AIMA

JOURNAL

Edition 120 | July - September 2019 | www.aima.org

Natural language processing in finance

Shakespeare Without the Monkeys

MESSAGE FROM AIMA'S CEO

A warm introduction to our 120th edition of the AIMA journal. We are delighted to showcase a detailed collection of insights provided by our members. We would like to convey our thanks and appreciation to all those who contributed to our latest edition.

The journal opens with a thought-provoking piece on cryptocurrency analysis from co-founder and managing partner of Bardicredit, who seeks to shed light on the future of blockchain - 'the next big thing after Bitcoin'. Keeping on trend with how technology is impacting the work of finance, Man AHL provides an insightful overview on natural language processing (NPL).

The initial performance of the still nascent Canadian alternative mutual fund market receives a detailed evaluation. CIBC notes how the juvenile market has shown signs of solid growth potential since its inception.

Considering the recent interest rate cuts in the US and the potential for future monetary tightening, BNP Paribas poses the question as to what investors are seeking amidst a changing market environment. The analysis builds from the June Operational Due Diligence conference that the international banking group co-hosted with the Alternative Investment Management Association (AIMA).

Keeping on topic, CME Group explores the extreme sense of frustration by the Federal Reserve, amidst plans Fed to lower its federal funds rate target even further in response to the trade war speculation slowing global growth and sparking US spillover fears.

We also have several articles commenting on various industry regulatory developments, INDOS Financial Limited explores how the revised Anti-Money Laundering (AML) legislation, which was introduced by the Cayman Islands in 2018, has been received by the industry. Meanwhile, SS&C, the leading cloud-based provider of financial services technology solutions, offers a detailed perspective on un-cleared margin rules (UMR), as well as the regulatory roadmaps regarding UMR that firms will need to navigate going forward. Additionally, Consulting and Capricorn Regulatory Hosting looks at the regulatory outlook for hosting platforms which are an increasingly important part of the business models of smaller managers.

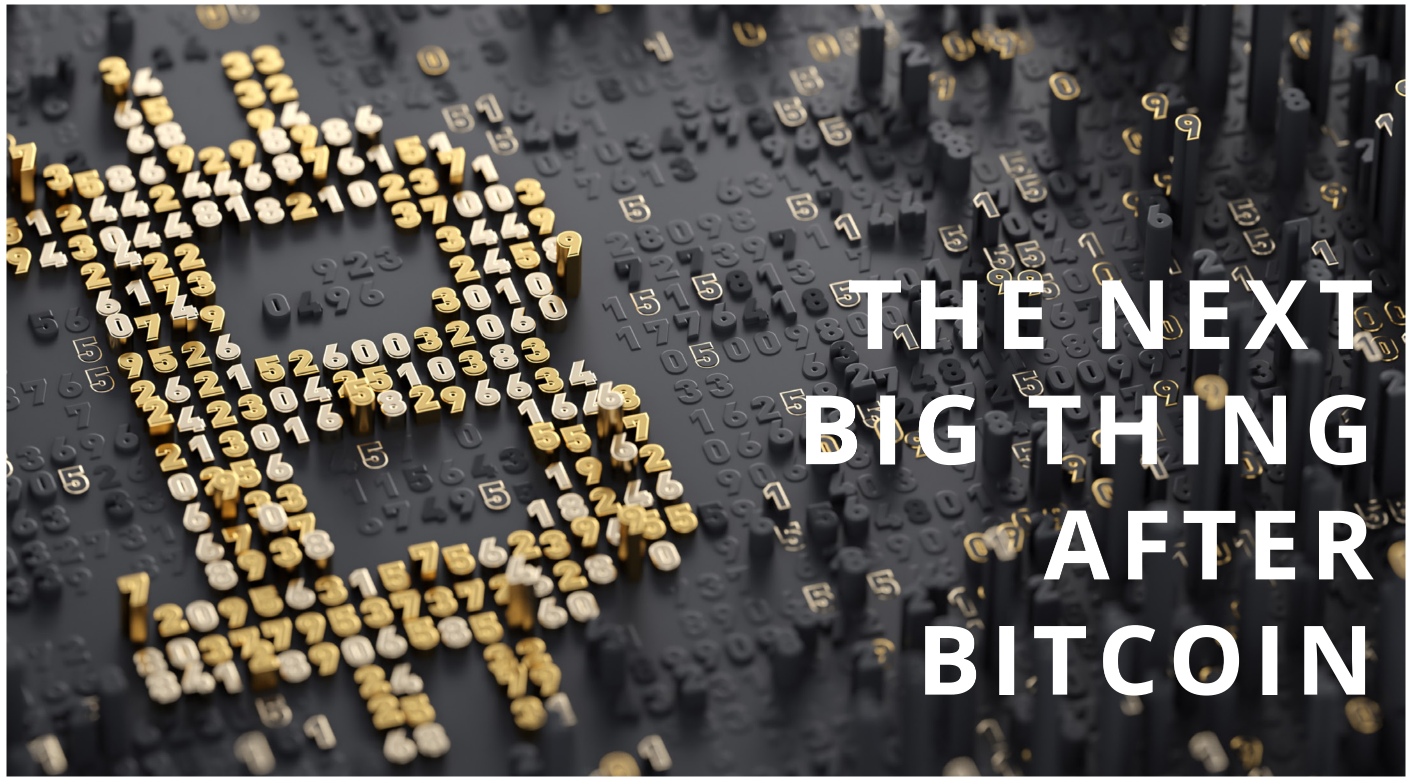
Duff and Phelps discusses the shift of global tax towards a harmonisation across all jurisdictions and the revised focus on local and territorial substance requirements from the Organisation for Economic Co-operation and Development (OECD), particularly the implications of the swift introduction of several substance legislative measures on managers.

Gowling WLG (UK) LLP describes how the new rules for pre-marketing funds and reverse solicitation aims to harmonise activities managed within the structure of AIFMD, as well as the current rules in practice, amongst other aspects.

Finally, Ogier looks at the development of sustainable investing in Asia. Although there are still challenges to be overcome when it comes to ESG investing, Asian asset managers have come a long way and are increasingly embracing sustainable investing as a key strategy.

We hope you find our new edition of the AIMA Journal engaging and informative and wish you both a positive and productive end to your year. Please do let us know what your thoughts are on this edition and whether you wish to contribute to any future editions.

Jack Inglis
Chief Executive Officer, AIMA



THE NEXT BIG THING AFTER BITCOIN

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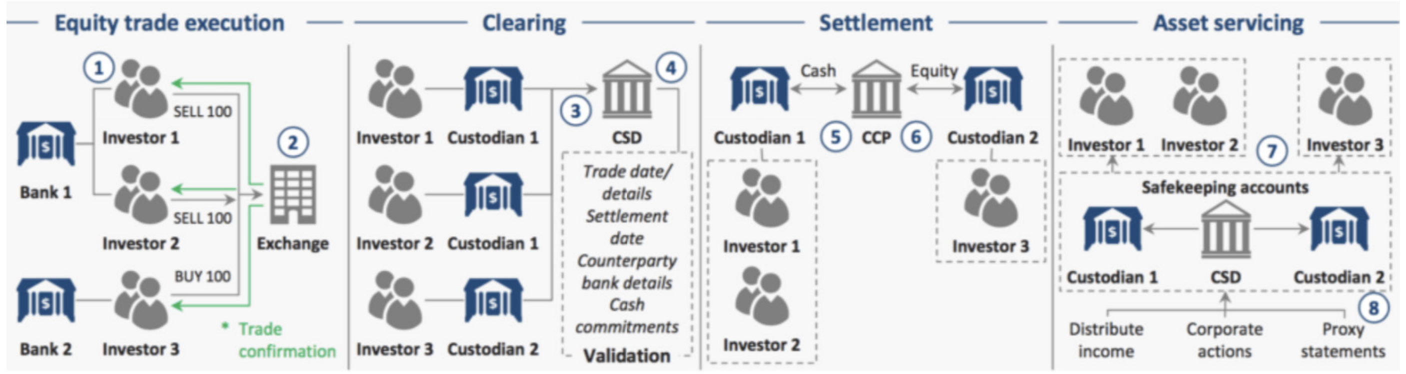
The most successful application of blockchain, so far, has been Bitcoin. This is what blockchain excels at - recording transactions and tracking who owns what without the involvement of a middleman.

It is this attribute of blockchain that will have far-reaching consequences for the socio-economic order that we live in. Our mistrust in other people (and our fallibility) begs for costly layers of intermediation and the necessity for authorities 'for the authorities' sake'.
Security Token Offering (STO) is the issuance of tokens on blockchain which represent real assets, equity, debt or future profit rights. Unlike traditional ownership rights like stocks or bonds, they are intelligent because they have inbuilt rules and actions that are performed automatically. Imagine a stock with automated dividends. Sounds like a true improvement, right?

Well, despite this, STOs suffer from being compared to ICOs - the now infamous fundraising campaigns that operated through the creation of new crypto-coins. STOs are often confused with ICOs, or - even worse - seen as the last-ditch effort by companies that missed the ICO bubble to raise some dough.

This is wrong. Right after the digital payments, STOs could be the next best application for blockchain. STOs are about using blockchain to represent and transact ownership rights. Present day securities are non-intelligent pieces of paper that are at best converted to an electronic copy. They cannot perform any actions independently. Someone has to do all the sending, receiving, storing and clearing around transactions of conventional securities.
To buy or sell a stock, people need a system to keep track of who owns what. At present, financial markets accomplish this through a complex net of brokers, exchanges, central security depositories, clearing houses,



Source: How Blockchain Could Disrupt Banking. CBInsights

and custodians. Add a layer of complexity on top, in that stocks are represented in electronic format.

When someone buys or sells a stock, that order is executed through a whole bunch of middlemen and third parties. Each step of the stock transaction, from trade (sending order to the exchange), through clearing (moving stock from one custodian to another) and settlement (cash transfer) to stock servicing (safekeeping, dividends, voting) involves multiple parties, each of which has to communicate with another in a complex network. Each party maintains its own version of truth in its own ledger.

So, what's the problem? After all, there is nothing wrong with complexity as long as it works, right?

Well, that's the thing - it sort of doesn't. The mechanism described above somehow evolved from the old system of paper ownership, which was later enriched by the element of electronic trading. Not only is it inefficient, but also prone to errors, which can lead to (nearly) unsolvable problems.

The case of Dole Food Co. illustrates this rather well. Matt Levine brilliantly explains how it is possible that the company had at one point some 12M extra shares. For one, when a company is undergoing larger transaction (like a merger), DTC stops tracking trades in the company's stock because it would be too hard. DTC 'places a chill on the stock'. The stocks are still being traded, of course, but DTC doesn't want to know about it. It is the responsibility of the brokers, custodians and other DTC participants to maintain some order.

Things got even worse thanks to short selling. Short selling involves selling a 'borrowed share'. The present day financial markets account for this by recording two positive shares (the original owner whose broker lends their share and the buyer who buys the borrowed share) and one negative share (the short seller). To make this work, the short seller has to pay dividends (and other payments) to the holder of the 'extra' stock.

Errors of this convoluted system (otherwise called financial markets) have become apparent when several years after the merger had taken place, the court ordered that the acquirer should pay extra consideration to original shareholders who held the stock at the time of the merger. And as it turned up, there were suddenly too many shares. It was up to the brokers to figure out who owns what 'really' and how to split the extra consideration. In many cases this was impossible.

Many short sellers yelled in protest, or they were simply no longer there to pay up the missing money to those who held the 'extra stock'.

A distributed common ledger to keep track of who owns what in real time would make a lot of this much easier. Aside from the fact that it would eliminate the inefficiency - the necessity to go back and do the forensic work to identify the rightful owners - blockchain is 'humanless' and that can be a good thing. Sure, the brokers would still have to call up the short sellers from years back, but they would have little grounds to object because blockchain doesn't make mistakes.

Security tokens bring the promise that many of the functions laboriously performed by multiple middlemen can be automated away. They are a more intelligent version of ownership rights - digital programs in place of paper. They have inbuilt rules and actions, which they perform automatically.

But there is more. STOs can do to private investments what P2P lending platforms did to private debt markets after 2008. People loved the idea of being able to lend directly to a small shop or just to another person to finance his/her business idea. It felt good to be completely in control of your own capital.

Thanks to the automation described above, STOs can become a new way to facilitate the flow of capital. Investments like a premium building in Manhattan have historically been available only to a few super-rich. Now, STOs have the potential to transform investing in private assets into a 'one-click' experience from anyone's desktop. Investor and territory restrictions can be 'encoded' in the token with smart contracts, as can be the asset servicing functions like dividends.

