that is, the MiFID II Directive (2014/65/EU)) and the Markets in Financial Instruments Regulation (Regulation 600/ 2014) (MiFIR)). However, as this is not the case, for now, regulators and the industry will need to keep a watchful eye over how the increased transparency requirements under MiFID II may assist in shedding light on trading patterns of ETFs within Europe.

Finally, no synopsis on increased regulatory scrutiny can be complete without the mention of increased transparency for investors. Now before you point out that MiFID II addresses this, it is clear that the regulators and the sector still feel there may be more to come within the ETF sector. Some of this relates to comments on the appropriate nomenclature used, something which was raised again in the United States earlier this year.

Those of us in Europe would argue that we already have the distinction between a UCITS ETF and products that do not fall within this category. Nonetheless, I would highlight that there is still a certain level of debate between the use of the label ETF versus exchanged traded certificate versus exchange traded product globally that means the conversation continues.

In addition to terminology, regulators are most concerned with ensuring that ETFs have appropriate descriptions and disclosures that explain the specific risk profile of an ETF. Again many would argue that we need to give time for MiFID II to demonstrate its effect before adding further requirements, but I would not be surprised if further globally based principles are released addressing some of these concerns. In fact, I note that the International Organization of Securities Commission (IOSCO), confirmed that it plans to look at ETFs in 2018, and has been reaching out to the ETF sector since then, with a report (draft or otherwise) rumoured likely to be produced before the end of the year.

The potential for ETFs in Europe

Reading the above, one realises the upcoming challenges the ETF sector has in getting its voice heard, but I am confident that this process is underway. This leads us to why ETFs still appear to be a buzzword this year and a possible source of growth. Some of this potential can be attributed to a "push" effect emanating from unintended consequences following the application of EU legislation to global products, such as the potential application of the regulation on key information documents (KIDs) for packaged retail and insurance-based investment products (PRIIPs) (Regulation 1286/2014) to non-EU ETFs. It may also be due to the appearance of a more level playing field with traditional mutual funds as a result of MiFID II's rules (and in the UK, the retail distribution review (RDR)) on payment of commission. While it is too early to tell where this all leads, it is clear that the trend towards (at the very least) understanding how an ETF operates and is constructed remains.

On the "pull" side, we are now in an environment where value for money is being discussed heavily and an additional level of scrutiny is being applied to fees. Again, ETF sponsors will need to be wary of the rhetoric behind this and ensure that when claiming such benefits, these are indeed reflective of the actual structure of a particular ETF.

Collaboration within the ETF sector

A number of us in the ETF sector often talk about the "ETF ecosystem" and for those who are new to it, I imagine it can seem impenetrable. From a personal perspective, I would add that I was in that place not that long ago (if you count in decades!) In general, I have found the ETF ecosystem to be one of the most open out there, with very senior individuals taking the time to explain how an ETF works, the ways in which liquidity is generated, and how cross border AP systems may work in practice. It is, with few exceptions, a very transparent sector. It will be interesting to see how this reputation for transparency continues, particularly as firms design products that are more "active" in nature. But, one may also argue that the same level of transparency and openness should apply across the spectrum of investment products irrespective of their wrapper? That is at least how the most recent EU product legislation and investment services regulation has been drafted.

Now, of course, a collaborative environment does not mean that there is not healthy dose of competition in the sector whether it be for "best of class" status, or being the first out of the blocks to launch the newest and most innovative (and, for some, bespoke) product range. But, that is to some extent the case for any potentially successful growth story.

To contact the author:

Monica Gogna, Partner, Dechert
LLP: monica.gogna@dechert.com

Taking a data-driven approach to optimizing target operating models

Palak Patel, Global Business Manager,
Bloomberg AIM

As the global asset management industry evolves, firms may find that legacy operating models and technologies are no longer sufficient to address current challenges and take advantage of new opportunities. In this article, two such firms provide insight into their data-driven processes of optimizing target operating models (TOM) and underlying technology to sustain competitive growth.

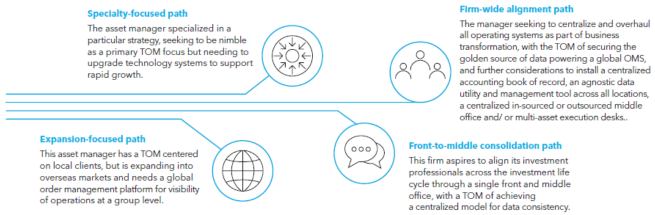
Starting on the path to optimization

Today's asset management firms are facing myriad and fast-changing pressures: investors are seeking higher yields, return, and income at a lower cost. Regulators, clients and internal stakeholders are issuing mandates of increased transparency and efficiency. An explosion of new market and "alternative" data may unlock (or surface) insights that drive performance, but requires rigour in management and application to deliver real value.

