AIMA

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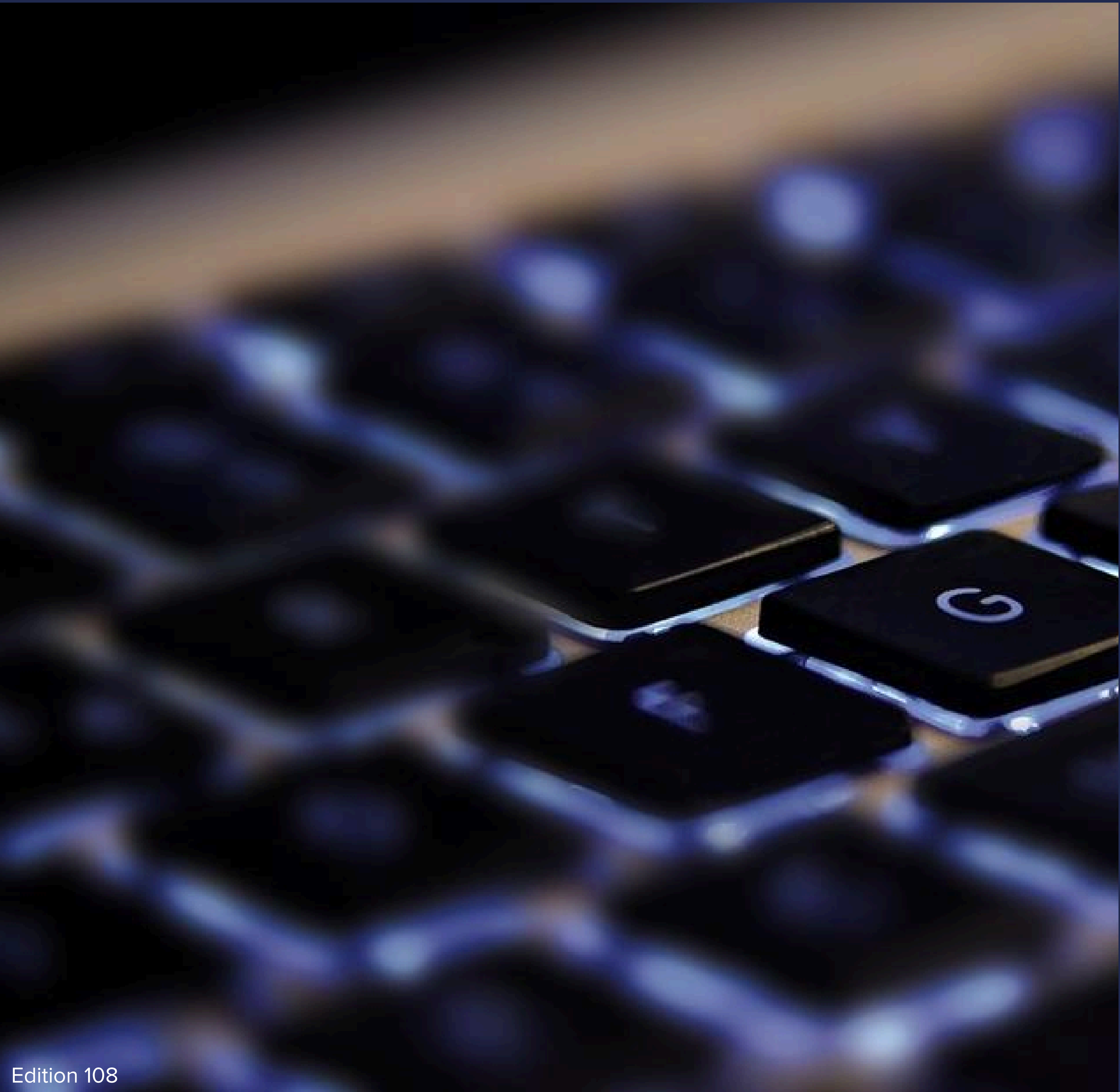

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Go for relaunch!

Read AIMA's CEO Jack Inglis on the newly redesigned AIMA Journal

Welcome to the new AIMA Journal

We are delighted to relaunch our flagship member publication, the AIMA Journal.

With this striking and modern design, we hope to better showcase our members' thought leadership, guidance and ideas. Do let us know what you think at the end of this page.

The AIMA Journal is distributed to approximately 12,000 people in over 50 countries and after more than 20 years and over 100 editions remains a popular and respected title.

To contribute to the next edition, please contact Dominic Tonner at dtonner@aima.org.

AIMA CEO Jack Inglis

The investment we are making in the new AIMA Journal is part of a broader overhaul of our branding and our digital and social media activities.

You may have noticed that we have refreshed our corporate identity with a new logo and font. We hope these changes better reflect the maturity and professionalism of both AIMA and the industry we represent.

We will shortly launch a new global website, which will be more interactive, easier to navigate and of value to a wider set of stakeholders.

New designs will be rolled out soon for our main member newsletter, the AIMA Weekly News, and a new newsletter highlighting our expanding event calendar. We are also planning to do much more via social media channels including Twitter and LinkedIn.

Taken together, these projects will increase engagement with our research and thought leadership and potentially enable us to reach new audiences.

We hope you like the changes - let us know what you think below or contact us at info@aima.org.

Tell us what you think

- I prefer the new AIMA Journal
- I prefer the old design

See results

Footnote 1

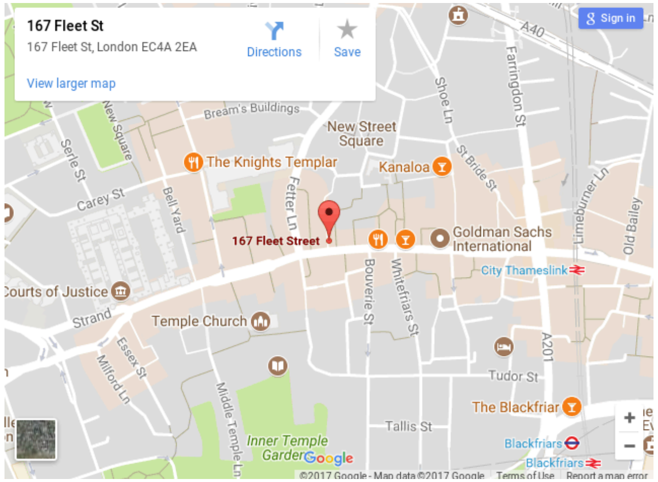
Footnote 2

"Quote"

– Attribution

Thanks for the update. We haven't used turtl from an events side. However, we are looking at creating an events brochure for the year like the BVCA one here. So may be something we could use, but aware from previously that the licences are an issue?

I suppose we could also look at using it for event sponsorship proposals but I suppose depends on timing. Attached an example here.



Rolling up the sleeves: Brexit and financial regulation

By Robyn Grew, Chief Administrative Officer, Man Group

Robyn Grew, Chief Administrative Officer, Man Group

'Do I think that Britain's role has somehow been diminished? No, I think it's been changed.' US Secretary of State John Kerry's diagnosis of the UK's position after the referendum was a welcome respite to the melancholic introspection that some are wallowing in. Damage limitation seems to be the primary issue that many are considering. From a financial regulatory perspective, the industry should take a more expansive view, asking what do we want from the UK's departure, and how can we best ensure that this happens.

The first issue that I believe should be recognised is that a constructive and open relationship between Britain and the continent benefits the financial industries of both. European regulations have the advantage of conferring access to the largest single market in the word. These laws allow the cross border offer of securities and funds (by means of the passport) which attracts many multi-national financial institutions to base operations in the UK.

> "Do I think that Britain's role has somehow been diminished? No, I think it's been changed.'
>
> US Secretary of State John Kerry

But the UK financial markets also matter – a lot – to Europe. The regulatory complexities of modern finance are such that upping sticks and moving to Frankfurt, Dublin, Paris or Madrid is a highly complex task and is probably not achievable within the two year negotiation window stipulated by Article 50. The EU, in short, will remain broadly dependent on the UK financial market for some time. Europe's own financial sector is weak in comparison, and there would be significant economic repercussions if it were to be starved of products and services from its major supplier – quite apart from any retributive British action against other industries.

There is every hope that the two sides can come to a mutually acceptable arrangement. Quite what this model will look like, however, is still very uncertain. Although Theresa May's appointment as Prime Minister has brought more clarity as to how the deal will be negotiated, whether it will be Norway, Switzerland, Canada, Albania, or even something completely different, remains an unknown.

Regulation has arguably been the defining story of the financial services industry since 2008. It is therefore imperative that those of us that work in this area discuss how best to shape its future, and make sure our views are heard.

The first and most obvious step will be to prepare government and the wider public sector for the job ahead. This is likely to go beyond usual lobbying efforts: the government and authorities can benefit from guidance, access to dedicated resource and expertise a long time before any implementation efforts begins. We should be sending our brightest and best to assist the government's Brexit unit, under the leadership of David Davis. They will need all the help we can offer, and we need to ensure that their efforts remain non-partisan and effective. This is a time for UK PLC to come together.

In terms of the detail of the agreement, it is clear that an EEA access model is essential if the UK's financial industry is to continue to give the same heft to the British economy that it has lent over the last 30 years. To maintain our cross-border passport rights, it is likely that we will have to maintain the lion's share of EU financial regulation.

Outside of Europe, however, we will be free to flex the regulatory environment for firms, funds or activities which do not touch the EU. This could allow us to create a twin track approach, with a set of EU-compliant rules for firms that wish to have access, and rationalised domestic ones for those who do not. In regulatory terms, these are the uncharted opportunities that Brexit provides. Asset managers could run AIFMD-compliant fund structures which could be sold into the EEA and parallel non-AIFMD compliant structures, run at a lower cost under a different regulatory framework. The UK listing authority could offer a more efficient and tailored structure for prospectuses. All of these represent potentially significant competitive benefits from Brexit and should be high up the agenda for firms as the settlement is negotiated.

Talk is cheap, of course, and to implement such visions will admittedly be a colossal task. Simply amending the UK statute book to decide which pieces of EU legislation should be adopted, amended or replaced, will be an 'absolutely all consuming' job, according to the former head of the UK Civil Service.

> "We cannot sit passively on the side-lines of the debate: we need to get stuck in, providing both vision and leadership"
>
> Robyn Grew, Chief Administrative Officer & General Counsel, Man Group

But staking out a visionary path is not always a matter of clear cut choices, and often begins with seemingly wild ideas. A Home Office civil servant, once commented on the great Winston Churchill: "Once a week or oftener Mr. Churchill came into the office bringing with him some adventurous or impossible projects; but after half an hour's discussion something was evolved which was still adventurous, but not impossible."

We cannot sit passively on the side-lines of the debate: we need to get stuck in, providing both vision and leadership. We need to ensure our views and ideas are heard and understood by government, regulators and negotiators. Doing so will not only allow this country to remain a prosperous financial hub within Europe, but also provide an opportunity to improve the UK regulatory and operating environment, hopefully making British regulation 'great' again…

Robyn Grew is a member of the AIMA Council

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SEC Amendments to Form ADV and the 'Books and Records' Rule under the Advisers Act

By Clifford Cone, Partner, and Ashwini Habbu, Associate, Clifford Chance

Clifford Cone, Partner, Clifford Chance

Ashwini Habbu, Associate, Clifford Chance

On 25 August 2016, the US Securities and Exchange Commission (SEC) adopted amendments to Form ADV and Rule 204-2 (the "Records Rule", and together, the "Amendments") promulgated under the US Investment Advisers Act of 1940, as amended (the "Advisers Act"). Originally proposed by the SEC on May 20, 2015 (the "Proposing Release"), the Amendments make notable changes to the information required to be disclosed on Form ADV as well as expand advisers' recordkeeping requirements.

In its adopting release (the "Adopting Release"), the SEC refines the concept of "umbrella registration" by a family of advisers, increases disclosure requirements in respect of advisers' separately managed account (SMA) businesses, requires more information on the identity of certain third-party service providers, and instructs registered investment advisers (RIAs) to keep more records of communications and other written material that contain performance information. Compliance with the Amendments will be required on 1 October 2017.

I. Form ADV

Umbrella Registration

Per its guidance in two no-action letters,[1] the SEC staff took a position that, under certain circumstances, it would not recommend enforcement against an investment adviser that filed Form ADV on behalf of itself and its affiliated advisers. In principle, the advisers could use an "umbrella" registration only if they controlled each other (or were under common control) and operated a single advisory business, among other conditions. The SEC explicitly endorsed that guidance in the Adopting Release and imposed a series of conditions that are consistent with the ABA Letters. Indicia of a single advisory business include a common group of advisory services and clients, uniform application of the Advisers Act and its rules to each adviser in the business and an enterprise-wide compliance program.

The SEC declined to extend umbrella registration to either non-U.S. filing advisers[2] or "umbrella reporting" by exempt reporting advisers (ERAs), but did not, however, withdraw certain "Frequently Asked Questions", in respect of which an ERA may file on behalf of one or more special purpose vehicles.[3]

In connection with umbrella registration, investment advisers will be required to file a new "Schedule R" in respect of each adviser that relies on a filing adviser's Form ADV. Schedule R requires information about each relying adviser, including: (i) its identifying information (Section 1); (ii) the basis of its registration (Section 2), (iii) the form of its organization (Section 3) and (iv) appropriate "control persons" (Section 4). The filing adviser must also indicate whether a relying adviser manages or sponsors private funds disclosed in Section 7.B(1) of Schedule D of Form ADV.[4]

The Amendments also added a series of additional questions in respect of an adviser's business as follows:

Form ADV Reference	Amendment	ERA	RIA
Section 1.F, Schedule D	Advisory Offices. Currently, Form ADV asks only about an investment adviser's principal place of business. The Amendments expand the disclosure to request information in respect of the adviser's 25 largest offices (based on the size of the workforce in each office).	✓	✓
Item 1.I	Social media activity (e.g., LinkedIn, Twitter). That disclosure would be required even if the adviser does not use the Internet to promote its advisory business or if its activity is intended for a purely non-U.S. audience.	✓	✓
Item 1.J	External Chief Compliance Officers. Presumably responding to the increased popularity of "outsourced" chief compliance officers ("CCOs") to manage RIAs' compliance programs, the Amendments require an investment adviser to identify whether its CCO is an employee or compensated by someone other than the investment adviser (or its related person), and if so, provide the name and EIN of the applicable person.	✓	✓
Item 5	Client Categorization. In addition to the wealth of new information required in respect of an adviser's SMA business as described above, the Amendments also require an RIA to: (i) identify RAUM attributable to different types of clients, rather than provide a percentage as Form ADV does currently and (ii) indicate the approximate amount of an adviser's RAUM attributable to clients that are non-U.S. persons. And if an investment adviser reports its assets differently in Part 2A (the "brochure") than it does in Part 1A, it must indicate as much.		✓
Section 7.B(1)(15)(b), Schedule D	Private Fund Reporting. The Amendments will require investment advisers to list identifying information (e.g., PCAOB registrations) of related persons disclosed on Section 7.A of Schedule D. And for those funds that rely on Section 3(c)(1) to avoid registration under the U.S. Investment Company Act of 1940, as amended, an investment adviser will need to indicate whether interests in those funds are restricted to "qualified clients" as defined in Rule 205-3 promulgated under the Advisers Act.	✓	✓

The principal motivation in each case appears to be to share with the general public more information about an advisory business and otherwise facilitate oversight by the SEC and its staff.

The Amendments make other, clarifying updates to the technical instructions of Form ADV. Notable examples include that:

- For Item 7 and accompanying Section 7.B of Schedule D: (i) in a master-feeder structure, indicate that feeder funds should not be counted to respond to whether any of the adviser's "clients" were solicited to invest in fund[7] and (ii) in reference to whether audited financial statements have been circulated to investors with unqualified opinions, the relevant period is the time since the adviser's previous annual updating amendment to Form ADV.
- For Item 8, to require applicants for registration[8] respond on the basis of their expectations once the adviser has the necessary RAUM.[9]
- For Item 9, to instruct the adviser to provide the PCAOB-assigned number of that adviser's independent public accountant.[10]

- For Item 11, to amend the "Disclosure Reporting Page" (DRP) to permit ERAs to withdraw a disclosed DRP if permitted by Form ADV.
- Generally, to clarify that ERAs must update corresponding sections of Schedules A, B, C and D and provide updated contact information when submitting their respective annual updating amendments.

Separately Managed Accounts

The Amendments dramatically increase the information RIAs must provide in response to Item 5 in respect of their SMA business. Depending on the value of the RAUM attributable to SMAs they manage, RIAs must report:

- the proportion of the adviser's assets under management that is represented by such accounts;
- the asset pools of those accounts based on a list of 12 categories;[11]
- the accounts' use of derivatives and borrowing;[12] and
- the accounts' custodians.[13]

The SEC did not define "separately managed account", but as in the Proposing Release, any advisory client other than pooled investment vehicles (i.e., business development companies, registered investment companies, private funds) would be deemed an SMA.

II. Records Rule

Currently, only RIAs are subject to the Records Rule, pursuant to which such advisers must maintain various written records in relation to their advisory business. Undoubtedly motivated by recent announcements of the SEC's Office of Compliance Inspections and Examinations examination priorities,[14] as well as recent orders from the SEC's Enforcement Division that have penalized advisers for the use of misleading performance information,[15] the Final Release adopts two, critical changes to the Records Rule:

- An adviser must maintain originals of any communications (sent or received) in respect of an SMA or securities-related recommendation that includes information related to performance or rate of return. Under the current Records Rule, RIAs are only required to maintain certain types of communications, including recommendations or investment advice generally, receipt, disbursement or delivery of funds or securities or in respect of the placement or execution of an order to purchase or sell any security.[16]
- An adviser must keep all communications to any person that explains the methodology for calculating performance information or a rate of return. The current Records Rule included a de minimis exception, whereby records were not required to be maintained if distributed to fewer than 10 recipients.[17]

RIAs should begin to consider revisions to their compliance policies and procedures now, including to update their IT systems and software and to train relevant personnel, so that they will be in compliance before 1 October 2017.

The SEC has adopted incremental changes to Form ADV and its staff has issued periodic guidance on various topics related to the Advisers Act, but these Amendments represent the most sweeping and substantial changes to advisers' compliance obligations since the "15-client" exemption from registration was repealed in July 2011. Given the uptick in enforcement activity, and the breadth of the Amendments, advisers would be well served to act quickly to familiarize themselves with the new requirements.