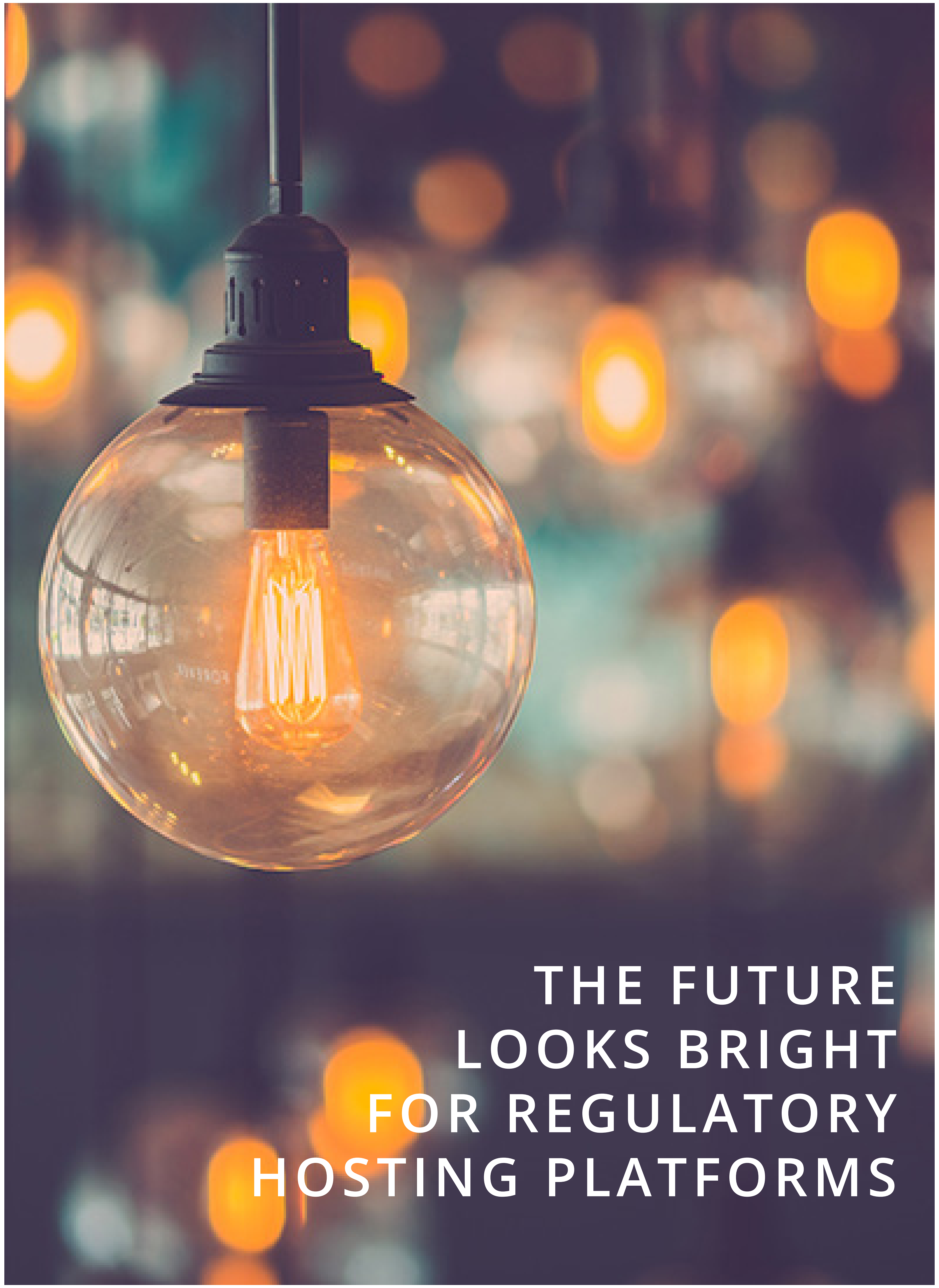
Ownership of premium assets like buildings, yachts, cars, or even just private unlisted companies can be divided across much larger audience of investors with much less paperwork and virtually no involvement of the costly middlemen.

The potential is large, but the market is still very nascent. STOs are like building a highway on top of another one. On more than several occasions, security tokens replace the existing infrastructure of the present day financial markets, yet people are understandably trying to fit them into the current legal and regulatory frameworks.

Undertaking an STO can be a costly endeavor. Often, companies that are planning to do an STO end up hiring an armada of lawyers and sink into a lengthy correspondence with regulator to learn (create) the process. Fortunately, first 'proto' advisory shops are emerging to advise entrepreneurs and companies on how to do STOs properly.

It will be many years before security tokens can replace the volume and liquidity of traditional securities, but even in their present form, STOs (when done properly and legally) can be an innovative, paperless and seamless way of connecting investors to premium, alternative projects, which have historically been only accessible to a few super-rich.

bardicredit provides turn-key tokenization services. Our services cover legal, regulatory, and ultimately the tokenization process. Before bardicredit, George was in consulting (PwC), banking (Sberbank) and tech (smart data Braintribe). He co-founded a technology company (Shout) and he was a guest writer for Forbes US.



THE FUTURE LOOKS BRIGHT FOR REGULATORY HOSTING PLATFORMS

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The outlook for start-up managers, advisers and distributors in the UK remains volatile.

New firms are spending as much time and resources on navigating the ever-changing regulatory and political landscape as they do on managing and marketing their own product and services. Increased investor focus on a firm's governance and risk management processes add further layers of complexity. This further distracts the principals from what they really want to do – make investment decisions.

The emergence of regulatory hosting platforms and authorised firms that allow small or young businesses to operate under their regulatory license, provide managers with a turnkey solution. It is much more attractive, in these uncertain, times than committing and dedicating time and resources to obtaining and maintaining direct regulatory authorisation.

The long overdue, and welcomed, FCA review of principal firms in the investment management sector and accompanying "Dear CEO" letter (20 May 2019), sent a clear message – the future of regulatory hosting platforms looks bright, but only if you've got your act together. The days of running a platform on a shoestring budget with a robust risk appetite and a loose understanding of regulations, are over. The FCA's "Dear CEO" letter serves as a benchmark, not only for regulatory hosting platforms, but for potential clients and investors to measure the service, independence and peace of mind they currently receive from their regulatory hosting providers.

As regulatory hosts and compliance experts, Robert Quinn Consulting understands the benefits of a strong partnership between a regulatory host and a manager and what it can bring to a firm's operations and also to the ability to attract institutional capital. Regulatory hosts with strong executive teams and dedicated experienced staff can identify and continually manage your regulatory risk - leaving you to focus on the markets.

Let's review some of the key issues highlighted by the regulator:

Governance arrangements

First on the FCA's list of concerns at principal firms was a lack of effective governance arrangements and deficient risk control frameworks. Citing SYSC 4.1., the FCA states that firms must have:

- Robust governance arrangements
- A clear, organisational structure with well defined, transparent and consistent lines of responsibility
- Effective processes to identify, manage and monitor the risks it is or might be exposed to
- Internal control mechanisms, including sound administrative and accounting procedures and effective control and safeguard arrangements for information processing systems

What this means, is that a hosting platform must have documented policies and procedures to assess and monitor the risk profile of your strategy. Documenting a risk assessment of a potential manager by an independent regulatory host is the vital first step. Does the platform have individuals with experience in the space where the manager trades? Does the platform foresee any sharp edges (e.g. strategies in illiquid or difficult to value instruments or U.S. clients that can trigger registration with the SEC or CFTC)? Does your regulatory host have the ability to make regulatory disclosures should your strategy include taking major shareholdings, short positions, or even the ability to operate research payment accounts should this be your chosen route? Identifying these and other issues should result in the platform implementing bespoke monitoring plans and risk frameworks, providing managers and their investors' comfort that the relevant risks are being managed.

Ongoing monitoring

The FCA expressed significant concern over inadequate and ineffective compliance monitoring. Platforms should have full-time, dedicated senior compliance practitioners robustly reviewing all aspects of a manager's business, as well as the ability to monitor daily, weekly and less frequent trading strategies. These arrangements should also include the supervision of recorded lines and e-comms. All of which requires the platform to employ individuals that have significant experience on the buy side, as well as systems that can adapt to and monitor its universe. Having this in place means a manager will have a compliance monitoring programme tailored specifically to their business. Higher risk areas should be flagged and monitored with an appropriate frequency. As the FCA noted, monthly trading checks on a manager that trades daily are not acceptable.

Capital requirements and liquidity assessment

Another point of concern raised by the FCA in respect of Appointed Representative (AR) platforms, is that platforms need sufficient financial resources to meet their obligations and the obligations of their ARs. How that arrangement is structured may be a commercial matter for the platform and its managers, but the obligation remains with the regulated firm. It is also clear that platforms need to be on top of their fixed overhead requirements, liquidity assessment and the limitations of professional indemnity insurance. In addition, the FCA found that revenue from regulated activities conducted by the AR was not being correctly reported. A knowledgeable regulatory host will ensure that appropriate mechanisms are in place from the outset of the engagement to mitigate the risk of incorrect reporting.

Does the regulatory AIFM have the ability to monitor capital requirements and mechanisms to deploy more when needed, for example on the receipt of investor capital into the fund?

Conflicts of interest

The FCA has focused on the identification and management of conflicts for the past few years and MiFID II highlighted that this trend will continue, regardless of the potential disruption new regulations may cause. Successful platforms will recognise that their business model has inherent conflicts which need to be appropriately identified, managed and monitored.

Proactive management

In order to thrive, platforms will need a corporate governance structure that facilitates team decision-making and withstands institutional level challenges. Consistent with the FCA's comments on diversity, a senior management team or board of directors with a range of different financial services experience can be well placed to identify the risks and conflicts that each manager poses. Senior individuals are a product of their experience and lessons learned earlier in their careers. Focusing on and using that diversity of experience will provide a platform with the tools to succeed, as it will have the ability to identify and manage a much broader set of risks. Having a single stakeholder make decisions that focus only on profit margin or sales can lead to an ineffective control framework.

All of the above point to regulatory hosts knowing the future and inherent risks of a business, before the business does itself. A new client, a new market or a new fund can all trigger new regulatory issues and new headaches. Taking a less proactive approach may exacerbate that headache and put the trust between you and your clients at risk. An experienced, well resourced, independent regulatory host can prove to be the perfect remedy for these types of headaches.

With the right controls and expertise we believe that platforms will thrive and become the primary solution for new start-ups if they can pass the same due diligence from institutional investors. Having senior compliance experts involved is vital.

Following the implementation of the Senior Managers & Certification Regime (SMCR) in December, platforms should take the opportunity to map out responsibilities for assessing and supervising a manager from the cradle to grave. While SMCR will not apply to the ARs themselves, the platform needs to assign individuals to key responsibilities within the principal's business. Given the risks, a disorganised platform or one with part-time compliance professionals will struggle to find quality senior managers to perform these roles.

Platforms should welcome the feedback from the FCA following this detailed review of the hosting industry. Understanding the regulator's concerns and putting in place controls to meet the FCA's requirements and expectations will ensure that this pragmatic and cost-effective turnkey solution continues to grow in a post-Brexit environment.

COUNTERING THE FINANCING OF TERRORISM AND SANCTIONS POST-BREXIT

The focus of Anti-Money Laundering ("AML") begins with scrutiny on the investor side however, two key developments have emerged on the investment side of due diligence.

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First, the Financial Action Task Force ("FATF") has given a clear indication on how it currently sees Countering the Financing of Terrorism ("CFT") obligations where Proliferation Finance ("PF") is a linked priority. Second, Brexit will give scope for the United Kingdom ("UK") to diverge from European Union ("EU") sanctions regimes.

CFT

In July 2019, the FATF published the report Terrorist Financing Risk Assessment Guidance. The report is aimed at governments but gives insight into how CFT will develop in industry. The FATF states:

> 'While all countries should have a holistic understanding of all stages of Terrorist Financing ("TF") (raising, moving and use of funds or other assets), this report recognises that there is no one-size fits all approach when assessing TF risk'.

Simply, TF comes in many varied forms. The report recognises 'car rental, purchasing a kitchen knife' as types of routine transactional activity caught by the definition. At the other more relevant end of the spectrum, the report also makes recommendations for 'a developed country with a sophisticated financial sector that is not located anywhere near areas of conflict.'

The key analysis applicable to governments, supervisors and industry whenever required to make an assessment of TF risks is that:

(a) TF is different from Money Laundering ("ML"). For ML, the generation of the funds is an objective in itself where the source of funds is illicit and the end apparently legitimate. By contrast, in TF, spending is the aim where the funds may begin as legitimate but are being directed to a harmful end;

(b) Terrorists are adaptable and will vary how they raise and move funds;

(c) TF and actual terrorism may be linked, but they are far from the same thing; and

(d) Low volume of funds may be a high risk indicator for TF, but low risk for ML.

In its 'practical tool' appendix, the FATF's report explores a potential vulnerability of a country that has 'No measures, or inadequate measures, to freeze without delay terrorist funds and assets'. The report states the risk is that such a country would be attractive 'as a conduit for terrorist financing as the risk of funds and assets being frozen is low.'

Helpfully, the report considers the position of Non-Profit Organisations ("NPOs"). NPOs were singled-out by the Egmont Group in a recent report, as playing a part in 45% of known terrorist financing cases, across a statistically significant sample. In June 2016, the FATF revised its approach to NPOs, reiterating the importance of its risk-based approach because 'some NPOs represent little or no risk at all.'

The FATF's report calls for a much more granular approach, and a careful identification of the nature of threats posed by terrorist organisations to NPOs deemed to be at risk, as well as consideration of how terrorist actors abuse those NPOs.

As for the future of CFT, the FATF's report concludes:

> 'For developed countries with large financial and trade flows, the development of smart solutions in order to cope with "big data" and the continued development of multi-agency information sharing mechanisms will likely be important in ongoing efforts to identify and assess TF risk.'