In this environment, it's hardly surprising that many asset managers are reconsidering their operating models, as well as their investment in technologies to support modernised operations. While priorities vary based on each firms' goals for growth, one thing has become clear: consistent and timely access to dependable data is central to both the TOM and the technology strategy.

In recent client discussions, we've learned that firms who have taken the lead in implementing data-driven operating models are achieving measurable results. The front office can more quickly discover and act on investment opportunities. IT departments can more easily scale for growth and complexity. Executives can set realistic goals for firm growth launching new funds, raising new assets, complying with the latest regulations and clearly identify what's required for success.

As we tailor our support for our clients' goals, Bloomberg has identified four paths asset managers are taking on their journey to optimise their TOMs: specialty-focused, expansion-focused, front-to-middle consolidation or firm-wide alignment.



These paths and how to get started are more fully explored in a whitepaper available for download at https://www.bloomberg.com/professional/t...

The specialty-focused path: a boutique streamlines systems and grows AUM

In 2014, the founders of Jamieson Coote Bonds (JCB) saw an opportunity in their home market of Australia. With their combined several decades of fixed income experience, Charles Jamieson and Angus Coote believed that domestic investors--serving an ageing population of superannuation participants--would embrace an offering to increase exposure to the high-rating, high-yield Australian government debt favoured by international investors.

Operating a relatively young fund management firm, the team was aware that attracting investment from the institutional market would require that they demonstrate best practices in operations, compliance and systems. They determined that concentrating their information and technology spend with a single provider was the most cost-efficient and fastest way to achieve that goal, and thereby meet asset owners' due diligence requirements.

Jamieson explains, "We realized that we needed to keep our operating environment as simple and contained as possible, to minimize op risk concerns. At the same time, we needed a streamlined investment and trading workflow, with dependable connectivity to the markets and consistent data throughout the process."

JCB chose a scalable system that is also in use by a number of their domestic asset owners, which helped gain validation from that community. They credit this instant confidence in their systems with helping them close in on their goal of becoming a multi-billion AUM manger in just a few years.

The firm-wide alignment path: a global "golden source" becomes reality

Italy's largest independent asset management firm has grown internationally through acquisitions and partnerships, resulting in a presence that spans 17 countries. For Azimut Group's Francesco DeMatteis, Head of Risk Management, this global expansion presented a unique challenge: how to capture all portfolio activities across the globe, fully integrated within a risk management framework that adheres to corporate mandates while accommodating local differences in operations.

A key aspect of firm-wide alignment is the importance of data consistency in establishing transparency across multiple offices for global oversight. Says DeMatteis, “When you don’t have intelligent systems, it’s a problem, as looking at different figures results in different assumptions and different models. When you use one model for everything, you can get right to discussing what is going on with the portfolio, and not waste time reconciling figures.”

For example, Azimut’s risk team designed a NAV interface with a custom calculation, which they rolled out to every manager. Now, when something goes wrong in the market, everyone is looking at the same information, facilitating faster decision-making across the global business.

In addition, Azimut is finding efficiencies in operations through a unified order management system with middle office capabilities. For example, when one office approves a broker, all the other locations can use the same broker based on that one completion of due diligence, without having to repeat the process for every single location. Similarly, regulatory inquiries can be handled quickly and with confidence, due to a universal, transparent view of positions.

Embracing a data-driven TOM has also presented new opportunities for growth. DeMatteis explains, “We wanted to use funds with a higher level of complexity, and we had some portfolio managers that were doing strong activity in derivatives. Having a common platform allowed us to supervise and manage these more sophisticated funds so that other managers within Azimut could use them too.”

In conclusion, asset managers burdened with fragmented technology and disparate data cannot achieve an optimized target operating model. As these examples illustrate, forward-thinking firms are realizing their goals by creating TOMs that place data and analytics at the center of their technology strategy.

For further information, please contact: hedge_funds@bloomberg.net

Key GDPR issues post 25th May

Steven Snaith, Partner, Technology Risk Assurance at RSM

Steven Snaith

The long awaited General Data Protection Regulation (GDPR) came into force on 25 May 2018. The ruling impacts how organisations store, manage and process personal data about EU citizens. Non-compliance may lead to fines of up to € 20m or 4 per cent of global annual turnover (whichever is higher).

GDPR represents a significant change to how personal data is collected and handled. It affects not just organisations based in the EU, but any organisation that conducts business there or holds and processes information relating to EU individuals.

When it comes to adopting GDPR, financial services institutions are presented with both advantages and disadvantages. Since the financial crisis, the sector has seen a range of new regulations come into effect, such as FATCA and MiFID II. As such, organisations should be educated to some extent with the level of change that is needed for such large scale regulatory developments. Many organisations have already invested in resources to react to such new compliance requirements. However, GDPR shouldn't be underestimated. Compliance can be challenging and therefore needs specific focus as to where scope data resides in an organisation and how it is subsequently controlled.