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Footnotes

[1] "Amendments to Form ADV and Investment Advisers Act Rules," Investment Advisers Act Release No. 4091 (May 20, 2015) available at: https://www.sec.gov/rules/proposed/2015/...

[2] "Form ADV and Investment Advisers Act Rules," Investment Advisers Act Release No. 4509 (August 25, 2016) available at: https://www.sec.gov/rules/final/2016/ia-...

[3] An ERA's initial filing is due within 60 days of it achieving that status but all advisers must submit an annual updating amendment within 90 days of their respective fiscal-year ends. Assuming an investment adviser's year-end is December 31, that adviser would be subject to the Amendments in respect of the annual update to its Form ADV filed no later than March 31, 2018.

[4] American Bar Association Subcommittee on Hedge Funds, SEC No-Action Letter (Jan. 18, 2012) (the "2012 ABA Letter") (available at https://www.sec.gov/divisions/investment...); American Bar Association Subcommittee on Private Investment Entities, SEC No-Action Letter (Dec. 8, 2005) (available at: https://www.sec.gov/divisions/investment...) (together, the "ABA Letters").

[5] Reasserting item (iii) from the 2012 ABA Letter, the SEC remains concerned that such joint filings would impede its access to, and examination of, those non-U.S. advisers.

[6] A copy of these questions can be found at: https://www.sec.gov/divisions/investment....

[7] Form ADV, Schedule D at Question 3(b).

[8] Note: Disclosure would not be required if the social media platform was used by an affiliate only in respect of that affiliate's business.

[9] The Glossary to Form ADV will define "United States person" to mean any natural person that is resident in the United States (consistent with Rule 203(m)-1 promulgated under the Advisers Act (17 C.F.R. 275.203(m)-1)).

[10] Form ADV, Schedule D at Section 7.B(1), Question 19.

[11] Form ADV, Item 2.A(9) and accompanying Section 2.A(9) of Schedule D (that provision will also be renamed "Investment Adviser Expecting to be Eligible for Commission Registration within 120 Days").

[12] Form ADV, Schedule D at Section 7.B(1), Question 23(g), (h).

[13] Form ADV, Schedule D at Section 9.C.

[14] Investment advisers with less than $10 billion RAUM managed through SMAs must report this information annually, but above that threshold, advisers must report twice per year. The enumerated categories include: exchange-traded equity securities; non-exchange traded equity securities; U.S. government bonds; U.S. state and local bonds; sovereign bonds; corporate bonds – investment grade; corporate bonds – non-investment grade; derivatives; securities issued by registered investment companies and business development companies; securities issued by other pooled investment vehicles; cash and cash equivalents; and "other".

[15] Investment advisers with SMA RAUM between $500 million and $10 billion to report the dollar amount of borrowings attributable to SMA RAUM based on three thresholds of gross notional exposures. Advisers with more than $10 billion must report the same information and exposures within a list of six types of derivatives for each SMA category (supra n. 3) twice annually. No reporting in this respect is required of advisers with SMA RAUM of less than $500 million.

[16] Only those custodians that custody 10% or more of an investment adviser's SMA RAUM must be disclosed.

[17] Announcements of recent and related OCIE Examination Priorities can be found at: https://www.sec.gov/about/offices/ocie/n... (2013); https://www.sec.gov/about/offices/ocie/n... (2014); and https://www.sec.gov/about/offices/ocie/n... (2015).

[18] See, e.g., In the Matter of Virtus Investment Advisers, Inc., Adv. Act. Rel. 4266 (Nov. 16, 2015); In the Matter of Raymond J. Lucia Companies, Inc. and Raymond J. Lucia, Sr., Adv. Act. Rel. 4190 (Sept. 3, 2015); In the Matter of F-Squared Investments, Inc., Adv. Act. Rel. No. 3988 (Dec. 22, 2014); see also, SEC Press Release No. 2016-167 (Aug. 25, 2016) (in which the SEC's Enforcement Division announced penalties against 13 firms that violated securities laws by disseminating false claims made by another investment adviser), which can be found at: https://www.sec.gov/news/pressrelease/20...

[19] 17 C.F.R. 275.204-2(a)(7).

[20] 17 C.F.R. 275.204-2(a)(16) (see also 17 CF.R. 275.204-2(a)(7)).

Planning ahead for the Senior Managers and Certification Regime: What should you be doing now?

By David Cummings, Senior Associate, Employment, Robbie Sinclair, Senior Associate, Employment, and Sarah Hitchins, Associate, Regulatory, Allen & Overy

David Cummings, Senior Associate, Employment, Allen & Overy

Robbie Sinclair, Senior Associate, Employment, Allen & Overy

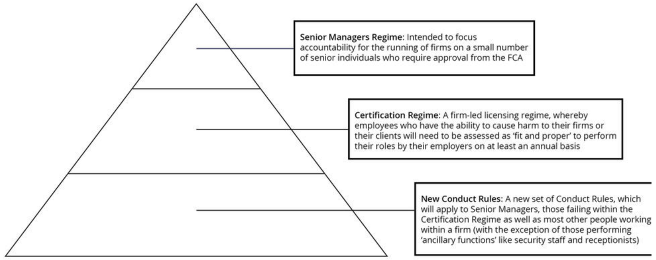
Sarah Hitchins, Associate, Regulatory, Allen & Overy

The Senior Managers and Certification Regime (SMCR) is due to apply to asset and fund managers from 2018. However, to date, the Financial Conduct Authority (FCA) has remained tight-lipped as to what the SMCR will look like for asset and fund managers.

In this article, we explore what the SMCR is likely to look like for asset and fund managers, as well as what firms can be doing now to prepare themselves for the forthcoming FCA consultation process and implementation programmes.

What is the SMCR going to look like for asset and fund managers?

The FCA) has not publicly commented about what the SMCR will look like for asset and fund managers. However, it is very likely that the basic structure of the SMCR will mirror what has already been put in place for banks and building societies, namely:



There may be some differences between the SMCR that applies to banks and building societies and the SMCR that applies to asset and fund managers – for example, the categories of people who will fall within each of the three layers of the new regime set out above.

Avoid starting with a blank piece of paper

Some asset and fund managers might feel that the prospect of implementing the SMCR is a daunting one, even before the FCA's consultation process starts. However, based on our experience of advising banks and building societies in relation to the implementation of the SMCR, this process need not be so daunting. Instead of scrapping current arrangements and starting from scratch, firms may be able to enhance, adapt and supplement their existing arrangements in order to meet the requirements of the SMCR. This approach may make for a smoother (as well as more time and cost effective) transition to the SMCR. With this in mind, even before the FCA starts to consult on the SMCR for asset and fund managers, firms may wish to undertake a 'health check' of their existing arrangements in areas such as governance, record keeping, policies and procedures and remuneration. This will help firms to be in the best position possible prior to any FCA consultations.

Governance

One of the key objectives of the SMCR is to clarify precisely who is responsible for what within a firm. When identifying who needs to be designated as a Senior Manager or a Certified Person, asset and fund managers will need to have a clear idea about who is responsible for what within their organisations. One way to get a head start on this process is for firms to ensure that employees have up-to-date job descriptions which accurately reflect their roles and responsibilities.

Now would also be a good time for asset and fund managers to ensure that reporting lines and delegation arrangements are clear and work effectively in practice. To the extent they do not already exist, up-to-date organisational charts should also be drawn up, so that responsibilities, reporting lines and delegations are accurately mapped out, especially at the most senior levels within firms.

New hires

A number of the banks and building societies we have assisted with implementing the SMCR have taken the opportunity to update their employment contracts for Senior Managers and Certified Persons. This is important because contracts drafted with a view to compliance with the old approved persons regime do not necessarily reflect the requirements of the new regulatory landscape in which staff subject to the SMCR are working.

Although the detail of the SMCR that will apply to asset and fund managers has not yet been fleshed out, now would be a good time to start thinking about how existing contract templates can be tweaked and strengthened before the new regime is implemented. With careful drafting, contracts can be appropriately updated even before the detail of the regime is set in stone and some of the key changes to consider are as follows:

- Update any references to the existing approved persons regime to include equivalent regulatory provisions and requirements (i.e. SMCR).
- Make employment conditional on holding any regulatory status that is

required for the employee to perform their role under the regulatory regime in force at the appropriate time, whether it be by approval by the regulators or through certification by the firm (as will be required under SMCR).

- Require new hires to warrant that they are fit and proper to perform their roles – this will be a key requirement for both Certified Persons and Senior Managers.
- Consider expanding any existing duties clause to reflect the new duties to which employees will become subject when the SMCR applies to them.
- Require new hires to complete a full handover of their responsibilities on termination of their employment (likely to be a key regulatory requirement for Senior Managers) or to assist with any such handover (an important role for Certified Persons to whom a departing Senior Manager has delegated responsibilities).
- Extend any existing grounds for summary dismissal to include non-compliance with any regulatory framework, e.g. under SMCR, ceasing to be approved by the regulators or failing to be certified by the firm as fit and proper.

Significant Influence Function holders

Some individuals who currently perform Significant Influence Functions (SIFs) will be designated as Senior Managers under the SMCR. As Senior Managers, their actions and inactions are likely to be subjected to a higher degree of scrutiny by the FCA, especially given the FCA's continued focus on individual accountability. Under the SMCR, Senior Managers are required to take reasonable steps to prevent a breach of regulatory requirements from occurring or continuing in their area(s) of responsibility. If the FCA can prove that a Senior Manager failed to do so, it may take enforcement action against that Senior Manager personally. This is similar to what the FCA may do in relation to SIFs under the current approved persons regime. As a result, asset and fund managers may wish to review or 'stress test' their current SIF arrangements, in order to assess in advance of the SMCR whether they would stand up to regulatory scrutiny.

Record keeping

Since the implementation of the SMCR in March 2016, a number of banks and building societies have been reviewing their record keeping procedures in light of the SMCR. Key areas of focus have included:

- How long email records and back-up tapes are retained for.
- Whether a central electronic storage space should be set up to store core documents relating to the SMCR.
- To what extent should notes be taken of informal discussions and meetings attended by Senior Managers.
- How should hard copy records (for example, day books) be retained.
- What access should Senior Managers be allowed to have to firm records after they have left the firm.

Most asset and fund managers are already likely to have policies and procedures in place to manage how these kinds of documents should be stored and retained. However, it would be advisable for these policies and procedures to be checked, in order to ensure that they remain fit for purpose – both now and also under the SMCR.

Policies and procedures

The new requirements of and terminology associated with the SMCR are likely to mean that a number of existing policies and procedures will require amendment. Some of these policies and procedures will only require light amendments, whereas others may require more substantial editing in light of the SMCR. In addition, it is likely that asset and fund managers will need to introduce new policies and procedures to take account of the SMCR. For example, a policy setting out how a firm undertakes its obligations under the Certification Regime to assess the fitness and propriety of certain employees. A number of banks and building societies also opted to introduce new policies which, although not strictly required under the SMCR, set out for employees what the SMCR meant for them.

In the lead up to the SMCR applying to asset and fund managers, now would be a good time for firms to ensure that their current suite of policies and procedures are up-to-date, and meet current requirements. This approach will help to simplify the process of updating and amending these policies and procedures to take account of the SMCR, when this time comes.

Training

A point that the FCA has been keen to emphasise for banks and building societies is that it is key that employees understand how the new Conduct Rules apply to them and their specific responsibilities. The FCA has already tried to emphasise this point to the industry through recent enforcement action it has taken against firms that featured training provided to employees. However, under the SMCR, 'one-size-fits-all' training programmes really are likely to become a thing of the past.

Given that the vast majority of a firm's employees are likely to be subject to the new Conduct Rules (i.e. not just Senior Managers and those falling within the Certification Regime), this type of more bespoke training will need to be prepared for and rolled out to a much broader population of employees. Firms will also need to take steps to ensure that accurate records of training completion are maintained, and that those who fail to complete mandatory training (whether on the Conduct Rules or other topics) are dealt with appropriately.

Disciplinary

Any matter capable of amounting to a breach of the new Conduct Rules or which calls an individual's fitness and propriety into question may well impact on that individual's ability to continue in their role, and may also be reportable to the regulators. It is also likely to fall within the ambit of the firm's HR disciplinary policy.

This overlap presents three key challenges for asset and fund managers to consider:

1. How to ensure that adequate policies and procedures are in place to assess disciplinary matters, as well as potential breaches of the Conduct Rules and an individual's fitness and propriety;
2. How to ensure that the documentation governing these three issues dovetails; and
3. How to ensure that the functions responsible for the relevant policies and procedures work together to ensure the appropriate, and consistent, outcome.

> "Proportionality in respect of these issues are still likely to be relevant across the asset and fund management in the industry which may give firms some flexibility in this respect at least in the short term"

Potential difficulties can be avoided if firms prepare early. Some new policies will certainly be needed – such as procedures to assess fitness and propriety and potential breaches of the new Conduct Rules. Asset and fund managers will also need to think carefully about who will own these policies (most likely compliance, with HR running the disciplinary side) and, most crucially, how relevant stakeholders operate these policies in practice. The most effective solution is likely to be some form of panel approach, with representatives of compliance, HR and other relevant functions convening to determine which procedures need to be followed and at what stage. In addition, we have found that this panel approach is extremely helpful in ensuring consistency of treatment. Record keeping (discussed above) will also be key throughout any disciplinary and compliance processes, both to ensure that the rationale for all decisions is adequately documented at every stage, and that outcomes affecting individual employees are adequately recorded and maintained on the system for the requisite regulatory period.

Remuneration

The SMCR and remuneration regulations are closely linked. Both focus on accountability and managing risk and reward. The remuneration codes (at least in part) inform the scope of the population of Certified Persons – i.e. those individuals who are "material risk takers" for the purposes of the UK remuneration codes - and also prescribe how the remuneration of Senior Managers and Certified Persons should be structured.

The precise scope of an asset and/or fund manager's likely population Certified Persons is unclear at this stage. However based on the current SMCR in force across the banking sector, at a minimum, Certified Persons will be existing 'material risk takers' under the relevant remuneration codes, in addition to other individuals performing client-dealing functions which require qualifications and head material business units. The identification of Certified Persons has been a complex task in practice for banks and building societies under the SMCR, so asset and fund managers should take the time now, as a first step, to consider which individuals may fall within the scope of the Certification Regime based on its existing Remuneration Code population.

In view of the SMCR's focus on individual accountability, asset and fund managers should also consider how remuneration plans and decisions can be adapted in practice to best reflect likely future requirements. For example, it may be appropriate to consider the appropriateness of any bad leaver, malus and/or clawback provisions that exist (or may not exist at this stage) in any discretionary variable incentive plans and/or to provide for the introduction of such ex-post/performance adjustment mechanism and/or additional triggers - for example - where it is determined that an individual is not fit and proper or has breached the new Conduct Rules, or fails to be approved by the regulators as a Senior Manager or to be certified by the firm.

Proportionality in respect of these issues are still likely to be relevant across the asset and fund management in the industry which may give firms some flexibility in this respect at least in the short term. However, the clear expectation of the regulators across the financial sector more widely is wide-spread use of performance adjustment mechanisms as inherent tools for firms to more effectively manage and balance risk and reward in respect of remuneration, combined with greater individual accountability under the SMCR. The same regulatory expectation will apply across the asset and fund management sector.

More generally, asset and fund managers will face a range of different - and at times intersecting - regulation when it comes structuring the remuneration of its Senior Managers and Certified Staff over the coming years at both sector and product level; including the Capital Requirement Directives, AIFFMD and UCITSV and MiFIDII, which will present challenges from a compliance perspective. Asset and fund managers should invest time now to understand this regulatory landscape, its impact on employees and its dovetailing with the added layer of regulatory compliance and expectations that will attend the implementation of the SMCR across the industry.

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ESMA guidance published on application of the AIFMD passport to non-EU countries - Go slow persists

By Bronwyn King, Counsel, Harneys, Hong Kong

Summary

It is business as usual for AIFs and AIFMs in non-EU countries, including the Cayman Islands, the British Virgin Islands and Bermuda, who must continue to comply with NPPRs in each EU Member State they wish to market into, which will be available until at least July 2018.

Bronwyn King, Counsel, Harneys, Hong Kong

On 19 July 2016, the European Securities and Markets Authority (ESMA) published its latest advice to the European Parliament, the European Council and the European Commission on the application of the Alternative Investment Fund Managers Directive (AIFMD) passport regime to asset managers and investment funds domiciled in non-EU countries.

The scope of the AIFMD is extremely wide and, with some limited exceptions, applies to EU and non-EU domiciled alternative investment fund managers (AIFMs) managing or marketing EU-domiciled and/or non-EU domiciled alternative investment funds (AIFs) to investors in the EU. AIFMs in countries outside the EU or Non-EU AIFs managed by EU AIFMs are currently required to comply with the National Private Placement Regimes (NPPR) in each EU Member State they market into. Under the AIFMD, ESMA was tasked with advising the European Parliament, the Council and the Commission on (a) how the existing passport mechanism has functioned for EU AIFMs marketing EU AIFs (b) how EU AIFMs have marketed non-EU AIFs (c) how non-EU AIFMs have marketed AIFs under the NPPR, and (d) the application of the AIFMD passport to AIFMs and AIFs domiciled outside the EU.

ESMA's assessment commenced in November 2014 with ESMA seeking views from market participants at that time. These views were published in January 2015, and in July 2015, ESMA published its first advice (the Initial Advice) having assessed six jurisdictions (Guernsey, Hong Kong, Jersey, Switzerland, Singapore and the United States)(the Initial Jurisdictions) out of 22 which had been identified as being the domicile of non-EU

AIFMs that market AIFs in EU Member States. In its initial advice, ESMA called for a slow-down in approach. ESMA advised that it was too soon to give a definitive opinion on how the passport regime and various NPPRs had been working. ESMA also advised that a country-by-country assessment was necessary in order to appropriately advise on the possible extension of the AIFMD passport to “third countries”, recommending that the Commission delay the extension of the AIFMD passport regime to any “third country” until ESMA had given positive advice to a sufficient number of the 22 identified “third countries”.

At the prompt of the European Commission, ESMA published its second advice relating to the extension of the passport regime to “third countries” on 19 July 2016 (the 2016 Advice). The 2016 Advice provided a follow up assessment on the Initial Jurisdictions assessed under the initial advice, and fresh assessments on a further six jurisdictions (Australia, Bermuda, Canada, Cayman Islands, Isle of Man and Japan) in the list of 22 jurisdictions.