In summary, though aimed at governments, the July FATF report gives insight into the way global standards on CFT will be interpreted. Risk based approaches in industry will need to distinguish CFT from AML, as will supervision and enforcement at national level.

As for discerning a direction of travel for the FATF, in its thirtieth year, it has taken an expanding remit. In May 2019, the FATF adopted a 'new, open-ended mandate' and turned its attention to mitigating risks from virtual assets, and strengthening its standards on Countering the Financing of Proliferation (of nuclear weapons). China currently holds the FATF's presidency.

Brexit

At present, the predominant sanctions regimes are maintained by the US (via its Office of Foreign Assets Control at its Department of Treasury), the United Nations ("UN") Security Council (which informs regimes of UN member states, sometimes with immediate effect) and the EU. UK sanctions are maintained by its Office of Financial Sanctions Implementation (at HM Treasury) which maintains a consolidated list of all applicable sanctions, i.e. the sum total of those emanating from the UN Security Council, and those having direct effect under EU law. In the Cayman Islands, by way of further example, its Financial Reporting Authority is responsible for disseminating sanctions applicable in the Cayman Islands, derived from the UK list. The Canadian list of sanctions regimes is maintained by its Office of the Superintendent of Financial Institutions.

In the field of targeted financial sanctions, the UK prior to Brexit is dependent on the EU. The EU provided a mechanism for the UK to discharge its duties as a UN signatory. Without the Sanctions and Anti Money-Laundering Act 2018 ("SAMLA"), the UK could not meet its international obligations post-Brexit. Further, without SAMLA, the UK would lack the means to impose its own sanctions independently of the UN, in all but the most limited counter-terrorist arenas. Nor could the UK amend its existing Money Laundering Regulations, absent SAMLA.

Therefore, the central purpose of SAMLA is to enable the UK to continue to implement UN Sanctions regimes and, additionally, to deploy its own unilateral sanctions to meet domestic national security and UK foreign policy objectives. There will be the option for the UK whether to follow EU regimes. Presumably, UK overseas territories will mirror the UK's path and although the Cayman Islands has the ability to impose its own counter-terror sanctions regimes, it has not done so to date.

Just as there is a general transition period for Brexit, so, in the arena of sanctions, temporary legislation will enable the UK government to amend existing EU sanctions lists for a two-year period. However, this interim power is limited to adding or removing the names of designated persons to existing EU lists. It would be wholly inadequate in isolation, being quickly overtaken by events.

Simply, international targeted financial sanctions are most effective when deployed by a large number of countries, acting in concert to signify disapproval and seek to change the behaviour of another nation or international actor. That said, the US and EU have taken differing approaches to Cuba and Iran in recent history.

For the first time since 1972, the UK and its overseas territories now have the potential to take a different sanctions course from the EU. Whether this route is taken will depend on the incumbent in power at Number 10 Downing Street, and the extent to which he or she wishes to align the UK more with the US than the EU. In theory, the UK could even embark upon a third path of unilateral sanctions, distinct from both the US and EU.

Aside from sanctions, post-Brexit the UK loses its EU mechanism for making regulations for the purposes of AML and CFT. SAMLA also bridges this legislative gap. Before Brexit, the UK is again reliant on the European Communities Act 1972 to transpose EU Directives on AML and CTF. Ultimately, these Directives were driven by standards and guidance from the FATF. Such powers were used in June 2017 to transpose the Fourth EU Money Laundering Directive and associated Funds Transfer Regulation, which provided a wholesale revision of the UK's 2007 Money Laundering Regulations with even greater focus on adoption of a risk based approach.

As with sanctions, although the European Union (Withdrawal) Act 2018 preserves the UK's AML / CTF regime as at 31 October 2019, the UK needs an additional power to make, amend and repeal relevant regulations by secondary legislation. The lack of a SAMLA type power would prevent the UK updating that regime to address matters including emerging risks and updated international standards from the FATF.

Again, there is the potential for the UK and its overseas territories to take a different path from the EU in the arenas of AML / CFT. This seems more unlikely than in the arena of sanctions, where an individual Minister (or Prime Minister) may make more of an impact with the designation of targets for financial sanctions. By contrast, AML and CFT are driven by global standards emanating from the recommendations and mutual evaluations of the FATF. There is far less scope for divergence here, at the direction of a strong-willed political leader, or otherwise.

'For developed countries with large financial and trade flows, the development of smart solutions in order to cope with "big data" and the continued development of multi-agency information sharing mechanisms will likely be important in ongoing efforts to identify and assess TF risk.'

ALTERNATIVE MUTUAL FUNDS: GROWTH POTENTIAL LOOKS SOLID COMING OUT OF THE GATE

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The Canadian alternative mutual fund market is less than a year old and there are already 16 companies participating with a total of 42 funds on the shelf. Total AUM stands at $3.6B and we think the right ingredients are in place for alternatives to grow into a meaningful share of the $1.5T mutual fund market. The introduction of alternative mutual funds is good news for the industry and we believe the product will also benefit investors over time.

We believe that most of the right ingredients are in place for the market to grow rapidly in the coming years: i) there is broad fund sponsorship, including many of the largest fund companies in Canada that have vertically integrated business models; ii) the vast majority of funds are widely accessible with low minimum investment thresholds; iii) investors have a broad selection of product from which to choose, including a wide variety of investment strategies and fee structures; iv) some alternative funds have already been included into managed solutions (~21% of AUM is help by other funds); and v) performance to date, albeit over a short time frame, demonstrates that the funds are delivering the low volatility returns they are designed to achieve.

Risk Ratings Are A Good News/Bad News Story

One of the most common questions asked by investment companies prior to the launch of alternative mutual funds was how they would be treated from a risk rating perspective. There was a concern that the risk rating might unduly punish strategies that used more sophisticated investment strategies, such as shorting and derivatives, even if the intention of such strategies was to reduce return volatility. There are two sources of risk ratings – the one assigned by the fund manufacturer and the one assigned by the dealer (i.e. advisory and financial planning companies).

The risk rating assigned by the fund is fully transparent and appears on regulatory filings. The good news is that the vast majority of the AUM and funds (24 of 42) are rated low to medium (comparable to a balanced fund or corporate fixed income fund), which we view as a positive outcome as it speaks to the risk mitigating potential of alternative mutual funds. 13 funds have a medium risk rating (comparable to a large cap equity portfolio), 3 are rated low risk (comparable to a money market or low risk fixed income fund) and only 2 are rated medium to high (equivalent to an equity fund that is concentrated in a specific sector or region).

The risk ratings from dealers are less transparent. In some cases the dealers may just use the rating from the fund company, but in many cases the dealer will assign their own rating. Our understanding is that many dealers have assigned a medium risk rating to strategies with a historical track record (depending of course on the track record) and a high risk rating to strategies with no track record. The challenge is that many of the alternative mutual funds launched to date do not have a 3-year return history and hence, have been assigned a high risk rating regardless of the actual underlying investment mandate.

A Closer Look At Fund Structure

There were a number of questions that industry participants had around fund structure and competitor intentions before regulations were finalized. Questions included types of mandates, the use of sub-advisors, fee structure and others. We siphoned through fund prospectuses and now have specific data points on which to base answers for these questions.

We categorized the universe of funds into two broad investment objectives: i) absolute return (positive returns regardless of market conditions); and ii) alpha type strategies where the intention is to outperform a benchmark over time on either an absolute or risk-adjusted return basis. We find that alpha type strategies are more common, which is perhaps a function of regulatory restrictions around shorting (maximum of 50% of gross value).

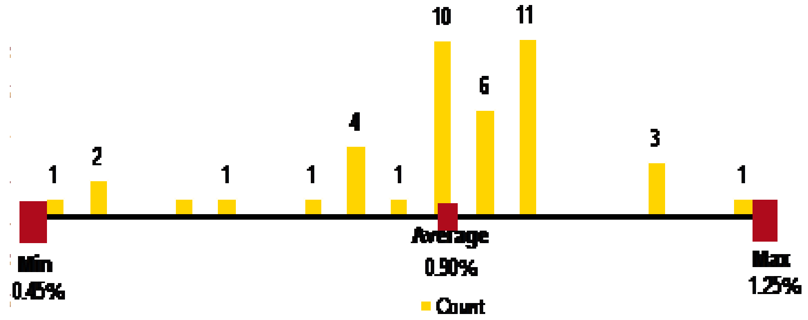
In terms of asset classes, the most common is equity funds followed by multi-asset class. In most, but not all, cases the equity funds have an alpha generating investment objective. The multi-asset class tend to have an absolute return objective. We are somewhat surprised by the small number of funds that are focused on fixed income strategies. It would seem like there is strong demand for yield enhancing product given low yields and demographic needs.
The majority of funds have a performance fee (30 of 42 funds). The performance fee is typically 15% or 20% with a couple of fixed income mandates using a 10% performance fee.

Product has generally been designed to be widely accessible to investors. A minimum initial investment of only $500 is required for more than half the funds. Effectively all the funds offer daily redemption rights with minimum hold periods no different than traditional mutual funds. Also the funds are offered in multiple series (A, F, I, etc) with pre-authorized purchase plan and systematic withdrawal plans to fit investor needs. Effectively the liquidity and accessibility looks very similar to traditional mutual funds, as intended.

Drilling Down On Fee Structure

Fees were a key discussion point as investment firms contemplated alternative mutual fund offerings. The average base management fee on a series-F fund (no trailer fee) is 0.91%. Funds are clustered around the 0.9%-1.0% range. That is around where we would see most new equity fund product priced.

We count a total of 13 funds that use a traditional hedge fund performance fee structure – the fund earns a performance fee based on positive returns over a perpetual high water mark.



Source: Mutual fund reports and CIBC World Markets Inc.

There are also a good proportion of funds (10) that use relative benchmarks. Common benchmarks include the S&P/TSX Composite Total Return Index and FTSE Canada government bond indexes. These funds also follow a perpetual high water market methodology, which provides an incentive to outperform long only benchmarks consistently from year to year (shortfalls in any year have to be recovered in subsequent years before performance fees are earned).

The other performance fee structure we see is fixed hurdle rates, but it is far less common with only 5 funds using a fixed hurdle. The range of annual return hurdles is 2%-6%.

How Is Performance To Date?

We think it's worth looking at fund performance, even with very short track records, to see if alternative mutual funds are doing what they are intended to do. After all, performance will be one of the primary drivers of future demand. We have used daily NAVs for funds that were created before January 1, 2019 to calculate both YTD returns and the daily standard deviation of returns.

Absolute return funds are generating the types of returns that we would view as attractive. The average return is on pace to hit an annualized rate in the 6-8% range, a normalized equity return like outcome, and the funds are doing that with volatility that looks more like a bond index than an equity index. The range of fund returns and volatility suggests there is no excessive risk taking.

Performance from funds that we have categorized as equity alpha funds are also encouraging. The funds are generally designed to have a long bias (positive beta), but with less volatility than the market. Hence, we should not expect the average return to match equity indexes in a year when the S&P/TSX Composite Total Return Index is up 19% YTD and the S&P 500 Index (CAD) is up 19% YTD. But, we should expect return volatility, which we measure as the standard deviation of daily returns, to be lower than equity indexes. This is exactly what we find with the YTD results. We think relative returns could look better for equity alpha funds in a sideways or down market.

The conclusions for fixed income alpha funds are similar to the equity alpha funds. Returns have not kept pace during the 2019 YTD bull market, but returns have been attractive and with less volatility in most cases. Put more simply, these funds are doing what they are intended to do – provide attractive returns with less risk.

	YTD Return			Daily Vol		
	Average	High	Low	Average	High	Low
Absolute Return	3.3%	6.9%	1.8%	0.21%	0.31%	0.14%
Equity Alpha	5.7%	17.8%	-1.3%	0.38%	0.54%	0.19%
Fixed Income Alpha	4.3%	5.8%	3.3%	0.18%	0.30%	0.05%

Source: Bloomberg, investment company websites and CIBC World Markets Inc.

What's Next? Growing The Alternatives Market

There are a number of factors that could help the alternative mutual fund market grow into the $50B-$100B market we had originally envisioned. Broader participation from managed solutions (fund-of-funds), which account for $555B of AUM; advisor education and awareness; performance track records leading to more favourable dealer risk ratings; the launch of more alternative mandates through an ETF wrapper; more relaxed proficiency requirements for MFDA planners; and a change in market conditions that supports the benefits of investing in uncorrelated strategies. The right ingredients are in place to support AUM growth and there are a number of potential developments that could see growth accelerate. Stay tuned.

OPERATIONAL DUE DILIGENCE: WHAT ARE INVESTORS SEEKING?

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At the close of the first half of the year, the equities markets continued their decade-long march.

Even with recent rate cuts by the Federal Reserve, investors have not only remained invested, but have been willing to explore newer territories, from emerging markets to alternatives like private debt and other non-traditional strategies. While this has kept the spotlight on protections such as portfolio and reporting transparency, at the same time many clients continue to seek allocations that align with environmental, social and governance (ESG) investing best practices.

These and other themes were the focus of "Operational Due Diligence: What Are Investors Seeking?" co-hosted by BNP Paribas Securities Services and the Alternative Investment Management Association (AIMA). Held in New York on June 26, the conference included operational due diligence (ODD) professionals from Meketa Investment Group, Albourne Partners and J.P. Morgan Alternative Asset Management as panelists.