A primary focus area is the type of data that is collected, processed and stored. For hedge funds, this includes personal data on investors and investor personnel, employee's data, data on individuals at service providers, potential regulator contact details, website user data and data linked to wider organisations.

Organisations and individuals that determine the purpose and means of data processing are classified as Data Controllers and are subject to a wide range of GDPR regulatory obligations. Therefore, a hedge fund manager will generally be a controller of the investor personal data held. Moreover, a hedge fund, overall, will be a controller of the investor personal data held.

Under GDPR there is also an enhanced focus on Data Processers. If an organisation processes personal data for "purposes and by means determined by others", such organisations are classified as Data Processors. The regulatory requirements for Data Processors under GDPR are also enhanced. Service providers such as fund administrators and outsourced providers of, for example, HR and IT and services will be processors in respect of many activities.

So, what does this mean for financial services organisations? Some of the primary requirements include:

- Obtaining explicit consent from individuals before processing their data;
- Adopting processes that allow an individual's right to be forgotten, right to data portability

and right to object to data profiling to be met;
- Appointing a Data Protection Officer (DPO) if completing large-scale data processing;
- Ensuring third-party contractors meet GDPR requirements;
- Ensuring Data Controllers keeps records of personal data and processing activities;
- Ensuring Data Processors enhance their processes to meet GDPR requirements and
- Reporting data breaches to the relevant authority within 72 hours and notify affected individuals.

In this regard, for financial services organisations, it is important to know what data is stored and where it came from. Moreover, GDPR has led to refreshed policies, processes and procedures with regards to data governance.

The first year of GDPR

As financial services organisations head into the first year of GDPR implementation, it is important to test whether their new processes will help meet its obligations. Will they protect organisations in the way they expect and are they robust enough to keep sensitive data safe? Only by evaluating

controls will organisations be able to confidently answer these questions.

GDPR also emphases a proactive approach to data risk management. In this regard a Privacy Impact Assessment (PIA) should be conducted for any new IT systems or change in business process that involves scope data. A PIA can reveal any gaps in control frameworks before the change occurs to reduce the risk of a potential data breach.

It is good practice to carry out a PIA before new processes take effect. This will allow organisations to find and address control issues early on, giving them the best chance of avoiding reputational and financial losses if a data breach was to subsequently occur.

Maintaining momentum

An educated and prepared workforce is a fundamental requirement of continued GDPR compliance. Trained frontline employees will help organisations recognise threats. This will help ensure that any data breaches are reported within the required 72-hour window. Knowledge levels are currently generally high given internal development we have seen within the financial services sector and general media communications. Maintaining this momentum will be key, however. At the same time, it is important to review whether those tasked with spearheading GDPR internally have the right skills and support to effect change and maintain governance.

Similarly, organisations should also evaluate whether their Data Protection Officer (DPO) (or equivalent) fulfils the best practice requirements. Many organisations have asked their IT officer to take on this position. But expecting someone to check their own actions is inherently problematic; it can be difficult to identify issues and potential conflicts of interests.

Key focus areas going forward

Run a PIA before a change occurs

This will help organisations understand whether their new systems, processes, procedures and policies are fit for purpose.

Keep building awareness

Beyond the awareness and training delivered to data, simple methods such as screensavers and posters offer an easy and effective way to remind staff about the continual need for data integrity and protection.

Be clear about data handling processes

Financial services organisations typically hold large volumes of data about workers, customers and investors, including their address, date of birth, bank account details and medical records. Having a thorough understanding of in-scope data, and where changes in systems and data occur in the future, is of vital importance for organisations to underpin their data governance framework.

Internal governance and data breach incident response processes

Ensure that data privacy controls and incident response arrangements are well designed and tested for effectiveness. Any weaknesses can lead to a data breach and a potential fine. Moreover, it is also important to understand that fines won't necessarily be the 'appropriate' course of action to be determined by the local government agency (for example the ICO in the UK). Other sanctions available will include data protection audits, warnings, reprimands, and enforcement notices. Even more damaging than a fine, however, will be the ICO's (or equivalents') power to stop an organisation from processing data, impacting its reputation and its profit.

Conclusion

Overall, GDPR presents a risk but also an opportunity for financial service organisations. Clearly, there is an increased focus on the importance of robust data governance frameworks under GDPR – and the implications of a data breach will be much greater. However, by delivering greater transparency and accountability as to how investors' data is managed and controlled; the outcomes of GDPR can also enhance investors' confidence in how their personal data is managed. This can consequentially lead to greater engagement and confidence to encourage investors to provide their personal data, which can only be a benefit to the financial services sector. Moreover, organisations on a global basis that can demonstrate a data governance framework in line with GDPR can maximise the opportunity for competitive advantage that compliance with GDPR can offer.