In the latest round of assessments, ESMA definitively assessed Canada, Guernsey, Japan, Jersey and Switzerland as having no significant obstacles impeding the application of the AIFMD passport, however, the advice relating to the remaining seven “third countries” that were considered contained (the United States, Hong Kong, Singapore, Australia, Bermuda, Cayman Islands and Isle of Man) qualifications to varying degrees.

The persistent message coming out of the 2016 Advice suggests a continuation of the “go-slow” theme in the Initial Advice, with ESMA suggesting to the European Commission once again that they may wish to consider delaying the application of the AIFMD passport regime to “third countries” until ESMA has had the opportunity to deliver positive advice on a sufficient number of non-EU countries.

For those non-EU countries that have not yet received a positive assessment this recommendation may come as a relief from the perspective of creating a level playing field amongst the AIFs and AIFMs domiciled in non-EU countries that participate in asset management in the EU, particularly those jurisdictions such as the BVI, that patiently await any form of assessment. Yet, for the industry, a further call for deferral may come as a disappointment especially to those who have been awaiting positive guidance whilst either complying with the applicable NPPR regime in each relevant EU Member State where they market, or, in some cases, ignoring EU-sourced capital all together until clearer guidance is forthcoming.

The 2016 assessment - Cayman Islands and Bermuda

For each of the countries being assessed by ESMA, consideration is given to whether there were significant obstacles to applying the AIFMD passport regarding investor protection, competition, market disruption and the monitoring of systemic risk. For the Cayman Islands and Bermuda ESMA confirmed its view that there are no significant obstacles regarding competition and market disruption impeding the application of the AIFMD passport to those jurisdictions. ESMA has however delayed giving definitive advice in relation to the extension of the AIFMD passport to Bermuda and the Cayman Islands on the grounds that both countries are in the process of implementing new AIFMD-like regulatory regimes which will need to be assessed to determine whether they satisfy the criteria on investor protection and effectiveness of enforcement.

In relation to Bermuda, ESMA was also of the view that no definitive advice could be provided until the Bermuda Monetary Authority (BMA) has completed its review of the Investment Funds and Management framework under the Investment Funds Act 2006, in particular in relation to enforcement (on which new legislation is due to be adopted imminently).

In relation to the Cayman Islands, ESMA was of the view that no definitive advice could be provided with respect to the assessment of the effectiveness of enforcement and the monitoring of systemic risk until legislative changes (currently in the pipeline) are adopted in relation to imposing administrative fines and breaches of regulatory laws, and until the Cayman Islands Monetary Authority (CIMA) has implemented a macro-prudential policy framework which is expected to enhance systemic risk monitoring (such implementation is also expected to occur shortly).

ESMA did acknowledge in its advice that the interim versions of the draft AIFMD-like regulations proposed to be adopted in Bermuda and Cayman (which are not yet in force) would be very similar (in the case of Bermuda) and broadly similar (in the case of Cayman) to the AIFMD framework, but that this would need to be confirmed having regard to the final published versions (in the case of Bermuda) and related implementing regulations.

The European Parliament, the European Council and the European Commission now have to decide how to proceed and whether to activate the extension of AIFMD passporting to those countries which have received a positive assessment by ESMA. If they follow ESMAs advice to defer, it seems unlikely that passporting will be extended to third country AIFMs and AIFs until a positive assessment has been made in respect of a larger number of countries.

For now, it is business as usual for AIFs and AIFMs in non-EU countries, including the Cayman Islands, the British Virgin Islands and Bermuda, who must continue to comply with NPPRs in each EU Member State they wish to market into, which will be available until at least July 2018. We expect that when AIFMD passporting is extended, the Cayman Islands, the British Virgin Islands (which is following the lead of the Cayman Islands in preparing for ESMA's assessment) and Bermuda are likely to be included in the list of approved third countries.

The foregoing is for general information only and not intended to be relied upon for legal advice in any specific or individual situation.

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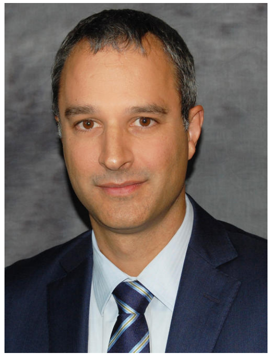
Opening up Australia's financial services industry

By Ben Benson, Special Counsel, and Elizabeth Hastilow, Partner, K&L Gates



Ben Benson, Special Counsel, K&L Gates

Elizabeth Hastilow, Partner, K&L Gates

Australia's financial services sector sits at the core of its economy. With around $2.5 trillion in assets managed from Australia, its investment management market is ranked the fourth largest in the world and the largest in the Asia-Pacific region. However, considering less than 5% of those assets represent funds sourced from overseas, the industry could be viewed as relatively insular. In recent years participants and the government alike have recognised the benefits of opening up the industry by facilitating foreign managers operating in Australia and the ability of local managers to capture foreign capital.

Building upon this mutual recognition, waves of policy reforms aimed at breaking barriers and creating opportunities have emerged and which, once fully implemented, will strengthen all aspects of Australia's financial services industry.

Johnson Report reforms

Competition among financial services centres for highly mobile global capital is intense. To enhance inbound investment into Australia and the offshore activities of Australian fund managers, the government and industry have been forced to address a number of barriers. As part of that effort the government established the Australian Financial Centre Forum which has been the driving force behind many of the recent reforms. The Forum's review of the financial services sector resulted in its 2009 report *Australia as a Financial Centre – Building on Our Strengths* (the Johnson Report) and set out a number of key recommendations, including the implementation of the following:

- An Asia Region Funds Passport (Passport);
- New tax flow-through collective investment vehicles (CIVs) such as corporate vehicles and limited partnerships that are familiar to foreign investors; and
- Tax exemptions and concessions for foreign investors.

Each of these have recently reached noteworthy milestones.

Passport to growth

On 28 April 2016 representatives from Australia, Japan, South Korea and New Zealand signed the final Memorandum of Cooperation (Memorandum) setting out the internationally agreed rules and cooperation mechanisms for the Passport. The Memorandum came into effect on 30 June 2016 and has also added Thailand as a signatory. It is anticipated that Singapore and the Philippines will also follow. The Passport, expected to be operational by the end of 2017, will be the most far-reaching multilateral regulatory framework in the Asia-Pacific region allowing for the cross-border marketing and distribution of certain collective investment schemes. Participating economies are required to implement any legislative arrangements necessary to give effect to the "Passport Rules" regulating the operation of "Passport Funds" within 18 months from 30 June 2016. It should be noted that many 'hedge funds' will not qualify as a Passport Fund because of the restrictions on borrowing, short selling and other aspects of a fund's portfolio allocation imposed by the Passport Rules.

The Passport is widely seen as a key building block to increasing financial integration across the Asia-Pacific region and, in particular, to facilitating the flow of capital into the region's equity and debt markets. The Passport is considered an enabler for the growth of regional savings and the creation of investment products specifically designed in the region, including for the region's growing retirement population and wealthy middle class looking for investment solutions to meet their specific needs. The Passport presents a powerful opportunity for fund managers from participating economies to target new markets across the region.

Improving access to offshore markets for local managers might be expected to provide cost savings through increased scale, enhance regional experiences providing further opportunities to export those skills with flow on consequences for the wider economy. Offshore fund managers selling products into a domestic market might also be expected to benefit that domestic economy by providing greater competition and investment choice for investors putting downward pressure on fees. The Asia-Pacific Economic Cooperation estimates that the introduction of the Passport will create approximately 170,000 new jobs in the Asia-Pacific region over the next five years and save Asian investors US$20 billion per annum in investment management costs.

"The Passport is widely seen as a key building block to increasing financial integration across the Asia-Pacific region and, in particular, to facilitating the flow of capital into the region's equity and debt markets"

Ben Benson, Special Counsel, K&L Gates

However, there remain two major reasons why a foreign investor might be unwilling to invest in an Australian product: unfamiliar vehicles providing tax flow through treatment and complex, uncertain, and uncompetitive tax treatment. Each of these impediments is also in the process of being addressed in preparation for the implementation of the Passport.

New Collective Investment Vehicles

The 2015/2016 Federal Budget ushered in a new era in investment management in Australia with the announcement that the Federal Government will introduce a new tax and regulatory framework for two new CIVs. The two new CIVs will consist of a corporate CIV and a limited partnership CIV. In accordance with the Budget announcement, the corporate CIV will be introduced by 1 July 2017 while the limited partnership CIV will be introduced by 1 July 2018. Both the corporate and limited partnership CIVs will be required to meet similar eligibility criteria as managed investment trusts (the current vehicle of choice for hedge funds and other pooled funds). For example, they will need to be widely held and be engaged in primarily passive investment.

> "Successful implementation of the Passport requires tax neutrality to ensure that domestic and foreign funds offered in the same jurisdiction are not subject to divergent or discriminatory tax treatments"
>
> Ben Benson, Special Counsel, K&L Gates

These new CIVs will be crucial for Australian fund managers and operators in the context of the Passport but will also provide an attractive vehicle to fund managers outside of the Passport regime. It is expected that if appropriate models are developed and combined with corporate and tax rollover relief, many managers may rollover their existing suite of funds to one of the new CIVs.

For Australian managers to operate in the Passport, Australia requires alternative forms of collective investment vehicles. Presently, the sole form available in Australia is the unit trust operated as a managed investment scheme. While it has been a mostly robust structure in Australia, it is unique to Australia, not used anywhere else in the world and is unfamiliar to foreign investors. Traditionally, foreign investors have been dissuaded from investing in Australian funds due to their lack of familiarity with the unit trust structure and some of the legal consequences arising from its use. This can put off investors entirely or require an Australian manager to devote significant time and resources to engender the level of comfort and understanding required before an investor is willing to deploy capital outside its home jurisdiction. Foreign investors are, however, very familiar with both corporate and limited partnership CIVs and so their introduction can only boost efforts to attract offshore capital to Australia.

The new corporate and limited partnership CIVs are expected to:

- Enhance the ability of Australian fund managers to utilise the Passport;
- Reduce barriers associated with

- Australia's unit trust structure by providing alternative investment vehicle options for foreign investors;
- Attract new foreign investors to Australia; and
- Improve the overall marketability of Australia's managed funds internationally.

However, the new CIVs must form only part of the new landscape. Successful implementation of the Passport requires tax neutrality to ensure that domestic and foreign funds offered in the same jurisdiction are not subject to divergent or discriminatory tax treatments. Continued reform to the rules regulating the taxation of foreign investors will therefore be needed.

Investment Manager Regime and Attribution Managed Investment Trusts

Between 2012 and 2015 Australia introduced an Investment Manager Regime (IMR) intended to remove tax impediments to investing in Australia with the aim of attracting foreign investment and promoting the use of Australian fund managers. The IMR is designed to place individual foreign investors that invest into Australia through a foreign fund in the same tax position in relation to disposal gains and disposal losses as they would have typically been had they made their share of the fund's investments directly (rather than through the fund). The regime is also designed to ensure that when a foreign investor invests through an independent Australian fund manager it will be in the same position, in relation to disposal gains and losses, as if it had invested directly.

Australia has also recently introduced a new tax system for certain managed investment vehicles (to be known as Attribution Managed Investment Trusts or AMITs) which elect into the regime. The underlying reason for introducing the AMIT regime is to provide greater certainty for investors, and for funds managers, as to the operation of the tax rules which apply to manage investment trusts. The current regime, designed historically for closely held investments, has been considered unsuitable for wholesale and retail funds.

> "The Investment Manager Regime (IMR) [is] intended to remove tax impediments to investing in Australia with the aim of attracting foreign investment and promoting the use of Australian fund managers"
>
> Ben Benson, Special Counsel, K&L Gates

Australia currently has a Managed Investment Trust (MIT) regime targeted at foreign investors seeking to make passive investments in Australian assets, particularly real property and infrastructure assets. This regime allows trust assets to be treated as being on capital account, so that any gains on realisation of those assets (other than direct and indirect interests in Australian real property) are generally exempt from tax in the hands of an offshore investor. The current MIT regime also imposes a final and concessional tax on taxable gains and on rent income generally at the rate of 15%. AMITs, as a type of MIT, will be entitled to these concessions. The main advantages of the new AMIT regime are:

- The ability to attribute income types on a fair and reasonable basis;
- An AMIT is treated in many respects as a fiscally transparent vehicle as trust income retains its character when distributed, and investors are treated as if they had received the item of income directly;
- The ability to segregate for tax purposes the assets and liabilities between classes; and
- Where a trustee is unable to accurately calculate investor entitlements at year end, and a variance to the true number is later discovered, an 'overs and unders' regime allows the variance to be reconciled by adjusting members' entitlements to trust income in the year of discovery, rather than (as is currently the case) requiring investor statements to be re-issued, and investors potentially needing to seek amendments to tax returns lodged.

Conclusion

Australia's investment management industry is internationally recognised for its size, sophistication, efficiency and competitiveness. It has developed its well-earned reputation largely around its effectiveness in managing a large domestic pool of assets. Its skills have outgrown this significant pool and are attractive to overseas investors. The series of interconnected policy reforms when implemented in an integrated fashion will combine to assist Australia's investment management industry in becoming both a significant exporter of financial services products and a key contributor to Australia's gross domestic product.

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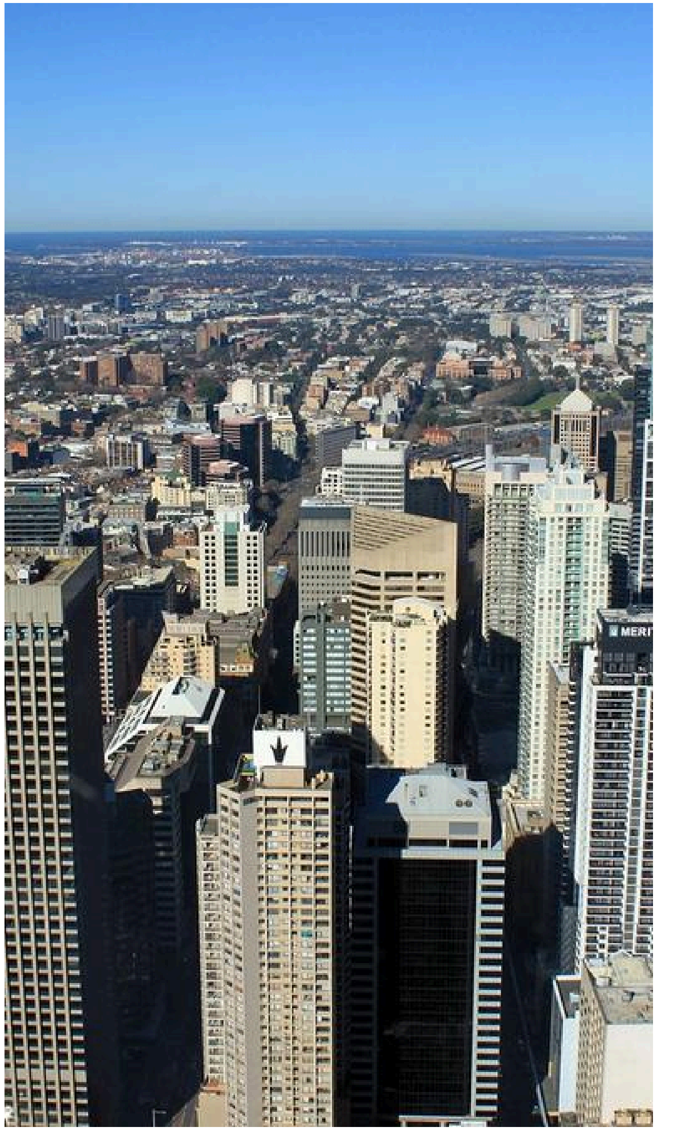

Capitalising on today's data management dynamic

By John Randles, Founder & CEO, Bloomberg Polarlake

John Randles, Founder and CEO, Polarlake

Having entered the market offering new and unique investment strategies, hedge funds tend to try to find their own way when it comes to introducing supporting technology and processes.

Many have chosen to cope with business and regulatory requirements by creating and implementing an internal technology stack. They either built their own solutions, or bought packaged applications, believing this would not only allow them to meet their exact needs, but also deliver competitive advantage by leveraging their firm's DNA.

Over the last 10 years, however, the reality is that more generic demands have entered the financial markets, ranging from regulation and risk management, to data governance and reporting. These demands have increased the rationale for a data management utility.

The need for a data management utility

The one constant across recent developments has been the need for accurate data, without which there could be no hope of meeting regulatory and business requirements, and improve cost management and operational efficiency. Although hardly a new concept, the regulatory and business demands surrounding data are widening considerably, leading to increased demand for:

- Improved data quality
- Transparent data governance
- Rapid integration with ever changing business processes
- Improved operational control and cost management

Hedge funds are again confronted with a range of possibilities, from building their own technology solutions, managing vendor and internal data via their own data management teams, to outsourcing technology, staff or both.

But having gone through these options already, they have come to one major conclusion: –"here is one arena of our business that is *common* across the industry - we all have to manage data." As a result, the search is on for a data utility.

Simplifying data management

But what should an industry-wide data utility provide in order to meet the needs of the largest and smallest of its users, at a cost that matches their individual business needs? Above all, it has to simplify data management for all of its users. As a result, this must deliver lower data management costs. The data utility must improve data quality, cleansing and managing data across multiple data sets. To allow all users to benefit from industry-wide knowledge and experience, automation must be applied wherever practical.

> "Here is one arena of our business that is common across the industry - we all have to manage data"
>
> John Randles, Founder and CEO, Bloomberg Polarlake

It must deliver in-built data management processes ranging from data vendor notification management, and physical data delivery to the application of data quality rules and exception handling. These processes should be available over multiple data sets ranging from instrument data to pricing data, index data, corporate actions data, positions data and legal entity data.

Challenges and key requisites

The term "utility" doesn't mean sophistication isn't needed. Linking data sets is key to a holistic approach to data management, which is what regulation ultimately requires of hedge funds. Whether it be AIFMD, EMIR, MAR, Form PF, MiFID 2, Solvency 2 or UCITS; data quality, data interdependency, data governance and operational and process control of data are all key to meeting current and ongoing regulatory requirements.

Equally, transparency and governance must be supported at a minimum by quality audit trails which not only record data changes and lineage, but also record changes to business rules and the application of exception processing. Firms should be able to choose which components they wish to use, the data vendors they need for specific tasks and volume of data they receive. In essence, they need a national grid which offers content as required.