Participants shared their unique viewpoints on the challenges of navigating gatekeeper requirements, while at the same time working to keep pace with investor priorities.

ESG to the fore

Interest in ESG policies has been growing as a result of end-investor demand, proliferation of focus in the UK, and, in some cases, generational change among staff at allocators - accompanied by new CIOs interested in incorporating ESG in investment decisions. Panelists are now seeing greater ESG engagement among fund managers, and the industry has arrived at a new era where it is increasingly important to consider business practices and corporate cultures when thinking about ESG. For example, establishing protocols for dealing with workplace harassment, applying diversity and inclusion standards, family leave, and support for community outreach or volunteer work are among areas of growing importance.

When evaluating ESG, ODD professionals emphasized the need for managers to document and evidence policies in ways that are quantifiable. Regardless of size and experience, managers must be able to present evidence of monitoring compliance with their policies and have formal procedures in place in the event of a failure to comply. Culture is also highly valued in the evaluation process; the satisfaction level of employees, retention, and support for policies protecting safety and well-being are all important considerations. There is an understanding that smaller firms will not have all the data available for a robust ESG evaluation; in these cases operational due diligence is flexible and adjusts accordingly.

Evaluation is challenged by varying definitions of what ESG means to different clients – diversity for example, is not defined by the same parameters across clients. Additionally, some investors may have very specific mandates that may be confined to a geographic region, or business type (such as women- or minority-owned). Niche requests like this can be difficult to meet.

Still, ESG remains an investor-driven, news-making phenomenon, and while it's still early days, by consensus the movement continues to gain momentum. Not surprisingly, ODD professionals report a significant uptick in investors wanting to ensure that managers have proper policies in place. As one speaker put it: "In short, ESG is increasingly becoming a big dollars-and-cents issue for companies."

Private markets pivot

As fund portfolios become increasingly tilted toward less-liquid alternative strategies running the gamut from private debt to real assets and more, how have operational due diligence providers responded? For one, the trend has brought issues around valuation and trading into greater relief, underscoring the need for advanced solutions and processes; firms must also ensure that funds have properly skilled people at the helm, given the level of complexity involved.

A notable challenge in private markets stems from a disconnect between the amount of lead time investment due diligence teams may believe is required for ODD and the actual time required to adequately evaluate operational risk. Participants described receiving calls from private-market managers who had abruptly decided to accelerate a fund closing and wanted the ODD team to complete their assessment on perhaps a week's notice, posing impractical deadlines for a thorough review of firm policies, compliance controls, legal documents and so on.

Among the key operational risk concerns highlighted is a lack of independent fund administration. While private equity has generally lagged hedge funds in this area, it is by and large a "legacy issue," remarked one speaker - one that is mainly exclusive to older firms that have self-administrated from the start. Indeed, panelists see the industry evolving; new funds launching today are more likely to have a separate administrator on board.

How much is too much?

All of these add-ons—ESG, private-market, new technologies—ultimately has led to much more work for ODD professionals. Client meetings that once lasted just a couple of hours now run at least twice as long, opined panelists. In a perfect world, one would have resources aplenty to manage the ever-growing, evolving set of ODD requirements. The reality, however, is that many firms are already running a very lean operation, and therefore must streamline even further in order to accommodate the additional workload.

To make the new responsibilities truly workable, many are increasing their reliance on risk-weighting metrics—that is, gathering as many documents and as much information as possible prior to due diligence meetings to identify which aspects of operations pose the most risk, and focusing the time spent during onsite due diligence meetings on those areas. For those who do more with less, there are also vendors that offer solutions for aggregating fund data on behalf of ODD teams, which in turn can bring even more efficiency to the table.

Barriers to entry have risen substantially over the past decade; before significant capital has been raised, startups need to ensure that adequate controls are in place. Infrastructure and resource constraints often require funds to seek outsourced services, but these also need to be monitored and controlled to minimize risk.

While there are some who insist that too much due diligence can erode alpha, when a major issue occurs, the whole industry is impacted. Accordingly, taking the extra step to make certain all requisite protections are in order - no matter how challenging or time-consuming the process may be - is not only good for investors, but for the broader industry as well.

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When a business is replacing, renovating or moving and there's an office to empty, we've created an initiative where the beneficiary of these things will always be a school.

If we give schools good quality business infrastructure when it's no longer needed; children and students will be better prepared to work in those offices when they leave education.

Donations to schools will enhance the environment in which our children learn. If we create a more aspirational place for children to study, they will be inspired. If we provide them with faster tech and more of it, their grades will improve.

If we give students these things in their schools, they will learn more about our businesses because they will be studying alongside tangible parts of it, with all its history.

Schools will collect the things an office doesn't need, or they can be delivered to them. We put the business in touch with every school where their things will be, because it's important to see the furniture and tech you've loved, being enjoyed in its new home. The Head will write and thank the business for the donation and send some great pictures of the things re-homed.

Some fantastic companies have already donated to Business2Schools, they include EFG Private Bank, Entrust Global, Gensler, Jaguar Land Rover, Refinitiv, Royal Lancaster, Tesco , The British Red Cross and Varde Partners.

The initiative is environmental, ethical and sustainable; it's the perfect measure of ESG and CSR. So, what do teachers say about it?

"*Amazing, education is so lucky to have you on our side.*" Tunbridge Wells Grammar School for Boys, Kent
"*This is an education game changer.*" Bishop Luffa C of E School, Chichester
"*If only you knew how happy you have made me today.*" Greenfields Primary School, Watford
"*Fantastic, count us in ;).*" St. Philip Howard Catholic School, Barnham

FED FRUSTRATION

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The Federal Reserve (Fed) lowered its federal funds rate target by 0.25% at its July 31 and September 18 FOMC meetings, in response to the trade war possibly causing slower global growth with fears of a spillover into the US, mainly from reduced business investment. Future cuts are in doubt, as there is plenty of dissension, especially from several regional bank Fed Presidents such as Boston and Kansas City. The Fed prefers consensus decisions, so the path and pace of future rate cuts is in doubt, so long as unemployment is less than 4% and inflation is close to the 2% target. A weaker economy due to the trade war would bring a consensus for lower rates. Still, one can sense extreme frustration in many of the Fed board members and regional bank Presidents. The frustration can be understood, yet it may be mis-placed if one takes a broader view of the Fed's dual mandate.

Dating from the 1940s and more explicitly since 1977, the Fed has a clear mandate given to it by the US Congress: to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates". Despite there being three items, who is counting anyway, these objectives are referred to as the dual mandate related to employment and inflation. Moreover, the Fed has traditionally defined stable prices to mean keeping core inflation more or less around a 2% target.

In terms of the employment objectives, current policy is a roaring success with the unemployment rate comfortably under 4%, which is extremely low by historical standards (the lowest in 50 years. As regards the inflation objective, core inflation has been bouncing in a narrow range from 1% to 3% since 1994, which is an amazingly long track record of success, given the experience of double-digit inflation in the 1970s.

Despite achieving both of its dual mandates, the Fed is quite frustrated. Why? Well, the Fed welcomes the low unemployment rate, but the Fed's not-so-hidden agenda has been higher real GDP growth. The Fed, like many politicians and elected leaders in Washington, wanted a stronger economic expansion after the Great Recession. They were hoping for a sustained period of 3% to 4% real GDP growth, and viewed the 2.3% achieved since 2010 as anemic. This interpretation of this longest economic expansion ever as anemic is simply wrong for a variety of reasons.

Demographic Patterns have lowered long-run potential real GDP growth

First, due to demographic patterns the US economy is highly unlikely to grow as fast as it did in the two previous long expansions of the 1960s and 1990s. The issue is that Baby Boomers are retiring and spending less, a lot less than they did when they were working. In retirement, appetite for spending shrinks. Their retirement income is constrained. Many boomers are dependent on interest income from savings, and super-low interest rates have destroyed that source of income. New generations are entering the work force, but not in as large of numbers as in the past. The prime working age population in the US, ages 25 through 54, has virtually stopped growing. Moreover, the younger generations are saddled with huge student debt loads – meaning, they may marry later, have kids later, buy a house later, and so cannot make up the slack from the retiring boomers. Thus, potential real GDP growth is more like 2.25% and certainly not 3%-plus. This will be the case until the mid-2020s when demographic patterns can again support 3% real GDP growth. Since the Fed can do nothing about demographic problems, its efforts with near-zero rates and quantitative easing (QE), while raising asset prices, have failed to encourage more real GDP growth. The corporate tax cut did manage to get a quarter or two of higher real GDP growth before its impact diminished. Now, the trade war is limiting the economy to sub-par growth.

There is a very optimistic side to this story. Even with much lower potential real GDP growth, the unemployment rate has declined toward historic lows. With the labor force hardly growing, it does not take as much GDP growth to lower the unemployment rate. Put another way, if one focuses on real GDP, one might be frustrated. But if one appreciates the reality of an aging population with virtually no labor force growth, then the achievement of less than 4% unemployment should be a point of celebration.

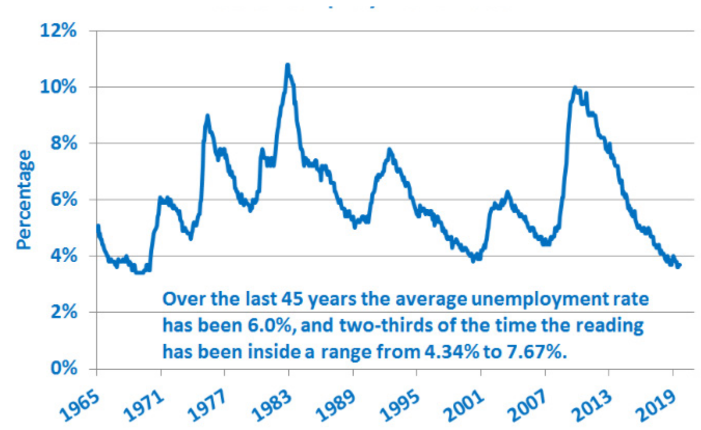

Chart Created by CME Group Economics.
Source: St. Louis Federal Reserve Bank FRED Database (UNRATE)

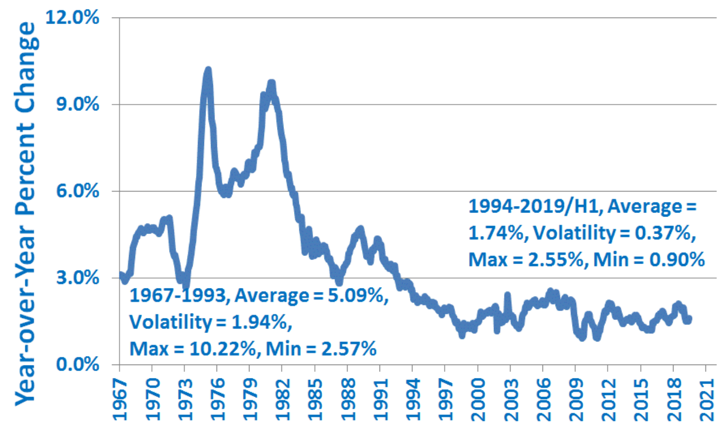

Chart Created by CME Group Economics.
Source: Data from St. Louis Federal Reserve (PCEPILFE)

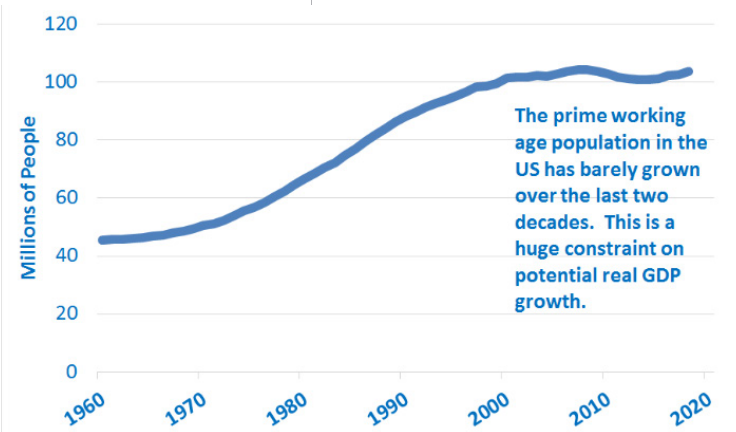

Chart Created by CME Group Economics.
Source: Federal Reserve Bank of St. Louis FRED Database (LFAC25TTUSA647N).

Inflation is no longer something the Fed can control, for a diverse set of reasons

As we have noted, core inflation has been running in a narrow range close to 2% for 25 years and counting. Inflation has had a very muted response to the equity tech rally in the 1990s, to the subsequent tech wreck, to the housing boom, to the Great Recession, to zero rates, to QE. Somethings besides monetary policy, or equities, or cycles in employment are now more important for explaining these two and half decades of price stability.

Again, there are the demographic patterns of an ageing population to consider, which are constraining consumption and helping to put a lid on inflation. There is the new era of competition. Before the Internet Era, companies had much more pricing power than they have today. Companies once controlled the flow of information about their products and prices were not easily compared. Since the mid-1990s, we have been evolving to ever greater price transparency with enhanced competition. The Internet has empowered consumers in the form of price transparency to engage easily in competitive shopping. Companies now focus on cost-cutting to maintain profit margins rather than raising prices because raising prices can mean a loss of business. This seismic shift in price discovery, and one ignores its implications for price stability at one's peril.