To contact the author:
Steven Snaith, Partner, Technology Risk Assurance at
RSM: steven.snaith@rsmuk.com
www.rsmuk.com

'The truth about hedge fund performance'

Tom Kehoe, Global Head of Research, AIMA

Tom Kehoe

This article was first published on the AIMA website on 4th June 2018

Summary

- Comparing hedge funds to equities made sense at one point, but not any longer.
- What investors truly care about is how hedge funds compare on a risk-adjusted basis.
- As a measure of risk adjusted performance, hedge funds have out-performed equities and bonds on a one, three, five, and ten-year period.
- Investors far prefer steadier returns with lower volatility than higher level of returns with excessive volatility.
- The better way to evaluate the role of hedge funds is as a risk management tool for the wider investor portfolio. Allocating to hedge funds allows the investor to meet individual and more customised asset-liability management objectives in terms of risk-adjusted returns, diversification, lower correlations, lower volatility and downside protection.
- The inclusion of hedge funds in an investor's portfolio comprised of bonds, equities and other asset classes can provide a more controlled risk profile and help to reduce its overall volatility. Further, such a portfolio can beat the traditional (60/40) balanced investment portfolio.

It's a phenomenon that seems as certain and as regular as the sunrise that the hedge fund industry is once again back in the crosshairs. The latest volley comes from a Toronto based provider of investment cost and performance benchmarking for large institutional investors including pension funds.

In our role as the representative of the global hedge fund industry, we welcome and encourage debate of all types regarding hedge funds. Respectfully, to the uninitiated, the critique from the Toronto provider is a compelling read. We too also feel compelled to react to it, to address the many misperceptions contained within the advice provided. We would like to thank the members of AIMA's research committee [1] in helping us to provide this piece.

The authors of the latest critique set the tone at the beginning of their paper by declaring that most hedge fund portfolios "have unattractive returns and no risk reducing characteristics". A bold statement if ever there was one, but also one without foundation.

Risk and return cannot be separated when evaluating hedge funds. To borrow a famous phrase from Warren Buffett, "the two golden rules of investing are number one – don't lose money and rule number two – don't forget rule number one!" Investors look for something similar in their hedge fund investments, to protect them from the Achilles heel of deep losses, reduce the daily volatility of equity and bond markets, and bring much-needed diversification to their portfolios.

What investors truly care about is how hedge funds compare on a risk-adjusted basis; a way of measuring the value of the returns delivered in terms of the risk taken on an investment. The most sophisticated investors far prefer steadier returns with lower volatility than higher ones with greater volatility, because of the risk of potential loss that higher volatility brings. Hedge funds deliver risk-adjusted performance that provides investors with diversification benefits, even during the most difficult macro-economic environments. Institutional investors continue to allocate to hedge funds because of the proven logic that a broadly diversified allocation still holds over time.

Earlier this year, in conjunction with Preqin, we analysed the returns of more than 2,000 hedge funds that report to Preqin's All Strategies hedge fund index, (an equal weighted hedge fund industry benchmark). We concluded that hedge funds have produced more consistent and steadier returns than equities or bonds over the short and long term. On a risk-adjusted basis, they have out-performed equities and bonds over a one, three, five and ten-year period. [2]

The authors of the critique highlight 2008 as being a prime example where "hedge funds did not provide investors with protection during extreme market turmoil". Respectfully, we beg to differ. Revisiting the events of 2008, which was arguably the ultimate testing ground for hedge funds, the average hedge fund portfolio fell in value by 20%. That was painful, but far less than the 50% drop in equities. Further the recovery (for the average hedge fund), was swift having regained its high-water mark (or to put another way, recovered from its 2008 losses) by October 2010, compared to global equities which remained under water until nearly three years beyond that.

That aside, comparing hedge fund performance to the performance of equities made sense at one point, but no longer. [3] To what extent are such comparisons realistic? Are they a like for like comparison or are we comparing apples and oranges. The hedge fund sector today is now more diverse and more global. A prime example of this is that investors in hedge funds have a choice of at least 20 different investment strategies [4] to choose from.

The better way to evaluate the role of hedge funds for investors is how they perform as part of a more diverse investor portfolio which includes equity, bonds and other asset classes. As per analysis conducted in a research paper [5] that we conducted with AIMA's Investor Steering Committee [6] and CAIA, the inclusion of hedge funds in an investor's portfolio comprising of bonds, equities and other asset classes can provide a more controlled risk profile and help to reduce its overall volatility. The paper goes on to demonstrate that investors who allocate to hedge funds on this basis as part of a more diverse portfolio increases the plan's probability to achieve a higher rate of return with less risk compared to similar returns or worse if the portfolio is invested via a 60/40 allocation or has little to no hedge fund exposure.