They must also be able to choose the level of service they require. This could include deciding whether exception management is to be handled by the utility or by the firms themselves.

Visibility is also essential. Access via data management workstations to visualise the processing of data through the utility must be available, at a minimum. Exception management and new instrument set-up should also be offered.

The utility must also present low-risk to firms, ensuring that they on-board to an existing service which will be available for many years to come.

Available today

Such utilities are in operation today. Hedge funds businesses have the immediate opportunity to capitalise on this dynamic and on the ground work that has already been carried out to benefit from:

- Improved data quality
- Lower data management costs
- Avoiding the constant software and hardware upgrade and maintenance cycle

For once, it is possible to gain immediately from the experiences of others by taking advantage of what is common across the financial community, whilst meeting the very individual needs of your own firm.

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The Luxembourg Reserved Alternative Investment Fund - A change-maker for AIFs

By Johan Terblanche, Partner, Marc Seimetz, Partner, Patrick Goebel, Partner, and Jean-Louis Frognet, Dechert LLP

Introduction – Background

The entry into force of AIFMD[1] resulted in a double layer of regulation, as there was regulation and supervision at the level of the product (regulated investment funds) and supervision at the level of the manager (AIFM)[2].

There are currently three types of investment funds in the alternative asset management industry in Luxembourg which are subject to the supervision of the Luxembourg supervisory authority, the Commission de Surveillance du Secteur Financier (CSSF):

- Undertakings for collective investment[3] (“Part II UCIs”) under part II of the law of 17 December 2010 on undertakings for collective investment, as amended (the "UCI Law"), which do not qualify as UCITS and whose units can be offered to any type of investor including retail investors ;
- Investment companies in risk capital[4] (SICARs) under the law of 15 June 2004 on investment companies in risk capital, as amended (the SICAR Law) which are reserved to well-informed investors and whose investment policy is restricted to investments in securities representing risk capital; and
- Specialized investment funds[5] (SIFs) under the law of 13 February 2007 on specialized investment funds, as amended (the SIF Law) which are reserved to well-informed investors and can invest in virtually any type of asset.

Largely inspired by the SIF Law and the SICAR Law, the reserved alternative investment fund (RAIF) was enacted by the law of 23 July 2016 on RAIFs (the RAIF Law) which became effective on 1 August 2016 offering greater flexibility on the product side by avoiding the double layer of regulation as the RAIF will not be authorized by the CSSF.

A comparison with a selection of other European regimes can be seen at the end of this article. The RAIF is available in a variety of legal forms.

Qualification as an AIF – Appointment of an external authorized AIFM

The RAIF is an undertaking for collective investment and must be an alternative investment fund (AIF)[6]. Unlike the SIF or the SICAR, the RAIF cannot be structured as a non-AIF[7].

The RAIF must always be managed by an external manager that is an authorized AIFM and cannot be managed by a manager that seeks exemption from the AIFMD under the sub-threshold regime of article 3(2) of the AIFMD[8] (the Sub-Threshold Regime).

Although the RAIF will not be authorized by the CSSF, the AIFM must ensure that the RAIF complies with the terms of the AIFMD. The RAIF is therefore indirectly regulated, as it is managed by an external AIFM that in turn must be authorized and ensure compliance by the RAIF with AIFMD requirements.

Comparison of the RAIF's main features to other Luxembourg fund vehicles

	Luxembourg ordinary company (e.g. SCS or SCSp)	Part II UCI	SIF	SICAR	RAIF
Qualification as an AIF	Generally, an ordinary company is a non-AIF unless its activities fall within the scope of article 1(39) of the AIFM Law	Always an AIF.	In principle, an AIF but can be structured as a non-AIF.	In principle, an AIF but can be structured as a non-AIF.	Always an AIF.
Exemption from the AIF-MD where the manager is a sub-threshold AIFM	Possible.	Possible.	Possible.	Possible.	Not Possible.
Appointment of an external manager that is authorized as an AIFM	Required if the company is an AIF that is not internally managed and does not seek exemption from the AIFMD under the Sub-Threshold Regime.	Required if the Part II UCI is not internally managed and does not seek exemption from the AIFMD under the Sub-Threshold Regime.	Required if the SIF/SICAR is an AIF that is not internally managed and does not seek exemption from the AIFMD under the Sub-Threshold Regime.	Required if the SIF/SICAR is an AIF that is not internally managed and does not seek exemption from the AIFMD under the Sub-Threshold Regime.	Always required.
Authorization and direct supervision by the CSSF	No.	Yes.	Yes.	Yes.	No.

Investment strategies – Dual regime

Under the general regime inspired from the SIF Law, the RAIF can, in principle, invest in any type of assets and follow any type of investment strategy. However, the portfolio of the RAIF must be managed in compliance with the principle of risk spreading. The RAIF Law simply refers to the requirement of risk spreading (as is the case with the SIF Law), but does not provide further guidance. A RAIF that exclusively invests in securities representing risk capital (the Risk Capital RAIF) is not subject to any risk spreading requirements. The concept of risk capital in the RAIF Law is taken from the SICAR Law and provides that investment in risk capital means the direct or indirect contribution of assets to entities in expectation of their launch, development or listing on a stock exchange. The Risk Capital RAIF must limit in its constitutional documents its investments exclusively in securities representing risk capital.

The governing body of the RAIF and the AIFM have the responsibility to assess the level of risk spreading deemed appropriate for the RAIF's portfolio. The AIFM and the RAIF's governing body (where applicable) may look for guidance to a certain extent to CSSF circular 07/309 on the concept of risk spreading for SIFs and, with respect to Risk Capital RAIFs, to CSSF circular 06/241 on the concept of risk capital for SICARs for guidance on the concept of risk capital.

The constitutional documents of the RAIF must determine whether the RAIF is subject to the general regime or whether the RAIF qualifies as a Risk Capital RAIF. The selected regime applies to the RAIF as a whole and cannot be selected on a compartment basis. It is debatable whether a RAIF may have lending activities as its main objective without falling within the scope of article 28-4[10] of the law of 5 April 1993 on the financial sector, the (the Financial Sector Law). Unlike Part II UCIs, SICARs or SIFs, RAIFs have not been expressly excluded from the scope of the Financial Sector Act[11]. However, it must be underlined that there was no intention of the Luxembourg legislator to make a difference between Part II UCIs, SICARs or SIFs on the one hand and the RAIF on the other hand.

Comparison of the RAIF's investment strategies to other Luxembourg fund vehicles

	Luxembourg ordinary company (e.g. SCS or SCSp)	Part II UCI	SIF	SICAR	Risk Capital RAIF	RAIF
estriction on eligible ssets	No.	No, subject to approval by the CSSF.	No, subject to approval by the CSSF.	Securities qualifying as risk capital.	Securities qualifying as risk capital.	No.
isk spreading requirement	No.	Yes.	Yes.	No.	No.	Yes.
isk capital requirements	No.	No	No.	Yes.	Yes.	No.
oan origination	Restricted to limited circle of previously known persons.	Yes.	Yes.	Yes.	Yes (restrictions may apply)	Yes (restrictions may apply)

Management – Depositary – Administration – Reporting

Any authorized AIFM established in Luxembourg or another EEA Member State can manage any type of RAIF. A non-EEA AIFM will be permitted to manage a RAIF, if, in the future, non-EEA AIFMs are authorized under the passport regime to manage and/or market AIFs in the EEA. A Luxembourg depositary must be appointed for cash monitoring, safe-keeping of assets and oversight duties as required under AIFMD. The depositary can either be a Luxembourg credit institution or the Luxembourg branch of a credit institution established in another EEA Member State. If the RAIF invests mainly in non-financial instruments, is not leveraged and does not grant any redemption rights to its investors during a period of five years after the first investment has been made, the depositary can also be a depositary of assets other than financial instruments in accordance with article 26-1 of the Financial Sector Law.

The administration of the RAIF must be conducted in Luxembourg. As an undertaking for collective investment, the administration and register-keeping of a RAIF can only be entrusted to an administrative agent and registrar authorized by the CSSF under the Financial Sector Law. The RAIF must produce an annual report, which must be made available to investors within six months of the end of the accounting year. The annual report must be reviewed by a Luxembourg statutory auditor (réviseur d'entreprises agréé). Separate annual reports may be drawn up on a compartment basis, provided consolidated information on all compartments is also contained in these annual reports. As any AIF managed by an authorized AIFM, the RAIF must comply with transparency requirements under the AIFMD and be subject to reporting to the AIFM's home regulator on the basis of the template of Annex IV of Commission Delegated Regulation[12].

Comparison of RAIF's management and administration to other Luxembourg fund vehicles

	Luxembourg ordinary company (e.g. SCS or SCSp)	Part II UCI	SIF	SICAR	RAIF
office and tion	Registered office must be in Luxembourg; administration is generally in Luxembourg.	Registered office and administration must be in Luxembourg; administration can only be delegated to a service provider authorized by the CSSF under the Financial Sector Law.	Registered office and administration must be in Luxembourg; administration can only be delegated to a service provider authorized by the CSSF under the Financial Sector Law.	Registered office and administration must be in Luxembourg; administration can only be delegated to a service provider authorized by the CSSF under the Financial Sector Law.	Registered office administration m Luxembourg; adr tion can only be to a service provi rized by the CSSF Financial Sector L
g depositary	Required if managed by an authorized AIFM.	Always required.	Always required.	Always required.	Always required.
nt of an audi-	Required, unless the company is not an AIF managed by an AIFM which does not seek exemption from the AIFMD under the Sub-Threshold Regime and two of the following three criteria are met: (i) balance sheet below EUR 4.4 million; (ii) net turnover below EUR 8.8 million; and (iii) average number of employees below 50.	Always required.	Always required.	Always required.	Always required.

Legal form – Creation of the RAIF

A RAIF can be structured as an umbrella fund with one or more compartments, where the assets and liabilities of each compartment can be segregated from the assets and liabilities of other compartments. The RAIF Law also permits cross-investment between compartments.

A RAIF subject to the general regime can be structured as a common fund (FCP)[13] which is a contractual co-ownership scheme without legal personality. A RAIF in the form of an FCP must always be managed by a Luxembourg management company. This management company can be a Luxembourg AIFM[14]. If the Luxembourg management company is not authorized as a Luxembourg AIFM[15], it must appoint an AIFM either in Luxembourg or in another EEA Member State.

A RAIF can also be structured as an investment company with variable capital (SICAV)[16] whose capital is automatically adjusted to its net asset value. In this case, the RAIF can be an opaque joint-stock company under the form of a public limited liability company (SA)[17], a corporate partnership limited by shares (SCA)[18], a private limited liability company (Sàrl)[19] or a cooperative company formed as a public limited liability company (SCoSA)[20]. The RAIF can be a transparent limited partnership under the form of a common limited partnership (SCS)[21] or special limited partnership (SCSp)[22].

Finally, the RAIF can adopt any legal form available under Luxembourg law when it is neither formed as an FCP, nor as a SICAV. The RAIF can also be structured as a joint-stock company with fixed capital where shares are issued at a nominal value or as a mere SCS or SCSp.

The RAIF (or any of its compartments) can be structured as an open-ended fund where units can be redeemed upon request of the investor or as a closed-ended fund where no redemption right is granted to the investors.

The creation of a RAIF must be acknowledged by notarial deed within five business days following its creation. Within 15 days thereafter, a confirmation (which must name the AIFM of the RAIF) must be deposited with the Luxembourg electronic gazette (Recueil Electronique des Sociétés et Associations - RESA).

RAIFs must be registered on a publicly available list maintained by the Luxembourg trade and companies' register.

	(e.g. SCS or SCSp)				RAIF	
Possibility to adopt variable capital structure	No.	Yes.	Yes.	Yes.	Yes.	Yes.
Possibility to be structured as a common fund	No.	Yes.	Yes.	No.	No.	Yes.
Possibility to create compartments	No.	Yes.	Yes.	Yes.	Yes.	Yes.

Eligible Investors – Marketing of the RAIF

RAIFs are reserved to well-informed investors which are any of the following type of investors:

- Professional Investor[23];
- Institutional Investors as defined by the administrative practice of the CSSF; and
- Any other investor who is neither a Professional Investor, nor an institutional investor, and who, subject to the following, invests or commits to invest at least EUR 125,000 (or equivalent in another currency) in the RAIF and confirms in writing that it will maintain the status of a well-informed investor. Where such an investor wishes to invest less than EUR 125,000 (or equivalent in another currency), such investor's experience and knowledge adequately to appraise the investment in the RAIF must be certified pursuant to an assessment by: a credit institution (within the meaning of Regulation (EU) No 575/2013); an investment firm (within the meaning of Directive 2004/39/EC); a management company (within the meaning of Directive 2009/65/EC); or an authorized AIFM.

A RAIF can be marketed to Professional Investors throughout the EEA under the passport regime, in accordance with the notification process established under the AIFMD. Marketing to well-informed investors who do not qualify as Professional Investors must comply with national rules and can only benefit from the passport if national rules permitted an extension of the use of passport under article 46 of the AIFMD.

A RAIF must have an offering document that contains all information necessary for investors to assess their participation in the RAIF. To avoid confusion with a Part II UCI, a SIF or a SICAR (whose offering documents are approved by the CSSF), the cover page of the RAIF's offering document must clearly indicate that the RAIF is not subject to the supervision of the CSSF. Important information in the offering document must be kept up-to-date before new investors are admitted to the RAIF. Separate offering documents may be established on a compartment basis, provided that the issuing document of a relevant compartment discloses that there are other compartments.

Dual tax regimes

The RAIF other than a Risk Capital RAIF is subject to an annual subscription tax (taxe d'abonnement) of 0.01%. The RAIF is exempt from the subscription tax on, among other items, investments in other Luxembourg undertakings for collective investment subject to the subscription tax. A RAIF whose investment objective is to invest in money market instruments and bank deposits or microfinance, or whose units or interests are held by institutions for occupational retirement or by similar institutions, is also exempt from the subscription tax.

If the Risk Capital RAIF only derives income and capital gains from transferable securities representing risk capital, the Risk Capital RAIF is in practice not liable to any taxes in Luxembourg, except for the minimum tax of EUR 3,000 (EUR 3,210 when the solidarity surcharge is included).

Tax regime comparison of the RAIF to other Luxembourg fund vehicles

	Luxembourg ordinary company (e.g. SCS or SCSp)	Part II UCI	SIF	SICAR	Risk Capital RAIF	RAIF
Subject to ordinary tax regime on profit and wealth	Yes, unless the company is an AIF adopting the form of an SCS or SCSp (which are tax transparent and considered as not carrying out a business activity under circular LIR 14/4 of the Luxembourg tax authorities), provided the general partner formed as a joint stock company does not hold more than 5% of the interests of the AIF.	No.	No.	In principle, a taxable person whose income and capital gains from securities qualifying as risk capital are exempted. Exempted from wealth tax.	In principle, a taxable person whose income and capital gains from securities qualifying as risk capital are exempted. Exempted from wealth tax.	No.
Subject to subscription tax	No.	Annual subscription tax of 0.05% on NAV (with the possibility to reduce the rate to 0.01% or to be exempted).	Annual subscription tax of 0.01% on NAV (with the possibility to be exempted).	No.	No.	Annual subscription tax of 0.01% on NAV (with the possibility to be exempted).

Conversion of an Existing Entity into a RAIF

A SIF or SICAR can be converted into a RAIF in accordance with applicable laws and the provisions of its constitutional documents. The conversion is subject to the prior approval of the CSSF with respect to the amendments of the entity's constitutional documents. A free redemption period may have to be granted to investors who are opposed to the conversion of the SIF or the SICAR into a RAIF.

A non-regulated Luxembourg AIF as well as, in principle, non-Luxembourg AIFs can also be converted into a RAIF. In addition to applicable laws and the provisions governing the constitutional documents of the relevant AIF, the RAIF Law requires the conversion be approved by a majority of two-thirds of the votes cast. The RAIF Law does not require a minimum quorum for the conversion vote.

RAIF – Comparison with similar EU regimes

	Irish QIAIF	French FPI	German Spezial AIF	Maltese Notified AIF	Luxembourg RAIF
Authorization and direct supervision by local regulator	Yes, authorization can be provided within 24 hours.	No.	No.	No.	No.
Possibility to be managed by a Sub-Threshold Manager	Yes, provided the manager will be authorized as AIFM within two years	Yes, but rare.	Yes.	Yes.	No.
Notification by AIFM to local regulator	Required.	Required.	Required.	Required.	Required.
Investment strategy	No restrictions.	No restrictions.	Some restrictions.	Some restrictions.	No restrictions.
Requirement of local members in the governing body	Two Irish residents required.	No specific requirements.	No specific requirements.	One Maltese resident required.	No specific requirement but widely market practice to have at least one resident.

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Footnotes

1 Directive 2011/61/EU on Alternative Investment Fund Managers.

2 An alternative investment fund manager, as defined under chapter 2 of the AIFMD.

3 Organisme de placement collectif (OPC).

4 Société d'investissement en capital à risque (SICAR).

5 Fonds d'investissement spécialisés (FIS).

6 AIFs are collective investment undertakings, including any sub-funds thereof, that: (a) raise capital from a number of investors, with a view to investment in accordance with a defined investment policy for the benefit of those investors; and (b) do not require authorization pursuant to article 5 of Directive 2009/65/EC on undertakings for collective investment funds in transferable securities.

7 SIFs or SICARs that do not raise any capital from investors do not fall within the scope of the definition of an AIF under article 1(39) of the AIFM Law. Examples of such SIFs or SICARs are entities whose access is limited to a predefined group of investors or which have only one investor within the meaning of the ESMA/2013/600, Final Report, and Guidelines on key concepts of the AIFMD.

8 The sub-threshold exemption applies to AIFMs managing assets below EUR 100 million or AIFMs managing assets below EUR 500 million provided no redemption rights are granted to investors during a minimum period of five years after the first investment was made and no leverage is undertaken. AIFMs qualifying for this exemption must only register with their home supervisory authority for the purpose of reporting.

9 Law of 12 July 2013 on AIFMs, as amended.

10 Professionals performing lending operations under article 28-4 of the Financial Sector Law are professionals engaging for their own account in the business of granting loans to the public.