Limiting the Fed's power to create inflation has been the rise of interest rate risk management in the financial sector and the increased use of capital ratios as a regulatory tool to guard against systematic risk. Enhanced interest rate risk management means that small changes in short-term rates have little to no impact on financial company profits, which translates into little or no impact on lending that might lead to more growth and inflation. As for the more aggressive use of capital ratios by regulators, financial companies that are capital constrained are limited in their ability to increase lending regardless of low rates or how many Treasuries or mortgages the Fed might buy. There is a trade-off between prudential regulation to prevent systematic risk and monetary policy to manage inflation. As the pendulum has swung toward prudential regulations involving capital ratios, monetary policy has become less effective to fine-tune the economy. [For those statisticians among you, this is akin to the trade-offs between Type I and Type II errors. For the religiously inclined, think about sins of omissions and sins of commission.]

What are the consequences of frustrated policy makers?

Central bank frustration can lead to heightened potential for poor policy choices involving unneeded experiments with new tools, done with the best of intentions yet at the risk of serious unintended consequences. Take zero rates, or even negative rates as practiced by the European Central Bank (ECB) or Bank of Japan (BoJ). While zero rates help corporate borrowers, zero rates take away the income stream from anyone depending on fixed income investments. This includes not only individuals but also pension funds, life insurers and others whose ability to fund their liabilities is tied to stable income generation, typically via fixed income returns. This results in decreased consumption when there is an aging population, as is the case for the US, Europe, and Japan. Negative rates, which the Fed has not adopted, are even worse. Negative rates are a tax on the financial system that constrains bank profitability and lending activity. Negative rates should never be considered an accommodative policy, and they almost certainly have contributed to a coming recession in Germany. Negative-yielding debt, of which there is $15 trillion in Europe and Japan, also sends a very compelling message about an extreme lack of confidence in the future.

Another unintended consequence of zero or negative rates is that it encourages potentially excessive risk-taking. Market analysts call this the search for yield, and higher returns only come with accepting higher risks. When the reckoning comes, the portfolio shocks could be severe due to the search for yield mentality encouraged by central banks.

Then, there is the challenge of the wealth divide. Massive asset purchases or QE by central banks, including the Fed, were designed to stimulate inflation. Instead, they created asset price inflation, which mostly benefited the wealthy, and did nothing to stimulate consumption, assist economics growth, or promote inflation.

The bottom line is that there is little central banks can do to create inflation in the face an aging demographic pattern, the era of greater price transparency, heightened prudential regulation focused on capital ratios, and improved interest rate risk management. But then, there is really no need for frustration, especially in the US. There is nothing to fear from hitting one's 2% inflation target. Indeed, a modest swing to slight deflation and back again is fine as long as the economy does not experience the devasting effects of massive deflation, such as occurred in the 1930s. Unfortunately, too many policy-makers have listened to too many economists who have gone astray by not appreciating the implications of demographics, technological change, and a different capital regulatory environment.

Finally, we have to add to this analysis by considering the trade war, which has helped to slow the global growth and complicate the Fed's decision-making. US real GDP is mostly driven by consumption. So long as consumers have jobs and the confidence they will keep their jobs, consumer spending can drive the economy forward, even with a trade war. The trade war does impact business investment, which has slowed dramatically with the uncertainty over tariffs and disruption of supply chains. But a slowdown in business investment does not necessitate a recession make, even if it takes real GDP to 2% or below. Even with 1.5% to 2% real GDP growth, since there is virtually no labor force growth, unemployment need not rise with the growth deceleration. So, as noted earlier, as long as the US unemployment rate is under 4% and inflation close to 2%, the Fed may well go back on "hold" despite some opposition from the doves on the FOMC and regardless of Presidential jawboning. If unemployment were to rise above 4% and appear to be heading higher, then the Fed would probably react quickly to drop its federal funds target back to near zero and possibly re-institute quantitative easing.

NEW RULES FOR PRE-MARKETING FUNDS AND REVERSE SOLICITATION

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The Cross-border Distribution Directive EU/2019/1160 (**CBDD**) and Cross-border Distribution Regulation EU/2019/1156 (**CBDR**) amend the Alternative Investment Fund Managers Directive EU/2011/61 (**AIFMD**) and introduce new rules for the pre-marketing of alternative investment funds (**AIFs**) in the European Union (**EU**).

The new rules will impact existing practices in relation to pre-marketing activities - the key change being the introduction of a new notification requirement for pre-marketing to professional investors in the EU, which will have implications for reverse solicitation.

Objectives of the new rules

The new rules aim to harmonise regulatory and supervisory approaches to pre-marketing activities for AIFs managed by EU alternative investment fund managers (**AIFMs**) within the framework of AIFMD.

Currently, what does (and does not) constitute 'marketing' under AIFMD varies significantly across the EU, notwithstanding that it is defined in AIFMD as the "direct or indirect offering or placement, at the initiative of (or on behalf of) the fund manager of units or shares of an AIF it manages, to or with investors domiciled, or with a registered office, in the EU."

This matters because, pursuant to AIFMD, 'marketing' an AIF in the EU triggers certain compliance obligations. This includes a requirement to submit a prescribed form notification to the national competent authority in the EU member state in which one wishes to market. Failure to do so may result in a fine or public censure. In addition, any subscription agreements entered into as a result of unlawful marketing may be unenforceable.

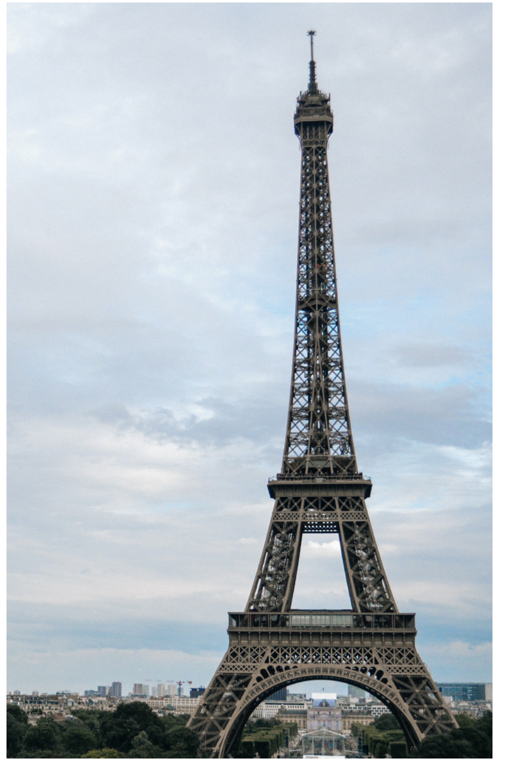
In contrast, reverse solicitation - i.e. where an investment is made, at the initiative of an investor, in an AIF managed or marketed in the EU - does not trigger any notification obligations.

Nor does pre-marketing. This is good for fund managers because it means they can test a market and explore whether there is sufficient investor appetite before proceeding with a particular investment strategy and establishing an AIF, and before obtaining a marketing passport or submitting a marketing notification and incurring the associated costs.

Current rules and practice in the UK

The UK regulator, the Financial Conduct Authority (**FCA**), takes the view that communications relating to draft documentation do not constitute 'marketing' under AIFMD. Instead, such promotional activities are subject to compliance with the financial promotion regime under the Financial Services and Markets Act 2000 (**FSMA**).

'Marketing' under AIFMD is deemed to take place in the UK when units or shares in an AIF are available for purchase and final form contractual documents are provided to prospective investors.



However the FCA recognises that other EU member states may take a different view (as has been the case).

Current rules and practice in the EU

There is no guidance from the European Commission or the European Securities and Markets Authority on the meaning of marketing pursuant to AIFMD, nor is there any consistency in terms of approaches relating to marketing (or reverse solicitation) in member states.

Similarly for pre-marketing, while some member states permit it, the way in which pre-marketing is defined, and the conditions attached to it, tend to vary. In other member states, there is simply no concept of pre-marketing.

The CBDD and the CBDR aim to address this divergence.

What is 'pre-marketing'?

'Pre-marketing' is defined in the CBDD as follows:

"The provision of information or communication, direct or indirect, on investment strategies or investment ideas, by an EU AIFM or on its behalf, to potential professional investors domiciled, or with a registered office, in the EU, in order to test their interest:

- in an AIF (or a compartment) which is not yet established; or
- in an AIF (or a compartment) which is established but not yet notified for marketing under articles 31 or 32 of AIFMD;

In the member state where the potential investors are domiciled or have their registered office, and which does not amount to an offer or placement to the potential investor to invest in the units or shares of that AIF (or compartment)."

Which AIFMs are in scope?

The pre-marketing rules apply to authorised EU AIFMs only. In the UK this would capture full scope UK AIFMs and small authorised UK AIFMs.

The CBDR extends the pre-marketing regime to managers of qualifying venture capital funds and qualifying social entrepreneurship funds.

Other small registered AIFMs in the UK (such as internally managed, closed-ended investment companies and external managers of certain property funds) are not in scope of the pre-marketing rules under the CBDD or the CBDR.

What about non-EU AIFMs?

The pre-marketing rules do not apply to non-EU AIFMs (such as Canadian or US fund managers) marketing their funds in the EU under the national private placement regime (NPPR).

It will be up to the national competent authority in each EU member state to determine whether to extend the pre-marketing rules to non-EU AIFMs under the NPPR.

Conditions for pre-marketing in the EU

EU AIFMs may engage in pre-marketing, provided that the information presented to potential professional investors:

- is insufficient to allow investors to commit to acquiring units or shares of a particular AIF;
- does not amount to a subscription form or similar document (whether in draft or final form); and
- does not amount to a final form constitutional document, prospectus or offering document for an established AIF.

Pre-marketing with draft documents

EU AIFMs may, as part of their pre-marketing, provide potential professional investors with a draft prospectus or draft offering documents, but the documents must not contain information sufficient to allow investors to take an investment decision.

The draft prospectus or draft offering documents must clearly state:

- the document does not constitute an offer or an invitation to subscribe to units or shares in the AIF; and
- the information presented in the documents should not be relied upon because it is incomplete and may be subject to change.

Record keeping

EU AIFMs must ensure their pre-marketing activities are adequately documented.

New notification requirement for pre-marketing

Within two weeks of starting to pre-market, an EU AIFM must send an informal letter or email to its home regulator with the following information:

- the member states in which it is (or has) engaged in pre-marketing;
- the time periods in which the pre-marketing is taking (or has taken) place;
- a description of the pre-marketing activities (including a description of the investment strategies presented); and

- a list of the AIFs and compartments of AIFs that are (or were) the subject of pre-marketing.

The home regulator will then inform the national competent authority in each member state in which pre-marketing is taking or has taken place.

This notification requirement is new and represents a key change for UK AIFMs, who typically undertake promotional activities under FSMA (without notifying the FCA) before they start 'marketing' under AIFMD.

What does this mean for reverse solicitation?

Currently, AIFMD does not restrict professional investors who wish to invest in AIFs on their own initiative. Confirmation from the investor that the offering or placement of units of shares of the AIF was made at its initiative is normally sufficient to demonstrate reverse solicitation. On a more practical level, it means the AIFM does not need to submit a marketing notification to the regulator.

Once the new pre-marketing rules come into force, any subscription by professional investors, within 18 months of an EU AIFM having begun pre-marketing, to units or shares of an AIF referred to in the information provided in the context of pre-marketing, or established as a result of the pre-marketing, is considered to be the result of 'marketing' under AIFMD.

This means EU AIFMs will be required to submit a marketing notification to the relevant regulator following pre-marketing.

It effectively means there will be an 18 month moratorium on reverse solicitation, though it is not clear whether this restriction applies to investors or to each EU member state subject to pre-marketing. Either way, it appears as though it will become more difficult to rely on reverse solicitation.

Who can engage in pre-marketing on behalf of an EU AIFM?

The following third parties may engage in pre-marketing activities on behalf of an EU AIFM:

- an investment firm or a tied agent (in accordance with the Markets in Financial Instruments Directive EU/2014/65);
- a credit institution (in accordance with the Capital Requirements Directive EU/2013/36);
- a UCITS management company (in accordance with the UCITS Directive EC/2009/65); or
- an AIFM (in accordance with the CBDD).

When do the new rules apply?

The new pre-marketing rules are expected to apply from August 2021.

The European Parliament adopted the CBDD and CBDR on 16 April 2019, and the European Council followed shortly after in June 2019. The CBDD and CBDR was published in the Official Journal of the EU on 12 July 2019 and (subject to limited exceptions) entered into force on 1 August 2019. Member states must transpose the pre-marketing rules into national law by 2 August 2021.

Notwithstanding Brexit, the UK is likely to adopt the CBDD and the CBDR into UK financial services laws. The Financial Services (Implementation of Legislation) Bill 2017-2019 provides a mechanism for HM Treasury to implement EU financial services legislation that is currently in the pipeline for a period of two years after the UK leaves the EU, and this includes the CBDD and the CBDR.

Funds looking to raise capital from professional investors in the EU from 2021 onwards must factor these new rules into their fundraising schedule.