The memory of the global financial crisis may be fading for some, particularly after the rising tide of equity markets since then, and the meagre volatility that markets have shown during that period. What a shame it would be if the lesson of 2008 is unlearned just in time for the next downturn.

The authors of the critique also takes issue with how hedge funds benchmark themselves to cash-based and specialty-hedge fund indices when reporting their performance. Instead, they put forward their own 'investable' benchmarks, yet there is no explanation as to how they constructed them. Upon closer analysis, the author appears to be solving for these benchmarks ex-post for the mix of equity/debt exposure that results in the highest possible correlation for the hedge fund portfolio.

This would incorrectly assume that investors would have been able to select the correct blend of equity/debt allocations ex-ante to replicate the return stream of their hedge fund portfolio. Put simply, this is a hypothetical approach, where the process seems to adjust cash and equity/debt weights using backward-looking volatility and correlations, two of the most important factors in determining hedge fund performance. On that basis, we would question whether the benchmarks are truly investable, as per the author's suggestion.

The authors explain that their custom benchmarks to measure hedge fund performance are specifically designed to have a beta of one. Perhaps a point lost on them is that most hedge fund portfolios are designed to have a beta of less than 1. Put more simply, investors allocate to hedge funds for their ability to diversify away from public markets. Indeed, the very best hedge fund managers do not align themselves to any benchmark.

We query the sample size of global funds that the critique surveys to produce its findings for this paper. As mentioned in their piece, "results for the paper are based on a one-time survey completed by 27 leading global funds and hedge fund data from 382 funds". By comparison, analysis carried out by the industry providers Preqin find an estimated 1,400 pension funds globally that allocate to hedge funds. The authors sample does not represent the average investor and its size cannot render statistically significant results. To extrapolate any meaningful trends on an investment plan's experience of allocating to a hedge fund from this analysis is questionable, to say the least.

We also query how the critique's authors arrives at its conclusion that "high costs are the main reason why hedge funds performed poorly." They do not disclose the constituents that make up the cost analysis that they present. In the interests of fairness and to help investors truly understand how they arrive at this conclusion, a more detailed breakdown regarding the cost analysis is required.

What is indisputable is that management fees being charged by hedge funds are being challenged. Where once a 2% management fee was considered the norm for the industry, nowadays it's likely to be closer to 1.6%. [7] Some hedge funds operate on management fees even lower than that. Further, managers and investors continue to find ways to align their interests more closely to each other so that fees are structured in a way that allows for a fair and equitable split between them both. [8]

Encouragingly, the critique's authors point to hedge fund use increasing across their global database "from 2.1% in 2000 to 52.7% in 2016, and those that have an allocation to hedge funds "have increased their allocation from 5.8% in 2000 to 7.7% in 2016".

On this point, we are in total agreement.

A measure of the continued attractiveness of the hedge fund industry to investors is demonstrated by the continued capital investment into the industry. Over the past 12 months, over $70 billion of capital investment has been allocated to hedge funds. Further, preliminary indications for 2018 point to a further $20 billion net inflow received by the industry year to date.

A further sign of the increased appetite for hedge funds is the return of the mega hedge fund launch. Over the coming month, the industry will welcome the largest hedge fund launch ever. This news comes amid a spate of mega hedge fund launches slated for the second half of this year. It begs us then to ask the question, if hedge funds really are so disappointing as the critique suggests them to be, then why the continued interest in them from some of the most sophisticated institutional investors across the globe?

In addressing these questions and others, we have an array of educational papers which we make available not just to our members but to the public also. In providing this service, we draw upon the expertise and diversity of our members to provide leadership in hedge fund industry initiatives such as advocacy, policy, educational programmes and sound practice guidance.

In recent years, discussions continue to persist about the value of hedge funds for investors. With these in mind, together with CAIA, the global leader in alternative investment education we launched a series of papers aimed to help trustees and other fiduciaries better understand and manage hedge funds. These and other investor-led guides can be found here. Please do take a moment to read these, and we would be grateful for your feedback.

Footnotes

[1] AIMA's Research Committee produces manager driven primary research and through leadership on all aspects of the hedge fund business model. Membership of this global committee comprises of hedge fund managers, asset managers, fund service providers and representatives from the hedge fund academic community.

[2] https://www.aima.org/article/press-relea...

[3] For further discussion on this and how better to understand hedge fund performance, please see "Apples and Apples: How to understand hedge fund performance" https://www.aima.org/uploads/assets/

[4] For further discussion on this and how better to understand hedge fund performance, please see "Apples and Apples: How to understand hedge fund performance" https://www.aima.org/uploads/assets/

[5] "Portfolio Transformers – Examining the role of hedge funds as substitutes and diversifiers in investor portfolios" https://www.aima.org/uploads/assets/up

[6] Membership of this global committee comprises of institutional investors who allocate to hedge funds. They include, state pension plans, sovereign wealth funds, endowment and

foundations, fund of funds, insurers, private wealth platforms, and family offices. The committee undertakes educational initiatives, including producing and endorsing investor-related education, and industry thought leadership to demonstrate the role that alternative investments offer in the investor portfolio.