11 Article 1-1 (2) of the Financial Sector Law determining those entities which do not fall within the scope of the Financial Sector Law (including its article 24-8) was not amended when the RAIF Law was adopted with a view to exclude the RAIF as it was previously made for Part II UCIs, SIFs and SICARs. This being said, article 1-1 (2) (r) excludes from the scope of the Financial Sector Law any persons carrying on any activity the taking up and pursuit of which are governed by special laws. The RAIF is governed by a special law, namely the RAIF Law.

12 Commission Delegated Regulation n°231/2012 of 19 December 2012 supplementing the AIFMD with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.

13 Fonds commun de placement (FCP).

14 Such a management company is authorized as an AIFM under article 125(2) of the UCI Law.

15 A management company that is not an AIFM is subject to article 125(1) of the UCI Law.

16 Société d’investissement à capital variable (SICAV).

17 Société anonyme (SA).

18 Société en commandite par actions (SCA).

19 Société à responsabilité limitée (Sàrl).

20 Société cooperative sous forme de société anonyme (SCoSA).

21 Société en commandite simple (SCS).

22 Société d'investissement spéciale (SCSp).

23 The term “Professional Investor” is defined under Directive 2015/65/EU on markets for financial instruments (as amended).

Structuring private credit funds and their asset holding vehicles

By Damien Crossley, Head of Tax, Macfarlanes

Damien Crossley, Head of Tax, Macfarlanes

In the closed ended credit space, we see three core strategies:

- Special Opportunities – funds investing in distressed, stressed and/or mispriced situations, typically but not solely via the secondary market.
- Junior Credit – funds investing predominately in junior or specialist debt with varying levels of equity exposure. These funds are typically investing via the primary market. In days gone by, they may have called themselves mezzanine funds.
- Direct Lending - funds investing in senior secured loans principally via the primary markets.

Notwithstanding these variations in strategy, the structural considerations for these types of closed ended credit fund are similar.

Fund vehicle

To date, the general preference for a closed ended credit fund with a UK or US nexus has been a limited partnership. Not only does this vehicle usually lend itself to the commercial terms of the fund, it is generally considered to be the most tax efficient vehicle for tax paying participators (including carried interest holders) and is also what investors expect to see.

The recent carried interest changes in the UK have caused some managers to revisit this question. On the one hand, those changes might reinforce the structuring of direct lending funds as limited partnerships (given that, in order for a direct lending fund to issue carried interest potentially qualifying for capital gains tax to carry holders who are not employees, the fund has to be a limited partnership). On the other hand, corporate and other non-partnership fund vehicles may reduce the impact of the carried interest tax changes in certain circumstances and this has led to alternative vehicles being considered. In most cases, however, we expect the limited partnership to continue to be the vehicle of choice for closed ended credit funds.

> "The net result of all of this, certainly in the direct lending space, has been an increased desire for EU limited partnership fund structures"
>
> Damien Crossley, Head of Tax, Macfarlanes

Fund jurisdiction

For funds managed or advised out of the UK, the usual choices for limited partnership jurisdictions are (i) England or Scotland; (ii)

Luxembourg; (iii) far offshore (for example, Cayman Islands and BVI); and (iv) near offshore (Guernsey and Jersey). Recently, Ireland has revised its limited partnership regime but we have not since this structure used to date. Previously, the choice was principally tax driven, however, now regulatory factors and investor requirements are equally, sometimes more, important.

For example, if the fund manager wishes to benefit from the marketing passport under AIFMD, both the fund and the manager will need to be EU based. Furthermore, many European institutional investors are requiring onshore structures for tax, regulatory and/or reputational reasons.

Another factor on choice of fund jurisdiction for direct lending funds concerns deployment and the development of new direct lending regimes permitting direct lending within jurisdictions such as Germany and Italy where this was previously prohibited or restricted. While these regimes are still developing, they generally require the fund vehicle to be EU based.

The net result of all of this, certainly in the direct lending space, has been an increased desire for EU limited partnership fund structures. Currently, the only two viable regimes are the UK and Luxembourg. However, a UK structure poses a number of potential problems. First, it is less VAT efficient for the fund manager, although this issue will rarely be decisive. Second, investing offshore cash in a UK fund gives rise to a remittance for any UK resident non-domiciled individual investors in the fund. Finally, the Brexit vote has brought into doubt the AIFM position of UK funds and managers for the future.

Accordingly, the Luxembourg limited partnership has become increasingly popular, particularly for direct lending funds.   The relatively new unregulated Luxembourg limited partnership vehicles (the SCS and the SCSp) has been particularly popular as they avoid the administrative and regulatory headaches that attach to a regulated fund vehicle. The upcoming RAIF regime in Luxembourg may also prove attractive as it will allow for unregulated limited partnerships with bankruptcy remote cells.

However, for managers who are less concerned with the European institutional investor market and keen to avoid some of the burdens of AIFM, the Cayman Islands remains the most popular jurisdiction as this is familiar to US and Middle East investors. Finally, some managers are putting in place parallel or subsidiary fund vehicles in different jurisdictions to meet conflicting investor and investee country requirements.

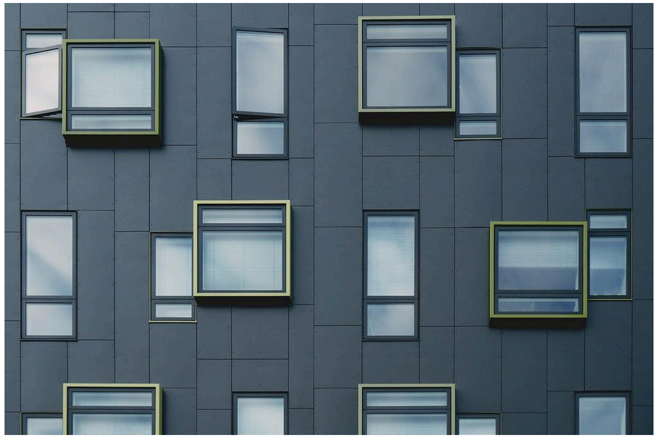
Currency sleeves and hedging

Many credit funds will seek to hedge their underlying investments (not made in their functional currency) back to their functional currency. These hedge contracts are usually put in place at the asset holding SPV level (described in further detail below). If investors of a significant size are seeking to invest in currencies other than the principal currency of the fund, managers sometimes set up currency 'sleeves' structured as parallel partnerships alongside the main fund which accept commitments in that other currency. These sleeves then hedge the underlying investments back to their functional currency. A frequent issue in these cases is whether these currency sleeves should have their own SPV asset holding structure or whether they can share the structure of the main fund. The latter case avoids the need to split trades between different entities but means it is necessary to trace the economics of the appropriate share of each investment and hedge contract back to the appropriate sleeve via the SPV funding documents. This can be complicated where, as is often the case, there is reinvestment within the SPV and the parallel partnerships' relative share of investments varies as FX rates fluctuate.

Asset holding SPV structure

If loans were made and held directly by a limited partnership fund vehicle, the fund would suffer interest withholding tax (WHT) on credit investments in countries such as UK and Spain.

It is usual for European focused limited partnership funds to invest via intermediate investment holding structures (SPVs) with the aim that those SPVs be able to access tax treaties and/or domestic exemptions in relation to investee jurisdictions. These SPVs are usually based in Luxembourg but Irish and UK securitisation vehicles can also be used. While most investors in such funds could access similar benefits if they invested in the underlying asset directly, most jurisdictions (even if they treat a limited partnership as transparent) do not grant limited partners treaty benefits at source. While certain jurisdictions would allow a reclaim of tax by such an investor, this is administratively burdensome and often very slow. Therefore, investors in European funds have, until now, required the funds to structure their investments via SPVs to avoid investee country taxation at source. This structuring has been possible due to the fact that European jurisdictions have not sought to deny SPVs used in this context treaty and similar benefits – this is due to the fact that the arrangements are perhaps not perceived as abusive by these jurisdictions and/or because the tax exemptions themselves do not offer an easy basis for denying their effect.



The ongoing OECD BEPS initiative (which includes a treaty abuse limb and could result in SPVs below funds being denied treaty benefits) is causing funds to look again at their SPV structuring with certain investors who would get treaty or sovereign benefits investing directly querying whether this structuring potentially makes them worse off. The issue with responding to BEPS now is that there is not a readily available alternative to Luxembourg (or equivalent jurisdiction) structuring for a pan-credit fund with a diverse investor base. The structuring works now and it may continue to work post-BEPS and so our advice to clients is not to change structure now but to anticipate potential changes in future. It should be noted that many jurisdictions do not charge WHT on interest and so BEPS related changes should not impact structuring of investments into those jurisdictions. Those jurisdictions include Germany (where the loan is not secured on German real estate), France and Netherlands.

A potential outcome of BEPS could be the imposition of US style limitation on benefits provisions to limit the use by funds of SPVs where they have a high proportion of investors from non-qualifying jurisdictions. This could result in an SPV underneath the main fund not being able to access treaty benefits. In that situation, a fund may wish to separate certain investors into different fund vehicles such that a SPV below at least one such fund vehicle (containing qualifying investors) could access treaty benefits.

In anticipation of such developments, many funds are bolstering their AIV (alternative investment vehicle) language in their fund documents to allow a subsequent reorganisation of the fund structure if necessary to respond to BEPS if to do so would be beneficial to investors. This could include pooling investors with good tax attributes separately from those without such qualities to allow for direct investing and/or investing via a SPV which satisfies any post-BEPS restrictions.

Finally, although managers will structure to minimise investee country WHT and SPV tax leakage, the fund documents will have to allocate the cost of any such taxes between investors and the manager. In other words the documents need to specify to what extent underlying tax suffered in the fund is treated as a fund expense and to what extent it is treated as a distribution to investors. This is important because it can affect the size of carried interest payouts. Historically, transparent fund vehicle documents have typically treated tax suffered within or beneath the top holding company as an expense, with withholding tax on the final distribution to the fund and taxes imposed on the fund vehicle being treated as distributed to investors on the basis that investors may be able to get a credit for such taxes. However, more tailored approaches are now being developed which look to whether the SPV structure has worsened the position of each investor compared to if they had invested in the underlying asset directly.

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General observations on activism, economics and the macroeconomic environment

By Michael Oliver Weinberg, CFA
Senior Managing Director
Chief Investment Strategist, Protégé Partners

We would like to share some of our general observations on activism, economics and the macro environment.

Activism - The prevalent strategies

Activism 101

Shareholder activism has become a prevalent strategy in the hedge fund world. Academic studies, such as the one by Professor Wei Jiang, et al., at Columbia Business School, have demonstrated that activism generates improved operating performance.[1] Activists have a gamut of tools, ranging from financial engineering, such as share repurchases and dividends, to corporate reorganization, such as divestitures, mergers and acquisitions. Activists are typically hedge fund or long-only managers who are inherently well skilled in finance and financial markets. It is therefore not surprising for them to recommend the aforementioned strategies. That said, activists also do recommend operational improvements.

Activism - The less prevalent strategies

Production Capacity

However, based on the studies we have analyzed[2], as well as our empirical observations, it is rare for activists to recommend expanding production. This begs the question why the skew toward recommending trimming production and not expanding manufacturing production. According to the U.S. Bureau of Economic Analysis, between the 1950s and today domestic manufacturing production has declined from a peak of approximately 27% of GDP to a fraction of that level.[3] This is not likely surprising to anyone. China and other lower cost foreign producers have gained share at the expense of the relatively higher cost United States.

Research and Development

Similarly, we rarely see activists espouse increasing research and development (R&D). In fact, often activists recommend the polar opposite, trimming research and development. For example, within the healthcare sector, we've observed a recent trend over the past few years has been for companies to aggressively roll-up other companies, and as part of the cost savings dramatically cut research and development. Until this past summer, these stocks had become prevalent longs among activists and growth stock investors.[4]

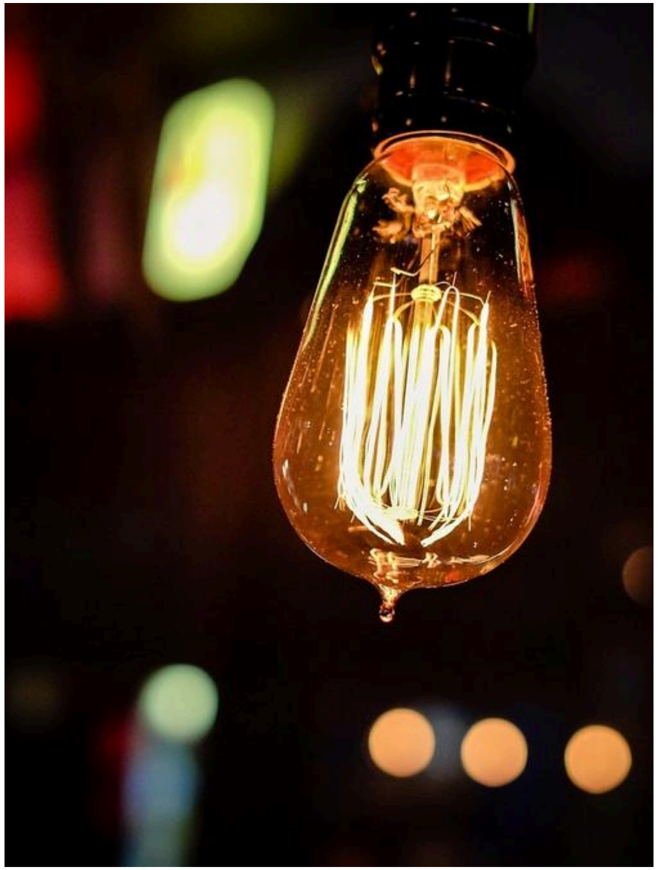
Research and Development

R&D 1.0

Gone from what we will refer to as traditional companies (that is, those that have been around for decades) are laboratories such as that which was part of Bell Labs. Scientists could research what they thought was most interesting, irrespective of immediate commercial applicability. Despite the indifference to immediate profit from their research, many great technological innovations as well as scientific innovations came from Bell Labs and other similar ones. We do not believe thoughtful R&D is entirely gone, rather we believe it has shifted to a different set of companies, which we will now highlight.

R&D 2.0

We believe R&D and innovation has shifted from traditional corporate America to Silicon Valley. The modern day equivalent of Bell Labs is Google and similar companies, where researchers, scientists and technologists may have carte blanche to work on whatever they believe is most interesting, irrespective of near-term commercial viability. For example, Google developed a self-driving car long before the Big 3 auto companies.[5] Similarly, Tesla recently commercialized electric cars before the Big 3 auto companies.[6] Uber commercialized the use of the internet to hail cars, not the taxi companies that will possibly go out of business because of it. Airbnb commercialized the technology to rent individuals homes out by the night, not any of the established real estate or lodging companies.



For those readers that are non-millennials, as this author is, do you remember the Sony Walkman? The iPod should have been a logical invention and extension of Sony's Walkman from decades ago. But it wasn't. It was created by Apple. Sony is of course a traditional Japanese company, rather than a traditional American company, but the analog still holds and the list of technologies invented by Silicon Valley goes on and on.

R&D 2.0 is not irrational for corporate America

We believe that Silicon Valley is American R&D 2.0 and our center of innovation. Traditional corporate America at best plays catch-up. Is this irrational? Not necessarily.   Corporate finance theory 101 theorizes that mature companies are best returning cash to shareholders in the form of dividend or share repurchases.[7] This is exactly what is happening. Corporate America is spending record amounts on share repurchases. R&D is similarly at or near record lows in traditional corporate America.[8] Yet funding of venture capital is near record highs previously achieved during the first technology, media and telecommunication bubble in the late '90s.[9] We believe just as contract manufacturers out-source production of electronic equipment for asset light intellectual property companies, Silicon Valley has essentially out-sourced innovation and R&D from traditional companies.

Productivity

To achieve real economic growth, economies need increases in productivity. Productivity growth has decelerated dramatically over the last few years.[10] In fact, Larry Summers and Ben Bernanke, were in a very public debate over whether this was secular stagnation as alleged by Summers.[11] Though we don't have an answer to this, we believe a study that quantified the aforementioned discussion, on R&D spent by Silicon Valley and traditional corporate America, would potentially provide an insightful answer, though we have not yet seen such a study. In any case, we will leave that for a subsequent discussion. At this time, we will just assume the activity has shifted from one constituency to another. In terms of the two constituencies' future, we will opine that it bodes well for that of Silicon Valley and poorly for traditional corporate America, as the former is likely to grow and the latter is likely to contract.

Global Labor Force

The impact of the internet

The trend toward relatively inexpensive manufacturing, discussed previously, and labor abroad has been prevalent for decades. However, more recent technology and the internet have expanded the developed world's access to inexpensive service labor in addition to the previous access to manufacturing labor. For example, with modern telecommunications, video and the internet, the western world's service sector labor force has expanded dramatically.

Examples

Indian information technology outsourcing and Mexican call centers are well known examples. However, we believe this is just the beginning of this trend. Medicine and other professional services are and will continue to experience similar trends. For example, a radiologist in relatively low-cost Asia, may read an x-ray from a patient in relatively high cost New York City via the internet and send the conclusion via the internet. Similar outcomes may be possible for other professional services such as finance, law, marketing, etc.

Employment

The question one should ask is what impact the expansion of the developing world service sector labor force has on the developed world labor force. We believe the answer is increased competition and supply, at lower prices. The implication is diminished demand for developed world labor and disinflationary, if not deflationary pricing on developed world labor. We believe this is one of the contributing factors to the underemployment rate in the United States since the global financial crisis. Moreover, we fear this trend will only get worse over time. That said, we do believe a solution to diminish this trend is labor force re-education. Those whose skills have become obsolete need to be re-trained with skills that are currently in demand.

China's four excesses

1) - Production

In recent decades, China has built massive production and capacity. If one looks at its foreign direct investment (FDI) as a percentage of GDP it is a record versus other emerging markets over past decades.[12] We are subscribers to George Soros's boom/bust theory: historically, when these other economies reached high FDI to GDP ratios but still below that of China's current ratio, the countries experienced 'busts' that followed what were typically investment driven 'booms.'[13] Somewhat ironically, China has become a relatively higher cost manufacturer compared to other Southeast Asian economies. These economies therefore also provide global production capacity.

2) - Infrastructure

We believe that excessive infrastructure is included in China's FDI. The different layers of government, state owned enterprises (SOEs) and other entities have all contributed to this excess which drove employment and economic growth.[14] We believe there are likely airports, roads, ports and other similar infrastructure with excess capacity that is not likely to be utilized any time soon.