NATURAL LANGUAGE PROCESSING IN FINANCE:

Shakespeare Without the Monkeys

"We want Facebook to be somewhere where you can start meaningful relationships," Mark Zuckerberg said on 1 May, 2018.

The announcement sparked gasps – not just from the crowd in front of whom Zuckerberg was talking – but also in financial markets. The share price of Match Group (the company that owns Match.com, Tinder and other dating websites) plunged by more than 20%.

Why is this example significant? The answer is simple: Financial markets were being swayed by a sentence made up of just a few words. There was not a single number in the announcement. More interestingly, Zuckerberg's comment did not impact Facebook's share price – the biggest effect was felt by a company that until that moment may not have even been considered a competitor to Facebook. The move was large, and almost instantaneous.

This behaviour – a few words causing strong reactions rippling through markets – happens all the time, albeit usually more subtly. The focus of this article is the automatic analysis of text by computers, also known as Natural Language Processing ('NLP'), which aims to extract meaning from words and predict the ripples even as they are happening.

What Is NLP?

NLP is a sub-field of artificial intelligence ('AI'), which seeks to program computers to process, understand and analyse large amounts of human (or 'natural') language.

How is this useful in finance?

Detecting Material Events

As we saw in the Facebook example, it's useful in uncovering market-moving events. Facebook unveiled a new product – like Apple unveiling the iPhone – and that resulted in a very strong market move. Numerous such events happen in financial markets all the time. Indeed, for a lot of them, text, or even the spoken word, is the primary source. As such, methods from NLP can be used to automate this process: monitoring many text data streams and automatically issuing notifications upon the emergence of market-moving events.

There are, however, many other ways in which machines can help.

Understanding Document Tone

Perhaps one of the most common applications of NLP in finance is measuring document tone, also known as sentiment. The idea is simple: get the machine to 'read' a document and assign it a score from -10 (very negative) to +10 (very positive).

Take the sentence below:

French Cosmetics giant L'Oreal said strong demand for luxury skin creams helped it beat fourth-quarter sales forecasts - another company reporting better-than-feared demand from China after LVMH last week.[1]

This would maybe get a score of 8.

Now take this sentence:

Construction was a weak spot with Denmark's Rockwool sinking 13% after full-year earnings missed expectations, and Sweden's Skanska losing 7.8% after it cut its dividend and lagged profit estimates.

This may get a score of -9 for Rockwool and Skanska.

While the two examples above are company-specific, sentiment analysis can also be done with respect to the economy in general, or even toward specific topics such as inflation or interest rates.

Modelling Document Topics

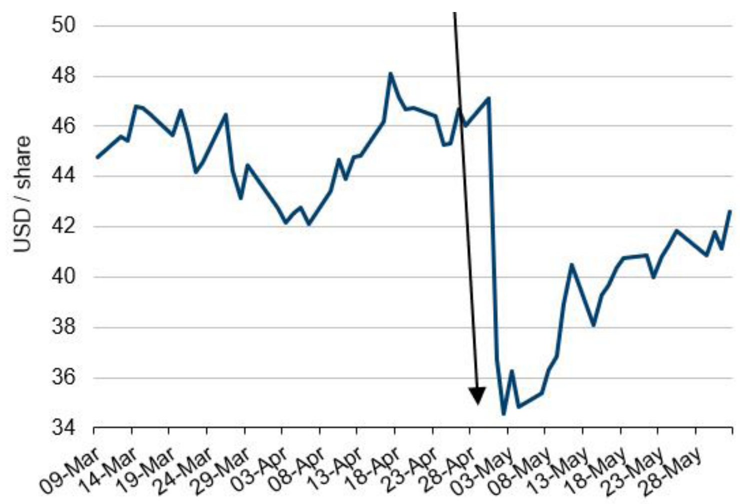
To be successful, NLP systems in finance often need to automatically extract a document's topic structure. Consider this snippet from a news article:

Oil prices fell on Monday after climbing to their highest this year earlier in the session as China reported automobile sales in January fell for a seventh month, raising concerns about fuel demand in the world's second-largest oil user.[2]

Often, the important information in a document is not just the tone, but its focus. In this example, there are two key topics: the first is oil, with words such as "oil", "prices", "fuel", "fell" and "climb"; the second is the global economy, with words such as "world", "China", "demand" and "sales". Understanding the topic

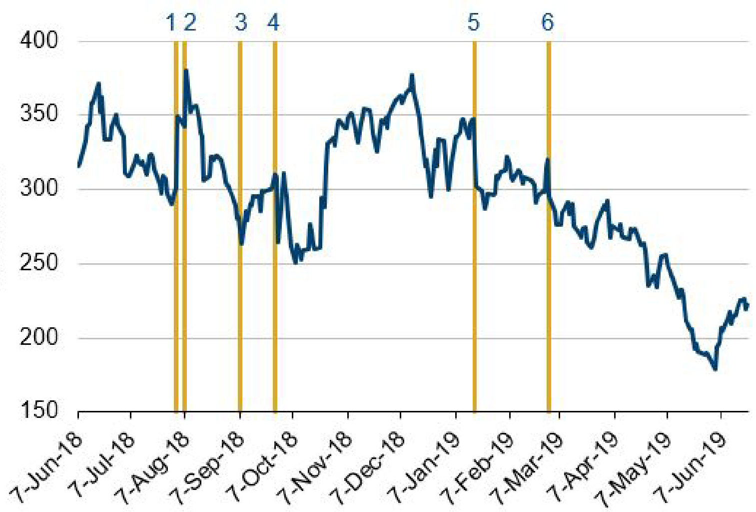
Figure 1: Facebook's Announcement Creates Ripples in Match.com

Share price of Match.com plunged on 1 May, 2018, as Facebook announced that it would integrate a feature for online dating directly onto its app.



Source: Bloomberg; between 9 March, 2019 and 1 June, 2018

Figure 2: An Example of How Events Affected Tesla



Source: Bloomberg; as of 21 June, 2019.
1. 2 August, 2018: Shares soar as Tesla says production of its lower-cost Model 3 sedan is growing and CEO Elon Musk says the company does not expect to need to raise more money from investors.
2. 7 August, 2018: Musk announces on Twitter that he wants to take Tesla private in a deal that would value the company at USD70 billion.
3. 8 September, 2018: Just hours after Musk finishes smoking marijuana in a more than 2 1/2-hour podcast with comedian Joe Rogan, it is confirmed that both his chief accounting officer and head of human resources are leaving. Shares plunge.
4. 27 September, 2018: Shares fall as the SEC accuses Musk of misleading investors with his 7 August tweet about taking Tesla private, raising questions about Musk's future.
5. 18 January, 2019: Shares fall sharply as Musk warns that Tesla could struggle to make a profit in the first quarter and as he cuts more than 3,000 jobs from the electric carmaker.
6. 1 March, 2019: Shares slide as Musk confirms that Tesla will not be profitable in the first quarter.

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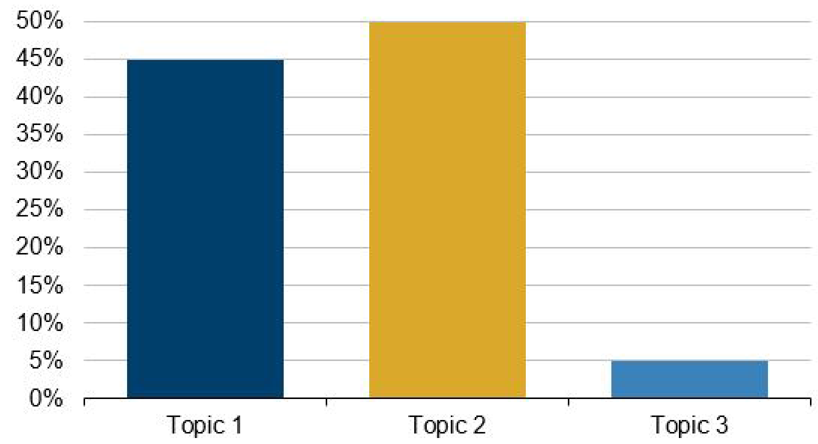
1 https://uk.reuters.com/article/europe-stocks/european-stocks-falter-as-investors-digest-weak-earnings-loreal-impresses-idUKL5N2031VI

2 Source: Reuters.

Figure 3: An Example of Machine Learning Models Inferring Topic Structure From a Document

Oil prices fell on Monday after climbing to their highest this year earlier in the session as China reported automobile sales in January fell for a seventh month, raising concerns about fuel demand in the world's second-largest oil user.



Topic 1: Oil	
Oil	5%
Fuel	3%
OPEC	2%
Topic 2: Global Economy	
China	3%
Demnad	2%
World	1%
Topic 3: Sectors	
Automobiles	4%
Utilities	3%
Banking	2%

Source: Man Group; for illustration purposes only. The model has determined that the sentence is 45% about Topic 1, 50% about Topic 2, and 5% about other topics. We have explicitly labelled Topic 1 as Oil and Topic 2 as the Global Economy based on the most probable words associated with each of the topics.

structure of a document helps identifying events, informs the correct attribution of sentiment and allows to assess document similarity on a semantic level.

The above example also highlights another subtle, but important, aspect of quantifying text data: timeliness. Even if we correctly identified the document's topics, there are two timeframes mentioned: "fell on Monday" and "climbing to their highest this year earlier in the session". Clearly, these two moves were attributed to a single entity – oil prices – yet they have opposite directions. Correctly identifying the evolution of events can be a crucial task for computer algorithms.

Detecting Subtle Change

This theme of subtlety is quite prevalent in NLP research. The information contained in text data is sometimes very obvious to the human eye (a new product launch in the news; lots of positive words by a company executive), but can just as often be buried. One example application of NLP is measuring textual change: comparing the same documents over time, and finding subtle differences.

For example, in IBM's 2016 annual report, the company had a snippet related to its brand risks under a risk factor called "Failure of Innovation Initiatives". In the following year's annual report, IBM decided to extract it as a separate risk factor called "Damage to IBM's Reputation", and explicitly listed eight broad categories of example sources of reputation risk.

Such subtle changes can be tricky and painstaking for a human to identify, especially given the typical length of annual reports and an investible universe of thousands of companies. Yet, to a machine, these changes are obvious: an algorithm can automatically scan through millions of documents and identify the added, deleted, or modified risk factors, classify them according to their topic, and even check which other companies have modified their risk factors in similar ways. Another example is the transcripts from the Federal Open Market Committee ('FOMC') on US interest rate policy, where the market typically reacts not to the current transcript, but rather to slight changes in wording between the current and previous ones.

Working Across Multiple Languages

All of the above examples are in English. While documents in English are convenient to consider because there is a vast amount of academic research in the area, it clearly isn't the case that all market-moving information originates in English. To be able to leverage text from different languages and sources, one has to either develop models specific to that language, or translate documents into English and then apply an English model. Both applications are currently a heavy focus of NLP.[3,4]

3 https://www.sec.gov/Archives/edgar/data/51143/000104746917001061/a2230222z10-k.htm
4 https://www.sec.gov/Archives/edgar/data/51143/000104746918001117/a2233835z10-k.htm

Figure 4: Comparing IBM's Annual Reports

IBM's 2016 annual report	IBM's 2017 annual report
[...] IBM has one of the strongest brand names in the world, and its brand and overall reputation could be negatively impacted by many factors, including if the company does not continue to be recognized for its industry-leading technology and solutions and as a cognitive leader. If the company's brand image is tarnished by negative perceptions, its ability to attract and retain customers could be impacted.	Damage to IBM's Reputation Could Impact the Company's Business: IBM has one of the strongest brand names in the world, and its brand and overall reputation could be negatively impacted by many factors, including if the company does not continue to be recognized for its industry-leading technology and solutions and as a cognitive leader. IBM's reputation is potentially susceptible to damage by events such as significant disputes with clients, product defects, internal control deficiencies, delivery failures, cybersecurity incidents, government investigations or legal proceedings or actions of current or former clients, directors, employees, competitors, vendors, alliance partners or joint venture partners. If the company's brand image is tarnished by negative perceptions, its ability to attract and retain customers could be impacted.

Going Beyond Written Text

All examples so far assume that the text we are interested in already exists in written form. That is not always the case. For example, every quarter, many global public companies host earnings conference calls – the timeliest source of financial results.[5] Techniques from speech recognition research can be used to automatically transcribe documents as the call is progressing, or even analyse the subtle nuances of management tone to measure emotions.[6]

Why Should We Care About NLP Now?

In the last 10 years, we witnessed a major wave of scientific breakthroughs. These innovations come from the field of neural networks – also known as deep learning.

Neural network models get their inspiration from the human brain. Building blocks, called artificial neurons, are connected together, in code, to form larger networks. These neurons take some raw input data, fire up and transfer their impulses forward, ultimately resulting in a prediction. A researcher can define the 'shape' of the network: the connectivity pattern between the neurons. By designing different layouts and stacking them on top of one another (hence the name, 'deep' learning), researchers can impose their prior knowledge of the world. Given sufficiently large and complex datasets and computer resources, the strength of the connections between the artificial neurons can be learned. The researchers can create the blueprint (called the 'architecture'), supply the data and guide the learning process; the neural networks adjust the neuron connection strengths to make the most accurate predictions.