[7] http://docs.preqin.com/newsletters/hf/Pr...

[8] To read more on how hedge funds and their investors are aligning their interests better, please see AIMA's "In Concert" paper at https://www.aima.org/uploads/assets/uplo...

Greek short-selling fines

Adam Jacobs-Dean, Managing Director, Global Head of Markets Regulation, AIMA

Adam Jacobs-Dean

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Back in 2014, some of our members participated in rights issues of Greek banks that were seeking to raise new capital. The Greek regulator, the Hellenic Capital Market Commission (HCMC), subsequently launched enforcement action against a number of hedge funds who had participated in those rights issues, alleging that they had breached the European Short-Selling Regulation (SSR) by selling their positions. We wrote at the time to HCMC and to the European Securities and Markets Authority (ESMA) to explain our concern that the HCMC was misinterpreting the SSR, but were not successful in encouraging the HCMC to change its stance. Now, following a long period of quiet, updated Q&A material from ESMA on this topic and a further round of fines issued by the HCMC have reignited interest in this topic for members. Are things finally moving again?

Our key contention is that the alleged 2014 breaches of the SSR were not short positions at all, but straightforward unwinds of long positions obtained through participation in rights issues. We explained this to ESMA and HCMC in 2015 and highlighted that the HCMC's stance seemed to be at odds with the interpretation of a broad range of market participants, whilst also potentially conflicting with previous statements from ESMA and the interpretation adopted by other national competent authorities.

It's fair to say that our efforts in 2015 to encourage the HCMC to change its stance were not successful. Indeed, even in terms of enforcement proceedings, very little has moved on in the intervening period: some firms are still waiting on notifications of fines (even though they know they are coming based on press statements by the HCMC), others have been notified of fines to be levied by the HCMC but can neither pay nor appeal those fines because they there is yet to be a final, formal determination of their case. Payment is further complicated by the need for a Greek VAT number, although legislative changes are being tabled to address this.

It came as a surprise, therefore, when in February this year ESMA updated its Q&A on the SSR to cover scenarios involving rights issues; and ESMA's statement while not a direct response to the Greek scenario does give weight to the idea that the fact that many of the trades in question settled without problem would suggest there was no breach of the SSR.

At this point, our members are weighing their options. Many firms I have spoken to and who take pride in an unblemished supervisory record are minded to pursue their claims through the Greek legal system. So it may well be that this topic continues its slow burn over the weeks and months ahead. In the meantime, it is likely that investment funds will be cautious about committing capital to the Greek markets in the face of such regulatory uncertainty.

AIMA expert group to drive the industry's response to digital assets and blockchain

Oliver Robinson, Associate Director, Markets Regulation, AIMA

Oliver Robinson

This was first published on 21st May 2018

In May AIMA kicked off its work on behalf of the global hedge fund industry to respond to the rapid rise of digital assets and digital assets funds, and discussions regarding the potential applications of distributed ledger technologies (DLT) in the asset management industry.

With over 1,800 coins and tokens in circulation globally and over 250 digital assets funds in the US alone, it is arguable that digital assets are beginning to move beyond the realms of a concentrated group of private investors and coin miners, towards becoming a new institutional asset class. However, there are significant political and regulatory challenges to overcome before the potential benefits associated with digital assets can be more fully enjoyed by investors and issuers.

Criticisms levied at cryptocurrencies include that they are not backed by any physical holdings, nor by any central bank. ICO tokens are criticised for being a tool for surreptitious issuers to attempt circumvention of securities laws. Questions also abound regarding how to categorise the new assets, what constitutes a security and how exchanges are to be regulated. These come in addition to fundamental concerns around anti-money laundering and other client checks which are preventing many large institutions committing to the asset class. There are also environmental concerns regarding the computer processing power necessary for contributors to the blockchain to ratify each set of transactions; for example, the electricity consumption for Bitcoin alone is currently broadly equivalent to that of Ireland, and rising.

However, to write-off digital assets and DLT would likely be short-sighted. Tokens and the use of smart contracts enable greatly enhanced flexibility for issuers in their capital raising. Cryptocurrencies can facilitate secure settlement of transactions between anyone in the world with a cryptocurrency wallet, wherever they may be. The DLT underlying cryptocurrencies also offers potentially significant operational cost savings in the asset management space where a highly-secure database is required and for which speed is not the upmost priority. For example, significant investment is being made in DLT in post-trade and settlement services, as well as regulatory reporting. Although it is clear that DLT has a way to go before commercially viable solutions are broadly available to the buy-side, it presents a rare opportunity to potentially revolutionise certain elements of the current operational landscape for the better.