3) - Resources

In recent times, Chinese sovereign wealth funds and SOEs have spent record amounts in both dollar terms and valuations to secure resources.[15] Such resources include iron ore, coal, crude oil and natural gas. For example, these Chinese entities made massive purchases of crude when the price of oil was $100 per barrel and above.[16] Currently crude is approximately $30 per barrel. We believe the same phenomenon holds for the other aforementioned commodities and many not mentioned here.

4) - Real Estate

The fourth component of China's excess is likely real estate. There has been massive speculative activity in Chinese real estate during the economic boom.[17] It is not uncommon for Chinese citizens to own multiple homes or apartments, many of which sit vacant and are not rented.[18] Contrasted with cities like New York or San Francisco there are relatively few if any zoning requirements in Chinese cities.[19] Supply is therefore much more easily able to out-strip demand. This is particularly the case in non-Tier 1 cities, but also the case in Tier 1 cities, such as Beijing and Shanghai. We believe this excess supply includes retail, residential, office and other commercial space. Jim Chanos, a well-known hedge fund portfolio manager, has written about ghost cities, where massive cities have been build and there are no tenants or owners. As previously stated there is infrastructure that goes to and supports these cities that we believe is superfluous.

Two analogs for China

1) - Japan in 1989

We believe China is akin to Japan in 1989. Japan saw its post-war economic boom and its stock market the Nikkei peak in that year.[20] Globally, and particularly in America in the years leading up to and in 1989 there was a perception that Japan was going to become a world economic power, if not the dominant world economic power. The Japanese were using their wealth to buy what were then the world's most expensive impressionist paintings, prestigious golf courses, the world's most desirable real estate (such as Rockefeller Center) and similar risk-seeking assets.[21]

Recently, there has been a similar perception of China to Japan when it was at its peak. For example, in the top New York City schools, Chinese has been added to what were previously exclusively Romance languages. Chinese investors bought the Waldorf Astoria hotel, though not Rockefeller Center as the Japanese once had, just a few blocks away at a record price per room.[22] Chinese Art has achieved record price levels, and Chinese bidders have bid many Western works up to record levels.[23] Similarly, Chinese high end consumers have bid top Bordeaux, Burgundy and Cult California wines up to record levels. For contrast, in the late ‘80s Japanese corporate buyers bought vineyards in Bordeaux.[24]

2) - The sub-prime crisis in the US

The U.S. subprime crisis was a primary driver of the global financial crisis. At the risk of oversimplifying it, this crisis was driven by bad loans that funded purchases of overvalued (or what would become overvalued) real estate. Per our earlier commentary that we believe China is experiencing real estate excesses, we believe that this has partially been financed with debt. We believe debt has also funded the excessive infrastructure, resources and manufacturing capacity that we believe is pervasive. In addition, as the U.S. had its share of frauds unearthed during the global financial crisis, we believe China too will soon have its share. We believe that a significant percentage of this bad debt resides in wealth management products (WMPs) that are relatively unregulated and opaque. Moreover, these products are often rolled-over, which is akin to 'lend and extend.[25] Were investors to demand their principal back, we believe in many instances this would be impossible and there would be substantial impairment.

Summary

We admittedly have very peripherally traversed quite a bit of ground, including general observations on activism, economics and the macroeconomic environment. We believe many of these themes and trends will persist over a long period. Similarly, they will impact the investment landscape and opportunity set. We hope you found this to be interesting and thought provoking.

Michael Weinberg is a Member of the AIMA Council

www.protegepartners.com

Footnotes

[1] http://www8.gsb.columbia.edu/financialst...

[2] See for example Martijn Cremers, K.J., E. Giambona, S. Sepe, and Y. Wang (2015): 'Hedge fund activism and long-term firm value'

[3]http://www.economonitor.com/thoughtsacro...

[4] https://www.lw.com/upload/pubContent/_pd...

[5] http://spectrum.ieee.org/transportation/...

[6] http://europe.newsweek.com/bob-lutz-man-...

[7] Pratap G. Subramanyam (2008): 'Investment Banking: Concepts, Analyses and Cases'. McGraw Hill

[8] https://www.stlouisfed.org/Publications/...

[9] http://247wallst.com/investing/2015/10/1...

[10] http://www.bls.gov/lpc/prodybar.htm

[11] http://www.brookings.edu/blogs/ben-berna...

[12] http://data.worldbank.org/indicator/BX.K...

[13] https://www.caseyresearch.com/articles/2...

[14] http://www.uscc.gov/sites/default/files/...

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Are controls reports fit for purpose?

By Fiona Gaskin, Director of Performance Assurance, PwC Dublin

Reliance on independently assured controls reports has been prevalent since the popularisation of the SAS 70 standard due to Sarbanes-Oxley. There are a number of different controls reports available to users now, but are they all the same? And are they of any use?

Fiona Gaskin, Director of Performance Assurance, PwC

Typically organisations who have outsourced a function receive controls reports in response to either specific questions posed to their current/ potential service organisation or are provided with one as a matter of course once a year. Anecdotally we know that many of these reports are simply filed away without being adequately analysed, despite the fact that boards/operations teams may be referring to the reports when demonstrating to regulators their oversight of service providers. Based on feedback from various regulators it is clear that such an approach is not adequate, and individual risks must be considered.

Taking the fund industry as an example, the Central Bank of Ireland (the CBI) believes that enhancing the effectiveness of fund management companies, their boards and investment fund boards better protects investors. In June, the CBI issued the third consultation paper on Fund Management Company Effectiveness – Delegate Oversight (CP86). This paper set out a number of proposed initiatives which were designed to further underpin substantive control by fund management companies (including self-managed investment companies, which are regulated as management companies), acting on behalf of investment funds, over the activities of their delegates.

A new concept of an "Organisational Effectiveness (OE) role" was introduced in CP86. The OE rule requires fund management companies to have an independent director who does not fulfil any other designated person functions to ensure that the fund management company continues to be organised and resourced in the most appropriate manner on an on-going basis.

Examples of the types of matters which the OE person will be involved in include monitoring compliance with the procedures and structures agreed by the board for the on-going monitoring of work delegated to third parties, and overseeing how well the arrangements for the supervision of delegates are working. The purpose of this rule is to obligate one person to oversee the totality of the delegate arrangements put in place to provide assurance that they all work well together.

Under the Irish law, the board of directors assumes ultimate responsibility for the management of the company. In light of the new OE rule requirement, fund directors can use third party controls reports issued by independent auditors when fulfilling the OE role as part of their responsibilities set out by the CBI as long as the controls reports are fit for purpose.

The following are some key areas to be considered when deciding if a controls report is fit for purpose:

Are my risks being addressed?

This may seem like a very basic place to begin, but a surprising number of users of controls reports simply take the report, check if it has an unqualified opinion and then file it away without really considering if it addresses their areas of concern. When any activity has been outsourced, an assessment of the risks relating to that outsourcing arrangement should be considered. The outsourcer then needs to consider how comfort may be obtained over each individual risk. In some cases that will be through detailed oversight which can be exercised within the outsourcer organisation (e.g. the completion of their own independent cash reconciliations). However, for other areas, there will be a reliance on the service provider. An analysis of where that reliance exists should then drive an appropriate level of oversight controls, including, for example, completing on site visits, reviewing a controls report, using SLA data each day, etc. Whatever the method or combination of methods, the key point is that the oversight must address the relevant risks.

Where reliance on a controls report has been identified as part of the oversight controls, the actual scope of the report should be mapped back to the key risks identified by the outsourcer. Spending time looking at the scope of any controls report is fundamental to relying on it. Firstly it is useful to consider the main key areas you are interested in. Taking an example, if you have outsourced your fund administration process you may have within your lists of related risks areas such as:

1. NAV errors
2. NAV is released late
3. Loss of data – accidental
4. Loss of data – due to hacking
5. Regulatory return errors

A typical controls report which focuses on financial reporting (SSAE16/ISAE3402/SOC1) will likely address the first two of these risks, and elements of the third risk in that they frequently cover backups. However, the fourth risk is not addressed in this type of report. If this is your concern, then you need to ask specific questions on this topic, and consider the relevance of requesting your service provider to complete an alternative controls report such as a SOC 2 (controls report focusing on security, confidentiality, privacy, processing integrity and/or availability).

Likewise the accuracy of a regulatory return will not be included in a report focusing on financial reporting, but the risk of lodging an incorrect regulatory return for the outsourcer could be substantial in terms of fines and sanctions. In these cases either specific on site work by those who have outsourced the activity may need to be completed and/or a request to the service organisation to provide a specific controls report be completed by the service organisation relating to this area (e.g. an ISAE 3000 report).

Secondly in relation to scope, once you have established that your areas of interest are in scope, there is still a need to look at the specifics of the scope. Sometimes looking for what has been omitted is as important as looking at what has been included, for example, does the report list out a number of transaction types which are included in the scope, but stay silent on the area of derivatives? Are supporting IT general controls for all key applications included in the scope? If not, the reliance you can place on the report is significantly reduced unless some other form of assurance over those controls is available.

Am I an intended user?

The service auditor's opinion should clearly state who the intended users are, for example, a controls report relating to financial reporting is usually the service organisations' current customers and their auditors. A Soc2 report is permitted to have a slightly wider definition of intended users. It is an important section of the opinion as it establishes if you can place reliance on the report.

Is it a "clean" opinion?

The service auditor's opinion contained in controls reports generally follows a reasonably defined structure (other than an ISAE 3000/AT101). It is important that you review the opinion to see if overall the independent service auditor concluded that the controls are fairly presented, designed correctly and, if relevant, operating effectively over a defined period.

Are there exceptions?

Exceptions occur when the testing of a control indicates that it is either not designed correctly or that one or more instances did not operate as expected. A significant amount of auditor judgement is required in determining if an exception should lead to an overall opinion qualification. Regardless of whether or not the report is qualified, to use the report you should read through all exceptions including management's response if provided. Management's response may or may not be validated by the service auditor – if it is not, then you should consider asking the service organisation for their response and evidence of any follow up action they have taken to correct the exception.

Is there a gap period?

As service providers in the asset management industry are servicing funds with lots of different period end dates, it can be the case that the report is not available at a time which works well for your oversight. It may lead to a large gap period (i.e. period between the report end date and the period end of your fund) in which case you might want to consider how you obtain alternative comfort for that gap period.

Are sub-service organisations included or excluded?

When the service organisation you have engaged also outsources activities relevant to the processing of your transactions, this extension of the outsourcing chain is known as a sub-service organisation. A controls report can use either a carve-in approach (i.e. the controls operated by the sub service organisation are included in the report) or a carve-out (excluded) approach. If they are carved out, you need to consider if the areas excluded from the report impact your risk areas and if so, what alternative work do you need to complete to demonstrate adequate oversight.

Are there complementary user control considerations?

Most control reports will include one or more sections which detail out "complementary user control considerations". These are key if you are looking to rely on the report, as basically the opinion is stating that the controls are only effective in meeting the control objectives if the outsourcer has these controls in place. Such controls may include things like making the service organisation aware of changes in who is allowed to authorise transactions, providing authorisation for some transactions etc. When relying on a report, it is important to map each one of these expected controls back to actual controls within your organisations. If no such control exists and the area is relevant, then a control should be implemented.

Who is the service auditor?

When determining the sufficiency and appropriateness of the assurance provided by a controls report, users of the report should also consider the service auditor's professional competence and qualifications. Controls reports are specialised in nature and not all controls report are equal. The service auditor's experience of completing similar reports and their technical ability to cover the areas involved contribute to their professional competence significantly.

Conclusion

Controls reports can be of great benefit to an organisation who has outsourced a function, but only if the user of the report appropriately analyses the content and ensures all key risks are addressed. If the risks are not addressed then the outsourcer has some options, including supplementing the controls report with their own independent testing and/or requesting the service organisation to amend the scope going forward. Given the costs involved in any detailed independent testing, the most cost effective method is usually demanding a report which is fit for purpose from your service providers – after all, your Regulator is likely to demand evidence of a high degree of formal outsourcing oversight from you.

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First line of defense: Empowering employees to make security conscious decisions

By Anthony Rapa, Assistant Vice President, Claims Advocate, FINEX Global Willis Towers Watson

Businesses are attractive targets to cyber criminals due to the vast economic advantage that can be gained from theft of money and information, as well as network intrusion. Understanding and protecting against outside threats should not, however, create a blind spot to an organization's first line of defense: their own employees. What employees do — or fail to do — can make or break an organization's cybersecurity strategy.

Recent studies suggest that approximately 60% of data security incidents are non-hacking-related. Phishing (broadly defined in the business context as sending fraudulent emails to unsuspecting employees to gain network access and/or obtain confidential, sensitive information or money) remains an effective attack. Symantec's most recent Internet Security Report notes that over half of inbound business email last year was spam. Even more disturbing is that the 2016 edition of Verizon's Data Breach Investigations Report (DBIR) notes that 30% of phishing emails in the data group were viewed by employees, and that 12% of employees opened the malware-containing attachment. Both numbers actually represent an increase over the previous year's data, suggesting that, despite knowledge of the danger, companies may not be placing adequate emphasis and focus on employee cybersecurity awareness.

Additionally, Willis Towers Watson's Claims and Legal Group (CLG) has observed an appreciable uptick in claims involving impersonation fraud, where an employee is tricked via email to transferring money or divulging sensitive information to someone posing as a high-ranking company official. This new twist on phishing has resulted in multi-million dollar losses to sophisticated firms. An April 2016 FBI Alert indicated that incidents of so-called "CEO spoofing" were up 270% since January 2015.

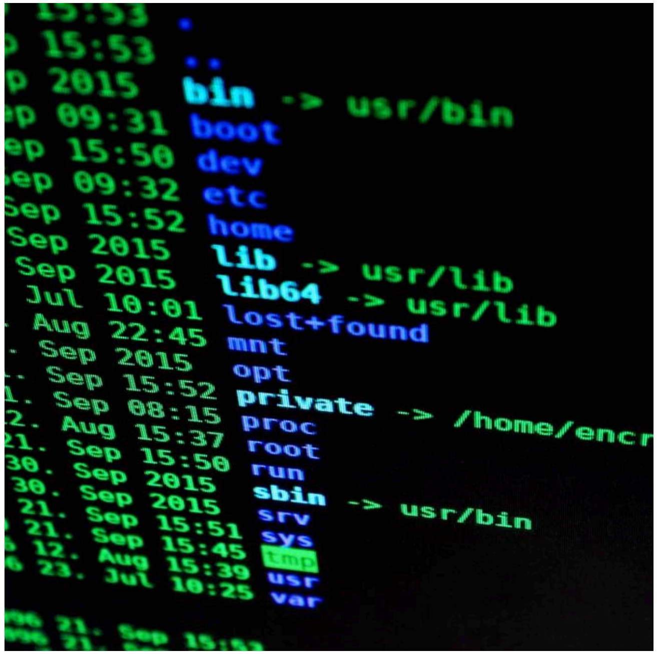
Lost laptops, phones, and physical files continue to serve as a major source of data security incidents. The 2015 Net Diligence Cyber Claims Study found approximately 10% of claims submitted to cyber insurance carriers were the result of lost or stolen devices. Along similar lines, Verizon noted in the DBIR that employees are 100 times more likely to lose a device than to have it stolen. The DBIR also noted that theft was most likely to occur in the victim's own work area (39%) or from the employee's personal vehicle (33.9%).

Human error also continues to account for a large percentage of security incidents. For example, Verizon notes that weak, default or stolen employee passwords played a role in 63% of security incidents. "Miscellaneous errors" accounted for 17.7% of the incidents, 26% of which were caused by an employee sending an email to the wrong person. Although these figures are by no means exhaustive, the message is clear. Despite knowledge of the danger and investment in employee training, a large percentage of cyber incidents continue to arise from employee errors.

Increased connectivity, personal devices and a 21st century workforce

Given the risk, one would expect that future changes in corporate strategy and technology will reduce the amount of behavior-based breaches. The truth, however, may be the opposite. Coming changes to technology, corporate policy and the composition of the workforce itself may have the potential to greatly increase the risk human behavior plays in data security. With more avenues for hackers to gain access to an organization's system there are also more opportunities to fool employees into making poor decisions. The internet of things (IOT) is a term used to describe the increasing number of connected devices that capture and share data with one another. As technology advances, even seemingly innocuous items, such as kitchen appliances, cars and wearable technology will gather data about everyday lives and share it over a wider network. McAffe Labs' 2016 Threats Predictions report noted that there were approximately 15 billion IOT devices in the 2015; by 2020 that number may grow to 200 billion. On the positive side, the IoT will allow businesses to collect massive amounts of new data, improving product design, safety and consumer satisfaction. At the same time, such data collection will make corporate networks all the more tempting as targets

Bring Your Own Device (BYOD) programs continue to increase in popularity. BYOD allows employees to connect their personal mobile device to corporate systems and access company data from anywhere. Aside from saving companies the cost of purchasing mobile devices, BYOD is highly convenient for employees. BYOD allows employees to stay mobile and connected on a single device while simultaneously enabling multitasking. Cloud-based computing also continues to gain traction in the corporate world. Employees now have access to important work information — and the corporate network — from anywhere.



Although companies can manage the risk created by BYOD through the use of encryption software and implementation, and enforcement of BYOD use policies, effective security requires a commitment from the users. While it is expected that employees who use their personal devices for work purposes may also download various apps, this practice poses a risk to organizations. In this regard, Ponemon Institute's "May 2016 report, Managing Insider Risk Through Training and Culture," noted that 54% of responding organizations are concerned about employees using unapproved cloud or mobile apps in the workplace. Therefore, it is imperative that employers include BYOD-specific training to employees, highlighting the potential risks in downloading suspicious apps. While the risks inherent in BYOD cannot be completely negated, through proper training they can at least be mitigated.

Finally, the Millennial Generation is becoming a larger percentage of the workforce. They are more tech-savvy than their older colleagues. Millennials are more comfortable sharing information on social media (including information that may not be appropriately shared) and more willing to experiment with new and untested technology.

In this environment of increasing connectivity and mobility, the need for employees to practice cybersecurity-conscious behavior is clear, but how can companies encourage such behavior?

Workforce culture as a solution

In May 2016, Willis Towers Watson published the results of a study analyzing the cyber risk inherent in employee behavior. We analyzed employee opinion results from more than 450,000 employees corresponding to a period during which significant data breaches were experienced within their organizations. The results were benchmarked against high performing companies (that had not experienced data breaches) and global information technology (IT) staff.