Neural network models have successfully modelled problems ranging from how to represent the meaning of words in a computer (word embeddings [7,8,9]), through capturing the meaning of chunks of words (convolutional neural networks [10,11,12]), to modelling the sequential (recurrent neural networks [13,14,15]), and compositional (recursive neural networks[16]) nature of phrases. Indeed, these ideas have been the foundation of many of the recent state of-the-art results in modern NLP.

Challenges When Using NLP

The first obvious challenge is scale. Unlike many numerical datasets, text data can be very large and thus requires significant investments in data storage and computation capacities.

5 https://seekingalpha.com/article/4241565-deere-and-company-de-q1-2019-results-earnings-call-transcript
6 William Mayhew and Mohan Venkatachalam (2012), The Power of Voice: Managerial Affective States and Future Firm Performance, Journal of Finance.
7 Tomas Mikolov, Kai Chen, Greg Corrado, Jeffrey Dean (2013); Efficient Estimation of Word Representations in Vector Space.
8 Jeffrey Pennington, Richard Socher, Christopher D. Manning, GloVe: Global Vectors for Word Representation.
9 Armand Joulin, Edouard Grave, Piotr Bojanowski, Tomas Mikolov (2016); Bag of Tricks for Efficient Text Classification.
10 Ronan Collobert, Jason Weston, Léon Bottou, Michael Karlen, Koray Kavukcuoglu, Pavel Kuksa (2011); Natural Language Processing (Almost) from Scratch.
11 Nal Kalchbrenner, Edward Grefenstette, Phil Blunsom (2014); A Convolutional Neural Network for Modelling Sentences.
12 Yoon Kim (2014); Convolutional Neural Networks for Sentence Classification.
13 Tomáš Mikolov, Martin Karafiát, Lukáš Burget, Jan "Honza" Cernocký, Sanjeev Khudanpur (2010); Recurrent neural network based language model
14 Shujie Liu , Nan Yang , Mu Li and Ming Zhou (2014); A Recursive Recurrent Neural Network for Statistical Machine Translation.
15 Tony Robinson, Mike Hochberg and Steve Renals (1996); The Use of Recurrent Neural Networks in Continuous Speech Recognition.
16 Richard Socher, Alex Perelygin, Jean Y. Wu, Jason Chuang, Christopher D. Manning, Andrew Y. Ng and Christopher Potts; Recursive Deep Models for Semantic Compositionality Over a Sentiment Treebank.

The next challenge is that 'natural' language often doesn't do a particularly good job of conforming to cleanly defined grammatical rules. Some datasets you may want to look at in finance – such as annual reports or press releases – are carefully written and reviewed, and are largely grammatically correct. They are thus relatively easy for a computer to analyse. But how about tweets, product reviews or online forum comments? These tend to be full of abbreviations, slang, incomplete sentences, emoticons, etc – all of which make it quite tricky for a machine to decipher.

Perhaps the ultimate challenge is talent. To make sense of text data, experts from the fields of linguistics, machine learning and computer science need to be hired. In today's highly competitive market, one needs to compete in the talent war for the best and brightest.

Conclusion

We believe NLP is an extremely exciting research area in finance due to the vast range of problems it can tackle for both quant and discretionary fund managers. In particular, firms with strong investments in technology infrastructure and machine learning talent have positioned themselves to potentially capitalise on successfully applying these methods to finance. Combined with the availability of more data than ever, vast amounts of available compute and improved tools [17,18,19,20], these exciting recent research advances may create a rich and fruitful alpha opportunity.

17 https://www.tensorflow.org/
18 https://spacy.io/
19 https://spark.apache.org/
20 https://github.com/manahl/pynorama

CAYMAN ISLANDS REVISED ANTI-MONEY LAUNDERING REGULATION – ONE YEAR ON

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On 30th September 2018, the Cayman Islands introduced revised anti-money laundering and counter terrorist financing legislation.

This AML legislation was in response to Financial Action Task Force (FATF) recommendations to combat money laundering and terrorist financing and formed part of a wider overhaul of financial regulation to protect the integrity and reputation of the Cayman Islands. As the first anniversary of the new legislation approaches, we review how the industry has responded and what changes may lie ahead.

Approaches to compliance

A key requirement of the legislation was for all funds that conduct "relevant financial business" in the Cayman Islands to appoint an AML Compliance Officer, Money Laundering Reporting Officer and a Deputy MLRO. These roles could be outsourced to individuals outside the Cayman Islands, but strict standards were set out requiring individuals to be independent of the fund, experienced and able to dedicate sufficient time to the duties.

A variety of approaches to compliance have been taken. Some funds have looked to their managers to perform the roles in-house, although this has generally been dependent on the ability of the individuals to dedicate sufficient time to discharge the obligations. Many funds appointed their existing administrator to perform the roles, partly due to the ease of the transition to meet the new requirements and the ability to leverage the existing AML processes in place. However, several fund administrators decided not to provide the service. The final approach taken has been to appoint a third-party service provider that is independent of the fund, the manager and the fund administrator.

Unexpected value

Many industry participants were initially sceptical of the value that would be derived from the new requirements. This was especially the case for funds that already appoint a third-party administrator to conduct investor AML checks. Fund directors and managers comment that the legislation has, in some instances, added more comfort and value that they had been expecting. This feedback is however dependent on the firms and models employed, since some AML providers are reported to have been relying heavily on confirmations from the fund administrator that procedures are being carried out, whereas others have been more thorough, reviewing procedures, transactions and investors themselves.

Independence and capacity

Echoing other areas in the funds industry, there has been growing demand amongst fund boards for independent oversight and review in order to add value to this mandatory AML requirement. Notably, some boards have questioned the independence of fund administrators when fulfilling the MLRO functions, and the robustness of a model whereby the fund administrator is monitoring its own activities. Fund boards are also starting to reflect on the capacity and the ability for MLRO officers to adequately discharge their duties when they are appointed by numerous funds.

Strong AML practices but weaknesses exist

As an independent CIMA AML Officer service provider, INDOS has conducted reviews across a range of fund administrators and managers and notes the high standards applied to AML processes. Despite these high standards, several issues have been identified that highlight the need for continued scrutiny. Examples include Politically Exposed Persons (PEPs) not previously identified by the fund administrator; insufficient AML / CDD being undertaken on PEPs and high-risk investors; investor due diligence certifications not completed to standard; weaknesses around testing of eligible introducers and some breaches of an administrator's own AML and customer due diligence policies and processes.

Seeking Clarity

Despite being one year old, there are some areas where further guidance from the Cayman Islands regulator, CIMA, would be welcome. These include where reliance is placed on AML regimes in operation in third countries that have less strict standards and material gaps in policy compared to Cayman Islands requirements, for example Cayman Islands 10% beneficial owner identification threshold compared to wider international standards of 25%.

Adoption of Cayman Islands Standards

Due to the outsourced nature of operations for the majority of Cayman Islands domiciled funds, the introduction of the AML legislation created a conflict in compliance standards between those set out in the CIMA AML regulations and those imposed by regulators in the jurisdiction of the fund administrator.

Initially, many administrators operating outside the Cayman Islands continued to rely upon the domestic compliance standards set out by their respective regulators, regardless of whether those standards were less stringent than those set out by the AML Legislation. Despite the difference in standards, the administrators continued to rely upon the "Equivalent Jurisdiction" status rather than uplift existing policies and change processes to accommodate. However, as the one-year anniversary approaches we are starting to see a number of administrators review and enhance their AML and compliance policies to meet the Cayman Islands standards.

CIMA – Additional AML / CFT Reporting

In March, the FATF issued a report on the Cayman Islands anti-money laundering and counter-terrorist financing measures whereby the Cayman Islands regulator, CIMA, was both commended for its efforts and highly regulated regime but also criticised for deficiencies in how rules and regulations are being followed in practice. One area that came under criticism was the potential exploitation of entities registered as 'Excluded Persons' under CIMA's Securities Investment Business Law (2019 Revision) (SIBL). CIMA has recently looked to address this by requesting all SIBL Excluded Persons to complete two AML/CFT reporting forms, providing information on the clients and activities of SIBL entities, together with their compliance systems and controls.

The granularity of the forms, which includes key data points such as client and customer risk, copies of policies and procedures, staff training requirements and AML controls clearly shows the level of the information CIMA is looking to collate in order to address the FATF findings and create a robust compliance framework. As the Cayman Islands remains under the spotlight as a member FATF jurisdiction, it is expected that CIMA will continue to perform data gathering and compliance monitoring around AML practices.

Looking forward

The Cayman Islands efforts to combat money laundering and terrorist financing are commendable and set a high standard for compliance and regulation. However, following FATF's mutual evaluation in March 2019, enforcement is likely to become a hot topic in the future. As a result, firms and funds that are not compliant with the AML legislation, should expect greater scrutiny and there is likely to be an increase in enforcement proceedings to address the concerns raised by the FATF.

UN-CLEARED MARGIN RULES IN THE EU AND U.S.: A PRACTICAL GUIDE FOR PHASE 4, 5 AND 6 FIRMS

by SS&C

Understanding when your firm comes into scope for the un-cleared margin rules (UMR) and complying with the key principles and requirements of the EU and U.S. regulation can be unnerving.

From September 2019 through to September 2021, an increasing number of firms will need to prepare robust and efficient processes to calculate and exchange initial margin (IM) to ensure compliance. Knowing when your firm falls into scope, as determined by the average aggregate notional amount (AANA), will help provide a timeframe for implementation.

Am I impacted?

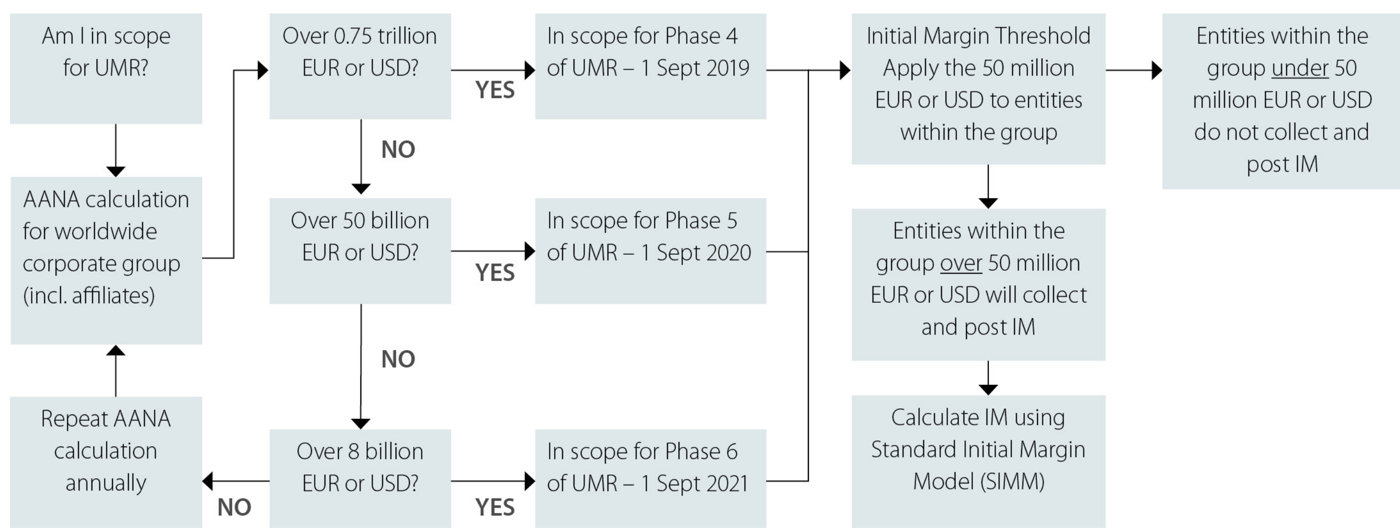
(NOTE: New 50 Billion threshold for UMR Phase 5 and one-year extension for Phase 6 announced by BCBS IOSCO in July 2019, has yet to be adopted by regulators in each jurisdiction)

Key principles of UMR

Although this regulation has been in force since 2016 for US swap entities and since 2017 for EU firms, there is uncertainty regarding the regulatory requirements for smaller firms in the phase 4, 5 and 6 categories.

To help navigate the mountain of documentation available for both EU and US margin rules, the main eight principles have been summarized below:

1. Margining practices should be in place for all derivative transactions not cleared by central counterparties (CCPs).
2. All financial firms and systemically important non-financial entities ("covered swap entities") must exchange initial margin on all non-cleared derivatives.
3. The methodology for calculating initial margin must be consistent across entities covered and must ensure that all counterparty risk exposures are fully covered with a high degree of confidence.
4. Collateral collected should be highly liquid and should, after accounting for an appropriate haircut, be able to hold its value in a time of financial stress.
5. Initial margin should be exchanged by both parties (post and receive).
6. Transactions between a firm and its affiliates should be subject to appropriate regulation in a manner consistent with each jurisdiction's legal and regulatory framework.
7. Cross-jurisdictional regulatory regimes should be consistent and non-duplicative.
8. Margin requirements should be phased in over an appropriate period to ensure that the transition costs associated with the new framework can be appropriately managed.



What do firms need to do?