What is clear is that key political and regulatory decisions regarding digital assets are being made now and that there is a significant role for AIMA to play in educating legislators, policymakers and regulators, and acting as an advocate for AIMA members active in the digital assets space globally. To this end, AIMA has committed to become the authoritative global voice of the alternative investment industry in the digital assets and DLT space.

AIMA recently held the first call of the AIMA Digital Assets and Blockchain Core Group (DAB), a senior-level industry steering group consisting of a global cross-section of experts tasked with driving AIMA's policy engagement, educational initiatives and operational guidance on all aspects of digital assets and DLT. The initial focus of the core group will be on policy and regulatory engagement, as well as broader education to help AIMA members find answers to their questions relating to this new space. As the regulatory and operational environment becomes more stable, AIMA will also develop industry operational and regulatory guidance tailored to digital assets; including a new AIMA DDQ module for digital assets funds and an AIMA guide to the regulation of digital assets globally. The AIMA DAB Core Group is complemented by the AIMA Digital Assets and Blockchain Circulation Group, which is open to any and all AIMA members wishing to stay up-to-date with AIMA's work in the cryptocurrencies, ICO and DLT space.

If you have any questions on AIMA's work or would like to be part of the DAB Circulation Group, please do get in touch (orobinson@aima.org)+

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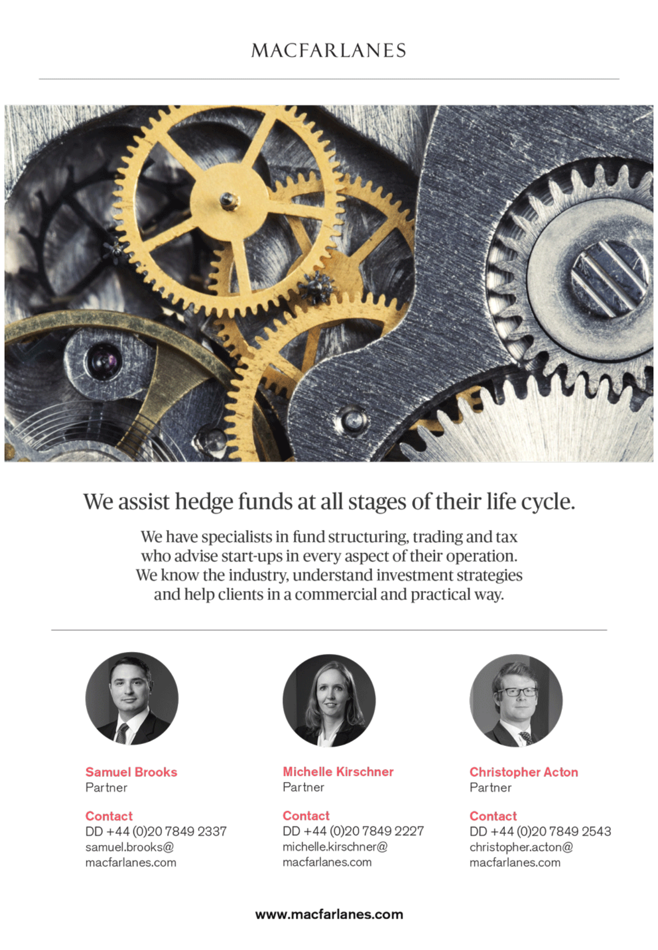

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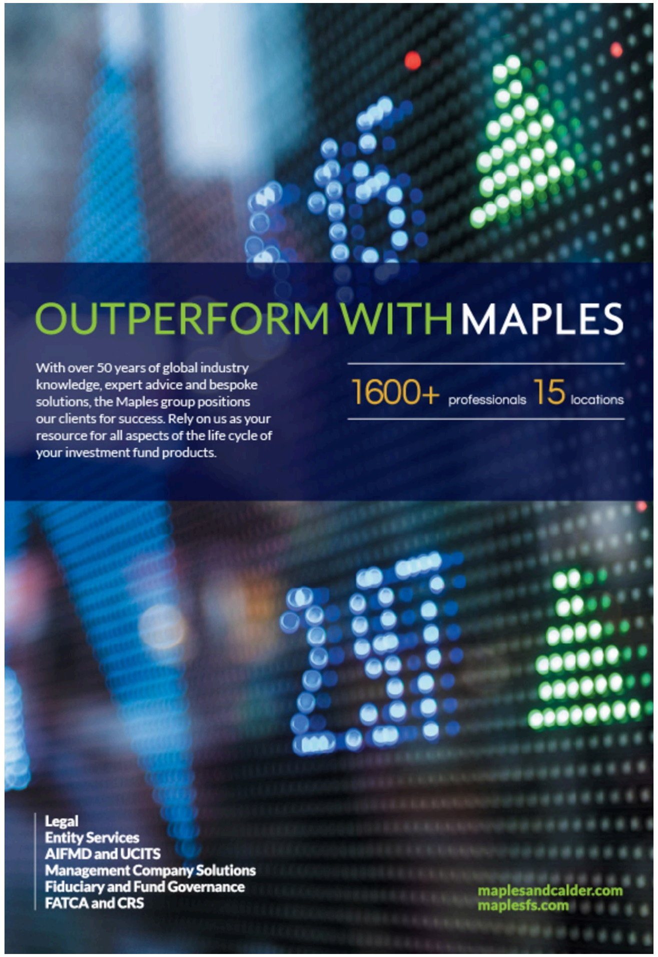