The study revealed that both the employees and IT professionals at impacted firms reported a lack of or inadequate training and leadership, suggesting that organizations may also not be keeping employees informed on the latest trends and attack vectors. And with respect to the IT professionals, employees specifically charged with the security of the company's network, a lack of training at onboarding creates an immediate and potentially lasting blind spot.

Cybersecurity is largely the result of the decisions made by organizations' employees each and every day. Teaching employees to practice regular security-conscious behavior, however, is easier said than done. Ultimately, investment in appropriate technology and a positive workforce culture that promotes training, company pride, and pay for performance can all help mitigate cyber risk, along with other risk mitigation strategies.

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MLP stands for 'managers lead the pack'

By Frances Watson, Partner, Ogier

Introduction

RAIF, NAIF and JRAIF; a revolution is taking place in the funds industry regulation as governments and regulators recognise that the Alternative Investment Fund Managers Directive (AIFMD) has forever changed fund regulation. Managers, not products, are the focus of fund regulation in the EU going forward. The Channel Islands, which have been assessed by ESMA as having “no significant obstacles” impeding the application for an AIFMD passport, now appear to be following suit.

Frances Watson, Ogier

It all started in Luxembourg at the end of 2015 with the proposals for a reserved alternative investment fund (RAIF). Hailed as a game-changer in the Luxembourg fund landscape, RAIFs have responded to the concern that the supervision and regulation of managers introduced by AIFMD was effectively a further (and therefore unnecessary) layer of supervision to funds which were already supervised at the product level.

RAIFs are available for structuring alternative investment funds which appoint duly authorised AIFMs (whether in the EU or third countries when passporting is available) without themselves being subject to regulatory supervision of the Luxembourg supervisory authority, the CSSF.

Then came the Maltese NAIF (notified alternative investment funds framework) which followed a similar pattern of enabling alternative investment funds howsoever structured under Maltese law which appoint full scope AIFMs wherever based and promoted only to eligible investors to come to market simply by notifying the Malta Finance Services Authority.

In May 2016, Guernsey unveiled its Manager Led Product (GMLP) which followed the RAIF and NAIF in terms of focussing on regulation of the manager but broke ranks over the acronym (presumably due to anxiety over sounding too similar to “giraffe”?)

Specifically:

- The GMLP may be used by AIFMs under

Guernsey's AIFMD Rules 2013 (Guernsey AIFMD Rules). (The Guernsey AIFMD Rules enable Guernsey AIFMs to opt into an AIFMD equivalent regime to assist the Guernsey AIFM to demonstrate to EU competent authorities compliance with AIFMD for third country passporting purposes.)

- Whilst to make use of the GMLP, Guernsey AIFMs need to be subject to the Guernsey AIFMD Rules, the Guernsey regulator, Guernsey Financial Services Commission (GFSC) has indicated in guidance notes that Guernsey AIFMs may apply for derogations. The ability to derogate from the Guernsey AIFMD Rules is important at the present time because passporting is not yet available. Accordingly, if marketing is taking place in the EU through national private placement regimes then equivalence is not, at present, required and the Guernsey AIFM is able to benefit from not being subject to the full scope of the Guernsey AIFMD Rules.

> "In all of its forms, the manager-led product is intended to reduce regulatory duplication which will speed up fund launch, which should translate into a reduction in overall formation costs"
>
> Frances Watson, Partner, Ogier

- However, most significantly, the GMLP applies both to funds of which there is a Guernsey AIFM and associated prospective licensees (e.g. a general partner of a limited partnerships). In the case of a fund, which is ordinarily subject to regulation, it will still be registered by the GFSC but no rules will apply to it. The Guernsey AIFM will notify the GFSC using a prescribed form and the GFSC will register the fund within one business day of receipt of the notification. Managers which are not Guernsey AIFMs (such as a general partner) can be included in the notification to the GFSC for the fund and will be licensed by the GFSC within one business day but no rules will apply to them, enabling regulatory capital to be concentrated at the AIFM level. Accordingly, arguably the GMLP has gone further than both RAIFs and NAIFs in allowing for regulatory efficiencies for managers whilst maintaining legal segregation.

Finally and most recently, a joint consultation exercise by the Jersey Financial Services Commission and the States of Jersey says formal plans for a Jersey registered alternative investment fund will be published by the end of 2016.

Practical implications

In all of its forms, the manager-led product is intended to reduce regulatory duplication which will speed up fund launch, which should translate into a reduction in overall formation costs. With its focus on sophisticated investors and the absence of “tick the box” minimum disclosure requirements it seems that manager-led products will facilitate more flexible constitutional and offering documents. Investor protection is addressed through the regulation of the manager.

Why are the Channel Islands following suit?

The manager-led product provides the optionality which Channel Islands managers, who sit outside of the EU but market both to EU and non-EU investors, need. It sets a framework which is in tune with EU fund regulation and which looks forward to full compliance when the passport is made available but can be used now within the national private placement regime.

However, it can also be used, with derogations, for those managers with entirely non-EU investors, albeit tied to the Guernsey AIFMD Rules. It should be of no surprise that the GFSC has indicated that it is considering developing a further regulatory framework using the same principles but with a discrete set of rules for Guernsey AIFMs marketing to jurisdictions outside of the EU.

But there is more to this than flexibility. The manager-led product has the potential to reduce fund formation cost and, in the form introduced by Guernsey, enables regulatory compliance and capital to be concentrated at the AIFM level, providing ongoing cost savings during the life cycle of a fund, whilst having the potential to address anxiety around substance issues. The future for Channel Islands regulation undoubtedly is now manager-led.

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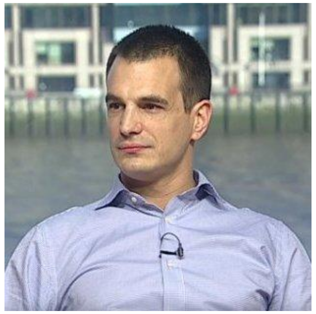
AIMA

Data 101: Understanding the information that drives your business

By Lazar Radenovic, Head of Technology, Obsidian Solutions



Lazar Radenovic, Head of Technology, Obsidian Solutions

Imagine walking into an investor meeting armed only with an iPad and the confidence that no matter what happens you are ready. Imagine that regardless of what portfolio or account question you are asked the information you need is at your fingertips. Then imagine if you didn't have to worry about what would happen if you lost or misplaced a client file with private information, or if a compliance officer comes knocking.

In this perfect world scenario, you would not only get the wow factor from your investors, but more importantly, you would confidently and consistently present accurate information while significantly cutting operational and opportunity costs.

So what's stopping all organizations, large and small, from achieving this data efficiency Nirvana? The truth is that it isn't only the lack of adequate solutions. There is that, but the bigger problem is that we, as an industry, have failed to keep up with best practices in terms of data architectures and rarely do we see asset managers build the types of foundations required for excellent security and high levels of efficiency.

Having spent most of my career running teams that deal with complex data problems across a variety of industries, I can say with a certain degree of confidence that there is no silver bullet solution to this problem, no magic wand that makes everything click. On the other hand, there are a set of best practices that you as an investment manager can follow, and by asking the right question you can lead your organization in the right direction. After all, with today's technology advancements, if you are standing still you are actually moving backwards and becoming less competitive by the day. So if at times this article feels too techy, that's a good thing, as the goal of this article is to bridge the gap between key tech concepts and sound business decisions.

The first thing we have to cover off is what most of you already know. Not all is data is equal, and shouldn't be treated equally. For example, having your organization invest a lot of time and money on making irrelevant accounting data rapidly accessible by mobile applications is not an effective utilization of your resources, neither is installing a high grade cyber security protocol to protect relatively risk free data. The challenge is that there isn't a set of guidelines that help non technical managers make quick decisions, and at times going to IT vendors can feel like a trip to the mechanic.

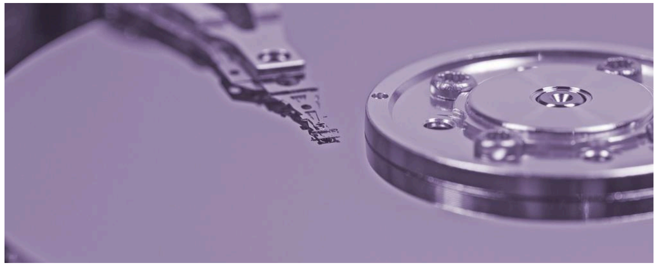
Having said that, if we break the decisions down into four fundamental categories of Security, Accuracy, Accessibility, and Longevity, you will be far better equipped to identify what is important to you and what course of action is appropriate.

To do so all you need to do is ask yourself the following four questions when evaluating a particular data set:

1) "What will happen if this data falls into the wrong hands?"

If the answer to this question makes you shiver, then security should trump all else. Not to say that security should prevent any of the other three categories from being implemented properly, but it should definitely influence how each problem is solved.

For smaller organizations, data security is as much about common sense as it is about company policies and security procedures. After all, most security breaches happen as a result of simple human errors, and sharing information with third parties who will make those errors.



"Encrypt everything!" That's my moto. Today's encryption is cheap, easy to use, and difficult to crack.

With a simple encryption policy, you can alleviate a lot of your concerns, and focus on protecting your systems, and by extension your encryption keys instead of worrying about leaks at every step.

It is important to understand that your data is at risk both at rest, i.e. while on your computer or phone, and in transmission, i.e. when you are sending it by email, webpage, or file sharing applications.

At rest:

Consider this; if your laptop was stolen today or your offices infiltrated, the thieves would likely have access to a wealth of data that would either compromise your investors immediately or provide them with enough ammo to penetrate your secure servers soon after.

Surprisingly this very real risk generally gets overlooked more often than not, and it's by far the easiest one to address.

Instead of relying on outdated policies like "employees shall not copy sensitive files to their computers" that aren't enforceable and more to do with blame allocation than risk reduction, try and find out if all of your co-workers have enabled BitLocker (Windows), or FileValut (Mac).

These are very simple to use tools that encrypt your entire drive, and if your computer was to be stolen or your office broken into, you net loss would be the cost of the hardware! For the thieves looking at your data would only see a random blob of information.

The best part; it's free, it takes very little time to setup, and costs almost nothing to maintain.

In transmission:

The only things that you need to know about the TLS 1.2 encryption algorithm is that it would take a super computer years to crack and that it's the standard for encrypting communication. Make sure that your email provider and any site you are about to share data with is using TLS 1.2.

Steer clear of unencrypted FTPs when sharing secure files. When it comes to FTP transmission, always look for the magic "S" either at the front or the end of the connection type (SFTP, or FTPS).

Aside from encryption and protecting your systems, to minimize risk further you need to know that your counterparties are playing by the same rules.

2) "What will happen if I get the numbers wrong?"

Naturally it depends what kind of information you are working with. If it's a back of the napkin model, then your exposure is not very high, on the other hand if you are striking a NAV, well, let's hope you know the answer to that question! The number one source for inaccuracies are mistakes caused by manual data entry, and logically by reducing steps at which humans retype data, we can significantly improve data quality (and lower long term costs!)

Tools like Excel are so extremely powerful that they often lead to overuse and overreliance. Essentially Excel makes us all into programmers. Each sheet allows us to weave cells with complex formulas and generate results way beyond the point where we can spot inaccuracies by eye. Every time a cell is updated we essentially launch a new program with very little or no actual quality assurance procedures. Something unheard of in software development.

While I'm a huge fan of the speed at which Excel can accomplish almost anything and often times argue against transforming flexible Excel worksheets into ridged computer systems, I'm also wary of how error prone data sets in Excel can be. It's always good to ask yourself; is the data set calculation repeatable, consistent, and does accuracy matter? If the answer is yes, then you should perhaps look at automating the model with stricter software controls.

3) "What will it cost me to make this data rapidly accessible?"

Effective data accessibility is the key to the future competitiveness in this industry, as it will both; drive costs down by commoditizing and automating manual processes, and increase business intelligence and competitiveness through data mining. For pure business efficiency reasons, we should naturally want all data as rapidly automated and accessible as possible, so long as the cost, which includes the cost of security compromises, is acceptable.

For example, something simple like advisor codes for subscriptions and redemptions that you may think should live in some archive in a back office system, could very much give your business a new way of improving sales. Imagine if there was a business intelligence dashboard that could plug into those numbers, show you visually which advisors are selling or buying your funds, cross reference against postal codes and your outbound efforts, and surface phone numbers for inactive advisors that your sales reps can call and prod along. The competitive edge becomes clear; the only factor is at what cost can this be done?

> "Simulate an emergency where you need to recover files, and see if your backup system can deliver"
>
> Lazar Radenovic, Head of Technology, Obsidian Solutions

One of my projects many years ago was leading a team that helped The Home Depot structure their data set, normalizing information from thousands of suppliers, with hundreds of thousands of products, and millions of seemingly unrelated attributes, while making all of this accessible in a split second to the consumer on the web or in the store! We had huge budgets for this, but the point is that everything is doable, and the good news is that the investment industry by comparison has a relatively constrained data sets which makes data strategies far more accessible to fund managers today.

In this context you should look at prioritizing maximum benefit for minimal cost and start from the top. Depending on the size of your organization and technical expertize, there are a number of free databases that can be implemented internally, with the key to data access being a layer of web services, essentially tools that securely and efficiently distribute your data to any program that needs them, even your Excel sheets!

4) "What will happen if I lose this data?"

With storage space costing what it does today (virtually nothing), it may seem like an obvious choice to keep backups of almost everything, but remember, with every new backup location you have a new security concern! The basic "offsite" backup strategy can consist of something like Microsoft's OneDrive, DropBox, or Box, while more complex strategies will ensure that even file changes and deletions can be reversed. The key is to understand what is acceptable in terms of data loss, are people allowed to permanently destroy information, and what are your procedures for retrieval when you have an emergency.

The number one recommendation I give companies regarding their backup strategies is to find out if they work before they need to use them! Simulate an emergency where you need to recover files, and see if your backup system can deliver. Hopefully by asking yourself some of these questions you will have answers to a few more of your day to day and long term challenges. As one of our clients put it, the thing every asset manager wants most is more hours in a day. Making your data work for you may just help you get that, and more.

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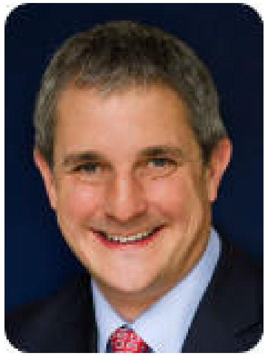
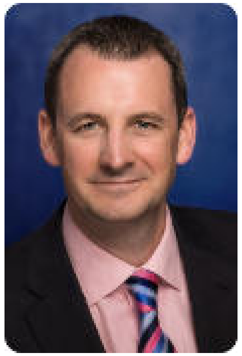
The impact of Brexit on UK asset managers marketing into the EU

By Peter Northcott, Executive Director, and Paul Carrigg, Product Management Executive, KB Associates



Peter Northcott, Executive Director, KB Associates



Paul Carrigg, Product Management Executive, KB Associates

Introduction

In one of the most important political events in recent European history, the UK voted on 23 June 2016, in an advisory referendum, to leave the EU. This has created great uncertainty. In this article, we review the political considerations and analyse the potential impact on UK asset managers.

Political considerations

The two main unknowns with Brexit are:

- The arrangement which will be negotiated, if and when the UK ultimately leaves the EU, is uncertain.
- How long it will take before the UK transitions into a new arrangement. We know that the formal process of leaving can be triggered by exercising Article 50 of the Lisbon Treaty, which provides for a 2 year deadline. We do not know when Article 50 will be triggered, although the UK Government has indicated it will not be until 2017.

What will the UK's negotiating position be?

The UK Government's negotiating position is currently unclear, although it is likely to seek both control of EU immigration and continued access to the single market. However, it seems very unlikely that both of these goals can be fully achieved. The EU won't want to grant the UK an attractive deal as it wishes to deter other countries from leaving. Certainly, those non-EU countries with full access to the single market have had to accept all four fundamental freedoms[1].

More specifically, those with access have an obligation to enact all EU legislation (and pay into the EU budget, albeit without any representation). The key question is whether the UK government is willing to give way on migration control in order to retain access to the single market?

What will the EU's negotiating position be?

This is even more difficult to answer as the EU is an agglomeration of various national and supranational interests. Some EU member states may be happy to sacrifice elements of free movement in order to maintain free access to the UK market. Other countries may be reluctant to offer the UK very much at all.

What might a final deal look like?

One possibility is a "Norway" type deal. This would mean membership of the EEA (or an equivalent arrangement) and accepting the four fundamental freedoms. If an EEA type solution is achieved then nothing much will ultimately change from the point of view of an asset manager although care would need to be taken during the transitional arrangements. While this option seemed to be favoured early after the referendum it now seems less likely due to the political imperative in the UK of seeking to limit EU migration.

Another possibility is a bespoke deal whereby access to the single market is wholly or partially sacrificed. Based on recent comments from British Government ministers, this looks like the most likely scenario although the details of any final settlement are very unclear.

Finally, the default option is for the UK to leave the EU without any agreement on access to the single market meaning the UK would revert to WTO[2] rules (assuming the UK was able to accede independently to the WTO without any delay or issues). The UK therefore becomes a "third country".

Given the level of uncertainty that exists, UK asset managers need to plan for the default option.

UK managers marketing in the EU under AIFMD

In the "third country" scenario, UK AIFMs would lose their marketing passports within the EEA.

In July 2016, ESMA[3] stated that there were no significant obstacles impeding the application of the AIFMD marketing passport to the following non-EEA countries: Canada, Guernsey, Japan, Jersey and Switzerland. The two key questions in this regard are:

- When will the European Commission approve these recommendations?
- Will the UK be allowed to be "grand-fathered" in as an equivalent regulatory environment or will it need to be freshly assessed like other non-EEA jurisdictions. This may lead to a gap in access as ESMA has already identified a number of non-EEA countries, presumably for assessment before the UK. If there is a gap in access the UK may need to rely on private placement regimes (which may be phased out by 2018).

UK managers marketing in the EU under the UCITS directive

UK management companies will not be able to passport services to UCITS funds domiciled in the EU. UK UCITS funds will no longer be able to passport into the EU and will likely have to seek country-by-country approval. The possibility of "third country" passporting which exists under AIFMD does not exist under UCITS.

The implications of Brexit for UK managers under MIFID

If the UK does not come to an agreement on EEA membership, it could potentially benefit from a "third country" passport regime under MIFID similar to that in existence under AIFMD. MIFID2/MIFIR will introduce a new arrangement from January 2018 which could allow a UK asset manager to continue to provide portfolio management services to clients in EU member states. The possibility of the UK benefitting from this passport would be contingent on the UK being deemed to be an equivalent jurisdiction following an assessment by ESMA. There is added uncertainty regarding this passport possibility as this has not been legally tested and this would seem unlikely to take place until/if the UK actually exits the single market.

Our view on the likely impact of Brexit

If the UK neither comes to an agreement on EEA membership nor negotiates an agreement for equivalent access, we see the following impact on the industry:

- In the absence of Brexit, a number of UK asset managers intended to passport the services of UK management companies to support investment funds in key EU fund domiciles such as Ireland and Luxembourg. With Brexit, this option will no longer exist. UK asset managers will need to establish management companies in Ireland or Luxembourg or more likely seek the services of independent management companies.
- UCITS and authorised EU AIFMs may delegate portfolio management to non-EU asset managers. An EU UCITS management company or AIFM may continue to avail of portfolio management services from a UK asset manager.
- A small number of UK managers utilise UK funds not just for the domestic market but also for the EU market (though most already use an Ireland or Luxembourg based UCITS/AIFMD compliant fund). The UK's exit from the EU will likely mean that those managers utilising a UK fund to access the EU will establish a fund structure in Ireland or Luxembourg for that purpose.
- It could be argued that smaller UK managers who do not distribute into the EU on a large scale may prosper in a potentially less onerous UK regime and simply rely on "third country" private placement regimes where required.
- UK authorised UCITS management companies and AIFMs will be considered "third country" counterparties under EMIR[4]. This is the new European regulation on OTC[5] derivatives. It imposes a requirement for clearing through central counterparties. UK asset managers would be subject to less burdensome EMIR rules and may not be subject to the reporting requirements.

- For non-UK managers consideration may be given as to whether or not funds should be established in the UK for the purpose of accessing UK investors. Given the openness of the UK to non-EU products, e.g. Cayman funds, it is anticipated that the UK is likely to be receptive to the inward marketing of funds located in Ireland or Luxembourg. An Irish or Luxembourg UCITS would be required to seek authorisation and register for public sale in the UK. While likely achievable, this will be less straightforward than the pre-Brexit simplified regulator to regulator approval process.

Footnotes

1 Free movement of goods, services, capital and people

2 World Trade Organisation

3 European Securities and Markets Authority

4 European Market Infrastructure Regulation

5 Over-the-counter

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Passporting post-Brexit

By Andy Gent, Director, Arkk Solutions

Andy Gent, Director, Arkk Solutions

A little over three months after the polling stations closed, the Brexit result continues to dominate headlines. The market reaction was instant, and whilst the Lyxor Hedge Fund Index reported a 0.8% rise in July 2016, it remained unclear what would happen next.[1]

It's worth remembering that opinion leant heavily towards the UK staying in the EU. Aviva polled fund managers in February 2016 and found 100% expected the nation to vote Remain.[2]

For regulatory filers, the Alternative Investment Fund Managers Directive (AIFMD) received the most scrutiny both before and after the referendum. As soon as the vote had an official date, experts began analysing every possible option. Would the UK join the EEA? Could the UK passport into Europe without AIFMD? What would happen to UK domiciled UCITS? For filers, and the technology they need to support their requirements, the uncertainty of the Brexit is a challenge that has dominated Q3, and threatens to continue for the next two years.

What does the Brexit mean for AIFMD compliance?

Since 2008, the sheer volume of new regulation has been a burden to fund managers. There's no doubt that the potential to decrease, or at least stabilise, the amount of reporting would be an appealing outcome of leaving the EU.

A few weeks before June 23rd's vote, we spoke to our AIFMD clients about the potential impact of the Brexit. One client felt that there would be no change to the reporting requirements, but that a Brexit may incentivise AIFMs to concentrate their business activities in the UK. This would be especially prominent if the UK does not join the EEA, and adopts a US or Hong Kong approach to AIFMD. The volume of regulation may not reduce anytime soon, yet the Leave vote does make it unlikely that any new regulation will be put forward until well after the Brexit implementation.

The end result will most likely see Britain negotiate to keep the same passporting rights it has now. Annex IV regulations have always been the price for EU-wide access. This will need to continue if fund managers want to market across the continent - and it's in everyone's best interest that they continue marketing. As London is the centre for European hedge funds, decision makers in the EU and the UK have a joint interest in working out the logistics of the Brexit. Awarding the UK a third-party passporting extension seems the most mutually beneficial outcome.

Will the Brexit impact how you report AIFMD?

Behind the scenes of regulatory reporting lies a significant technical challenge. There are over 300 data points to collect and some jurisdictions must convert their templates into XML format. In the wake of Brexit uncertainty, firms may be debating bringing AIFMD in-house with an internal system. Fund managers should remember the real cost of attempting to manage an AIFMD IT build from 2009.

When AIFMD was first announced, quite a few companies set off to develop in-house solutions, only to abandon the project a few years later. This is because at a glance AIFMD looks like another simple XML schema build. The reality is that maintaining an Annex IV reporting tool requires a team dedicated to the task. Keeping the software up-to-date, providing expertise on regulatory and Brexit updates, and ensuring that your build supports all schemas and variances, will require at least 2-3 people. The cost of maintaining a solution in-house goes far beyond the initial cost of building the tool.

Unlike everyday XML builds which your IT department will be familiar with, Annex IV reporting systems depend on a third party, the regulators. ESMA will release updates and new requirements whenever it needs to, which will not always fit in with your technical roadmap. To keep up with the varying demands of both ESMA and your local regulator, you would need to have resources available at all times to update the system. This ultimately makes an AIFMD build far more resource-heavy than first anticipated.

Schemas vary across Europe, and changes to a jurisdiction's requirements are frequent. January 2017 for example, will see Gibraltar filing in XML for the first time and Hungary joining the directive. Depending on the differences, filing to two jurisdictions could mean double the work for your IT department. It seems unlikely there will be extra development needed for the Brexit, but it's impossible to tell at this stage. Whilst the future of the UK’s passporting and AIFMD requirements are unclear, it is best to trust regulatory experts with your reporting. This means you don't have to undertake a costly and unmanageable in-house build, or keep an eye on the technical updates across Europe.

So if there is no significant change to financial regulation in the short term, what can fund managers do to prepare? We’ve spoken to our AIFMD clients to find out what they are doing as a result of the Brexit. The main comment we’re hearing: maintain business as usual and keep informed. Inactivity and indecision will cause the most challenges following the referendum. The top priority is to ensure that you remain focused on your current business objectives - there is no need to make plans based on speculation.

In time we will come to understand the full impact of the Brexit on AIFMD. For now, fund managers should ensure that they’re working with regulatory experts who can keep up-to-date with ESMA’s requirements. This gives you the breathing space to maintain business as usual, and to ensure that your clients feel confident and informed.

Footnotes

1 HedgeWeek, accessed 10/08/2016

http://www.hedgeweek.com/2016/08/10/2425...

2 Fund Strategy, accessed 07/03/2016

https://www.fundstrategy.co.uk/bond-mana...

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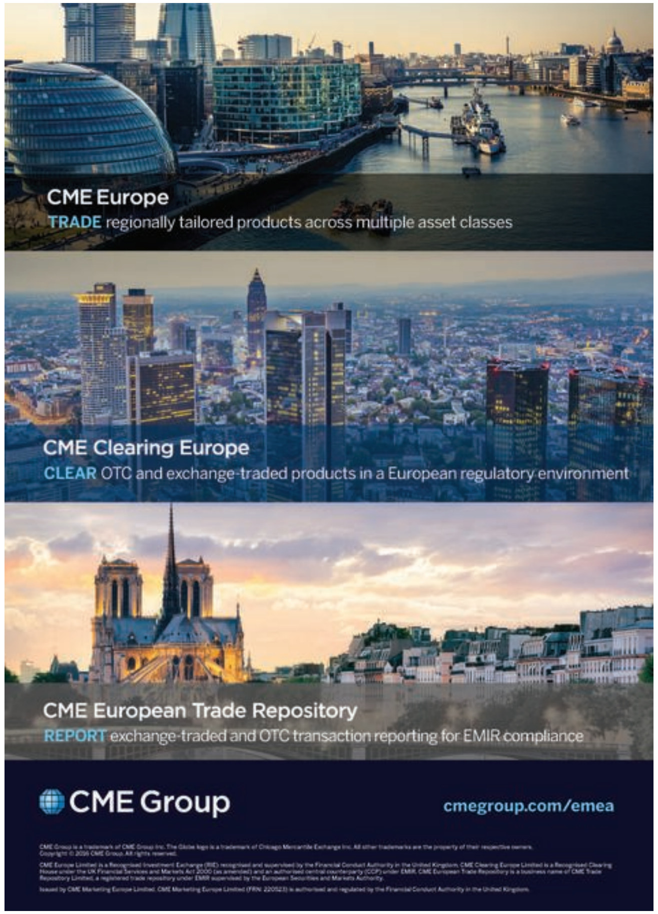

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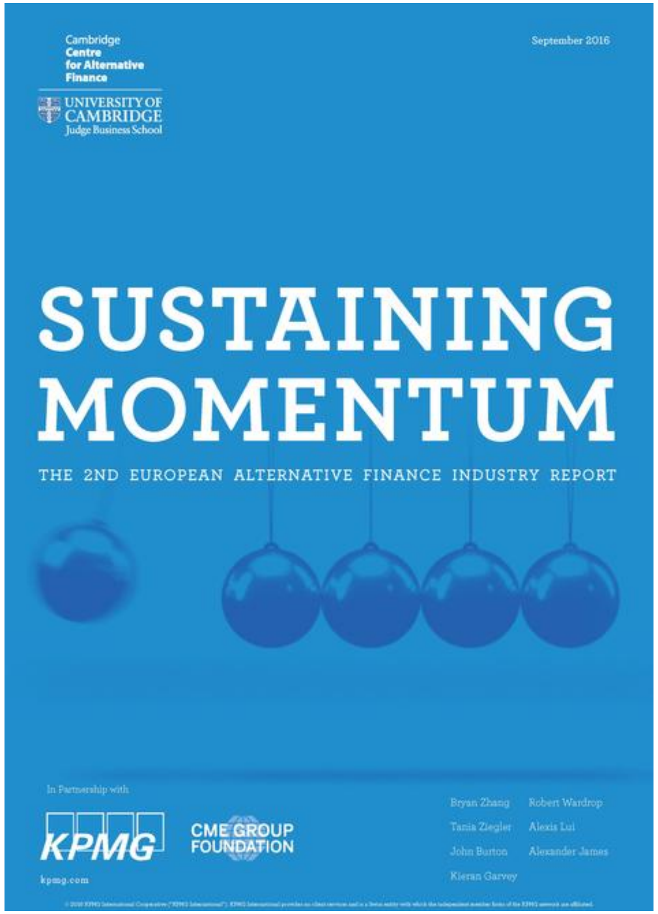

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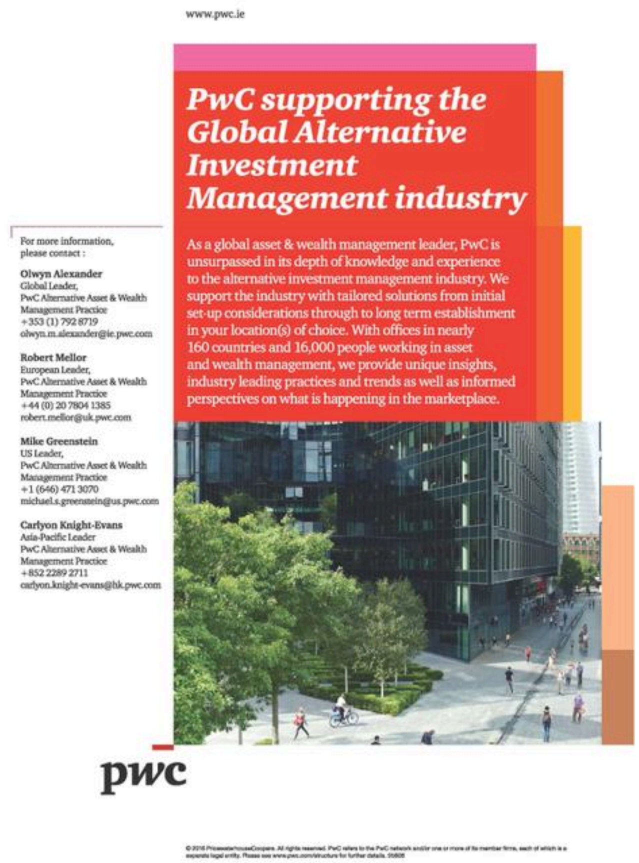

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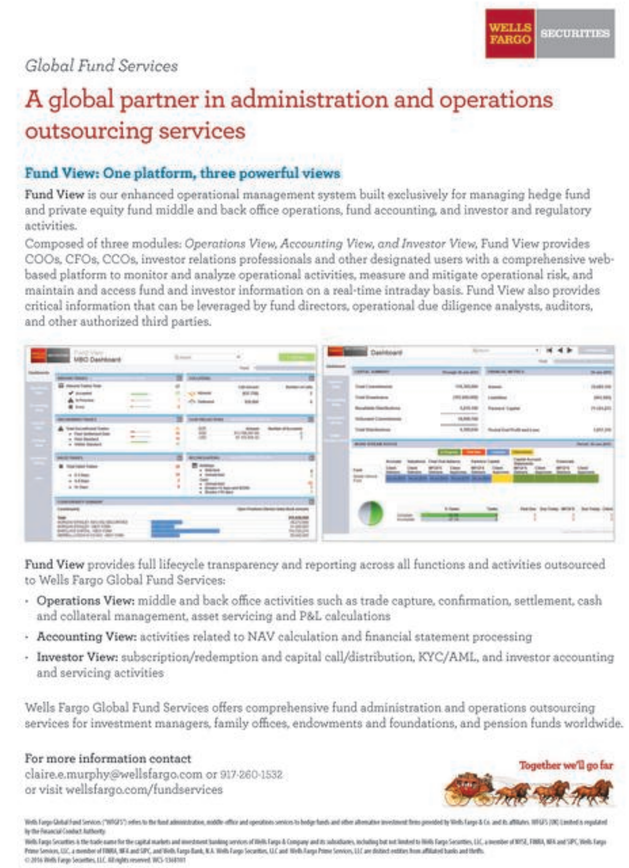

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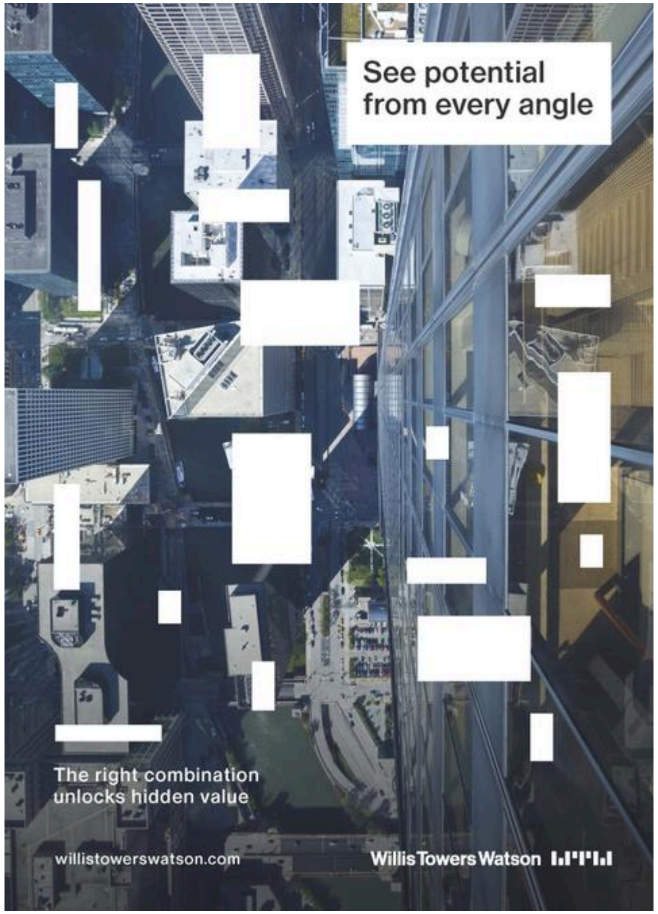

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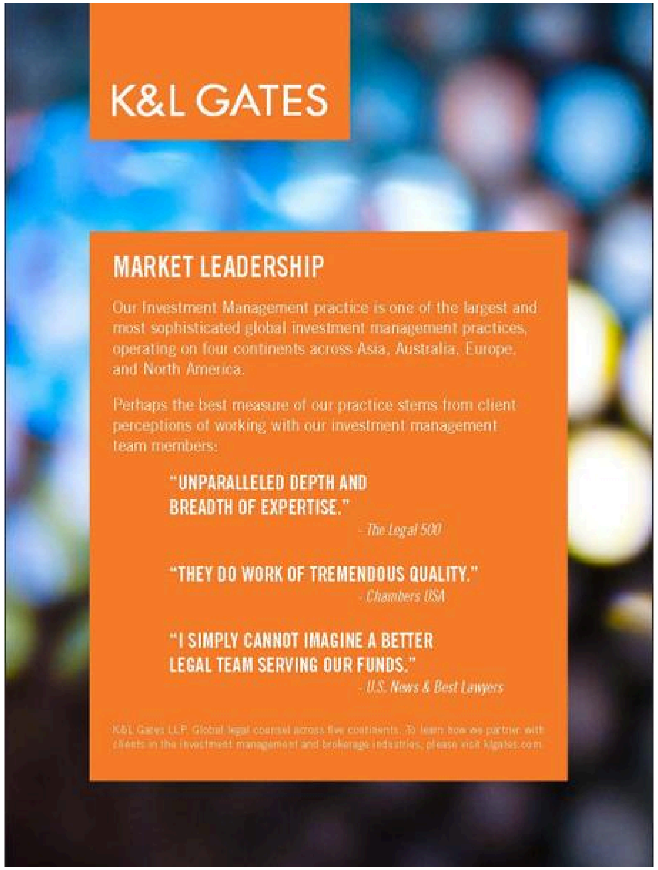

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