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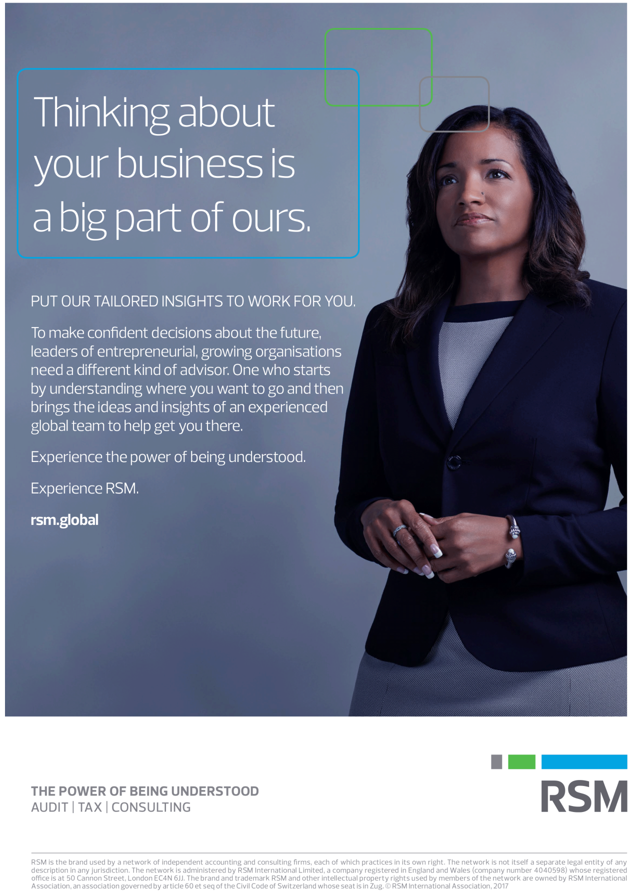

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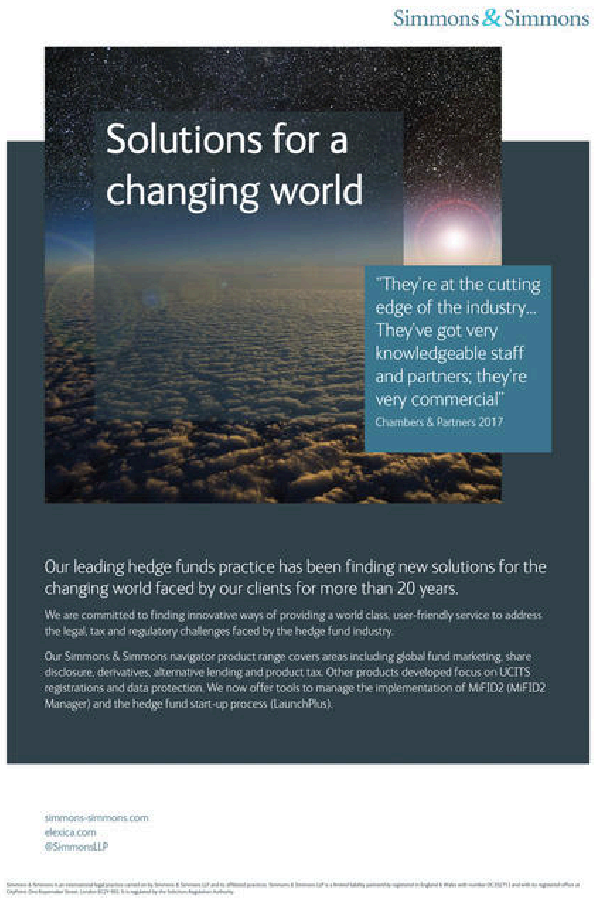

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Contact us

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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

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
jburron@aima-canada.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
Tel +61 (0) 412 224 400
apac@aima.org

Tokyo
Kanako Someya, AIMA Japan Secretariat,
Tel: +81-(0)3-4520-5577 ,
ksomeya@aima.org / apac@aima.org

Cayman Islands
cayman@aima.org

Bermuda
info@aima.org

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