Translating the key principles into business requirements that are robust, scalable, and cost efficient is a daunting task. Firms must review the requirements in more detail to better understand how to comply with UMR in each jurisdiction. To ensure successful compliance, they must also ask deeper questions that are more specific to their internal operational model. To help firms through this process, SS&C has created the following summary.

How can we help?

SS&C GlobeOp can help you navigate the regulatory and operational requirements of the new un-cleared margin rules. As a trusted partner to clients of all sizes globally, we are committed to sharing our experience and expertise to help our clients adapt to the ever-changing regulatory landscape. We continuously invest in our technology and our people to create truly scalable solutions and service models. Our solutions are efficient and transparent and provide controls to help our clients comply with regulatory requirements.

To learn how SS&C GlobeOp can help you prepare for the un-cleared margin rules, please contact us at solution@sscinc.com.

Reference:

- https://www.cftc.gov/PressRoom/PressReleases/7845-18
- https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180921a.pdf
- https://www.bis.org/publ/bcbs261.pdf
- https://www.fca.org.uk/markets/emir/margin-requirements-uncleared-derivatives

Requirements	How can this be implemented?
Phased-in approach annual check	• Calculate the AANA on an annual basis for the business days in March, April, and May each year for the whole group entity (including affiliates) in the EU. For the US the months to include are June, July and August of the prior year. • Worldwide corporate groups need to consider multiple currencies (to cover all applicable jurisdictions) and work with other entities in the group to calculate AANA at the parent level • Jurisdiction is determined by where each entity is domiciled, even though AANA is calculated at group level • Phase 4 firm threshold is 0.75 trillion EUR or USD depending on a firm's jurisdiction • Phase 5 firm threshold is 50 billion EUR or USD depending on a firm's jurisdiction • Phase 6 firm threshold is 8 billion EUR or USD depending on a firm's jurisdiction • If in scope, compliance starts September of the same year; if not in scope, then repeat the AANA calculation each subsequent year
IM threshold application	• If group is in scope for September 2019, 2020 or 2021, then apply the IM threshold of 50 million (EUR or USD) • Entities that are under the 50 million threshold are not required to put in place collateral arrangements and documentation and do not need to exchange IM • Entities over the 50 million threshold would be required to exchange IM and have the correct documentation in place • Benefits of this would be reduced operational change, collateral funding costs, and credit support annex (CSA) changes
Counterparty updates	• Disclose in-scope group entities' needs to counterparties as early as possible • Agree to process the IM calculation (e.g. International Swaps and Derivatives Association [ISDA], standard initial margin model [SIMM], exchange of margin, and dispute resolution) • Update CSA agreements to include IM for posting and delivering • Agree the split of minimum transfer amount (MTA) between variation margin (VM) and IM • Agree on eligible collateral and haircuts • Document which custodians counterparties will use

Vendor relationships	• Review vendor solutions to align with group business model
	• Consider vendors that offer:
	  • Robust automated solutions
	  • ISDA SIMM calculations for IM, as this is the industry standard and will result in fewer margin disputes
	  • Straight-though processing (from IM calculations to margin movements to reconciliation and dispute resolution)
	  • VM calculations to consolidate all margin requirements into one service
	  • Regular monitoring and management information for risk governance procedures
	• Account for costs associated with service arrangements and implementation

Custody arrangements	• New segregated custody accounts are required for IM • Account for costs associated with custody agreements and implementation
Operational changes	• Update internal mapping to allow for increased data feeds for in-scope funds • Establish and test data flows with vendors, counterparties, and custodians • Establish which department will provide processing and oversight • Establish training and updated procedures for employees • Average project timeline is nine to 12 months
Legal documentation	• Update client/fund master agreements to include IM • Update CSA agreements with custodians and agree MTA for VM and IM • Sign vendor and custody agreement
Risk governance procedures	• Establish an internal process to assess the appropriateness of the SIMM (at least annually) • Record the annual back and unit testing carried out by chosen vendor using ISDA SIMM licence • Audit the integrity of market data sources and management information systems regularly • Record annual AANA check

SUSTAINABLE INVESTING – WHAT IS IT AND WHAT IS THE FUTURE OF SUSTAINABLE INVESTING IN ASIA?

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Until recently the question of sustainable or ESG investing was not on the agenda of the vast majority of asset managers in Asia. One might have been told "ESG is not relevant to our strategy", "we meet ESG requirements by screening out industries such as arms, tobacco, gambling and alcohol" or that "we focus on financial returns and this is a topic best left for governments and NGOs".

Some of these sentiments certainly persist today. However, an ever-increasing number of Asian asset managers now acknowledge ESG as an important non-financial metric that needs to be analysed and accounted for as part of the investment process, particularly as ESG behaviour can be shown to play into financial outcomes.

Furthermore, there are a growing number of Asian asset managers which have constructed strategies focusing on sustainability or "impact" as a core part of their investment objective. Appetite for these types of strategies appears to be on the rise.

However, to be able to convert this appetite into actual investments, managers will need to demonstrate commitment and expertise not only in identifying profit making investments, but also in achieving positive social and/or environmental outcomes and clearly communicating how such objectives are met.

The term "ESG" was first coined in 2005 in a report entitled "Who Cares Wins"[1]. Over the past couple of decades we have witnessed the introduction of a dramatic number of laws, policies, targets and initiatives across the globe which are imprinting environmental and social considerations into the rules that govern our financial systems. This movement towards achieving a more sustainable and conscious economy has intensified since the completion of the Paris Agreement on Climate Change (185 countries have now ratified the Paris Agreement).

2015 may be seen as an inflection point for ESG being adopted into the private markets as this was the year that governments converged to agree on a global framework for financing sustainable development, namely the launch of the UN's Sustainable Development Goals (SDGs). Of central importance to the success of the SDGs is the mapping out of the intrinsic relationship that exists between strong financial systems and long-term sustainable development. The SDGs have provided a common language when it comes to sustainability discussions. However, industry is still in need of greater harmonisation on taxonomies and reporting standards if sustainable financing and investing is to go mainstream.

Today the vast majority of the largest global asset managers have made some form of commitment to "sustainability". In a research study conducted by Robert G. Eccles and Svetlana Klimenko[2], the duo interviewed 70 senior executives at 43 global institutional investing firms, including the world's three biggest asset managers (BlackRock, Vanguard, and State Street), giant asset owners such as the California Public Employees' Retirement System (CalPERS), the California State Teachers' Retirement System (CalSTRS), and the government pension funds of Japan, Sweden, and the Netherlands. They reported that ESG was almost universally "top of mind for these executives".

Environmental and social issues can impact companies in a number of ways. Earnings of a company may not be sustainable because they are linked to social abuses, poor governance or environmental infringements. Long term business outlook can be poor because the business model is not capable of adapting to environmental and social changes or related legal and regulatory developments.

Companies might become embroiled in expensive lawsuits, be subjected to fines and/or suffer significant brand damage. This can also impact the company's ability to attract and retain talent which may

2 The Investor Revolution by Robert G. Eccles and Svetlana Klimenko, Harvard Business Review May-June 2019 issue

have further financial repercussions. Ultimately, a company which fails to address the demands of the social or climatic environment in which it operates may be prone to losing market share or indeed collapsing altogether.

When it comes to ESG investing there are various approaches with differing intended outcomes. The integration of ESG may be primarily aimed at risk management, it may be part of the process for identification of "best in class" businesses, it might also be about "impact". Sustainable investing can be focused on harnessing the opportunities created as companies innovate to address particular environmental or social challenges faced in the world. An obvious example is in the energy space where we are highly reliant on innovations to meet the increasing global energy demands whilst at the same time reducing carbon emissions.

The "negative screening approach" to ESG investing is clear and easy to interpret but it is limited from an ESG outcome perspective as this approach doesn't directly address the fact that most companies face social and environmental risks and may also have some sort of social and/or environmental impact.

A "positive screening" approach involves a more detailed due diligence exercise, selecting companies with especially strong ESG performance. At the bedrock of this form of ESG investing is the recognition that high levels of good ESG practices is a strong indicator of a sustainable business. It is of course accepted that poor governance in a company is a sure way to destroy shareholder value over the long term, however, environmental and social practices can be just as fundamental.

Impact investing has the aim of directing capital so as to achieve a measurable social and/or environmental impact while at the time generating financial returns, thereby combing business with purpose. Impact investing generally requires "patient capital" on the basis that impact generally takes time. The idea that investing for profit and doing good can co-exist is taking some getting used to, but as impact funds have started to deliver returns the story is becoming more compelling. At the heart of impact investing is the concept that investors have the power to encourage better behaviours and drive outcomes by actively engaging with investee companies and utilising their voting power to drive such behaviours.

The momentum we are seeing at the individual level is an important part of the sustainability story and the opportunity to achieve "impact". The age of social media has enabled the "sustainability message" to spread far and wide but also quickly (it is worth noting that the financial impact of a business "getting it wrong" can be compounded as a result). This momentum is contributing to a change in consumer demands but it is also reflected in greater stakeholder activity. We are in a new age of shareholder activism where shareholders are exerting pressure on companies to step up and address specific issues. This has particularly been the case in the oil industry as shareholders have applied pressure on companies such as Shell to decarbonise and transition towards renewables.

A 2017 report by the United Nations Environment Programme identified[3] reinforcing trends contributing to growth in the green finance space: (i) increasingly systemic national action, (ii) greater international cooperation, and (iii) increased market leadership at the individual and collective level.

Looking at how this might apply in Asia, certainly we have started to see greater national and corporate action over the last 5 years. There has been wider adoption of stewardship codes, including nine codes between 2014 to 2018 in each of Australia, Hong Kong, India, Japan, South Korea, Malaysia, Taiwan, Thailand and Singapore. Hong Kong and Singapore have both advocated themselves as green finance centres and have put in place initiatives to drive this development. This year the Hong Kong Monetary Authority unveiled a set of measures to support and promote Hong Kong's green finance market, including the launch of its first green bond under its HK$100 billion green bond program.

Also this year the Hong Kong Stock Exchange released a consultation paper on improved governance and disclosure of ESG activities and metrics and the Hong Kong Securities and Futures Commission published guidance against "green washing". When it comes to progress in Asia, China stands out in its efforts to fund a "greener future" albeit that, as the largest carbon emitter in the world, there remains much to be achieved. China has risen to being of the largest green bond markets and it has introduced swathes of new environmental regulations and policies in recent years.

A notable development in Japan occurred in 2014 when the Japanese Government Pension Investment Fund, one of the world's largest investors and asset owners, publicized that it would comply with Japan's national stewardship code and in 2015 it signed up to the UN's responsible investment rules. Movements at the individual level such as the Extinction Rebellion and the #MeToo movement have also infiltrated parts of Asia.

Despite these developments, as it stands, green finance still represents a relatively small portion of traditional finance markets and this is particularly the case in Asia. An IFC paper that came out earlier this year[4] reported that the estimated investor appetite for impact investing is as high as $26 trillion, $21 trillion in publicly traded stocks and bonds, and $5 trillion in private markets. Indeed this flow of capital will be critical, as it has been reported that investment in the range of US$5 trillion to US$7 trillion will be required each year to deliver the SDGs by 2030[5].

For Asia to start playing a more significant role in this development we will need to see a greater number of initiatives and regulations from governments to assist to drive financial systems in this direction.

We'll also need better quality data from companies in the region and regulators will have an important role in setting the standards for companies to adhere to. Investors will need to go beyond the "low hanging fruit" and deploy their capital in a manner which drives better behaviours rather than a simple ESG "tick box" exercise.

Increasing evidence that ESG can be good for returns will also help drive investment in this area. The recent white paper by the Morgan Stanley Institute for Sustainable Investing reported that sustainable funds provided returns at least in line with comparable traditional funds but while reducing downside risks. Even more compelling was the finding that statistical data showed that during periods of volatility, sustainable funds were more stable.

Findings such as these will contribute to greater investor confidence when it comes to sustainable investing and we expect this to remain a hot topic for Asian asset managers during 2020.

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4 Creating Impact, the Promise of Impact Investing, IFC report
5 UNCTAD (2014). World Investment Report (2014). *http://unctad.org/en/publicationslibrary/wir2014_en.pdf*

ECONOMIC SUBSTANCE


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The evolution to a truly global financial world has meant that tax policies and practices have also needed to be reviewed at a global level. The last 10 years have seen a shift in the global tax environment towards seeking to create a more level playing field across all jurisdictions. As part of this harmonisation project, there has been a revised focus by the Organisation for Economic Co-operation and Development (OECD) on local substance requirements and more specifically territorial substance. This has resulted in the introduction of several legislative measures within a short space of time. The outcome of this focus will be additional compliance and reporting costs. The purpose of this article is to discuss what these changes are and how they impact asset managers and their investment structures.

Background to the substance legislation

Following the 2008 financial crisis there has been an increased focus on tax avoidance and a desire to harmonise tax systems to try and minimise tax arbitrage. The OECD sought to address this by the introduction of the Base Erosion and Profit Shifting (BEPS) measures. These provisions seek to create alignment between global tax regimes. Whilst these measures provided recommendations on how harmonisation may be achieved, adoption of the provisions was voluntary.

As a result, the EU made the adoption of a number of these measures mandatory for the 27 Member States. BEPS Action 5 focusses on addressing substance requirements. The focus on addressing substance stems from abusive structures that sought to take advantage of cross border tax arrangements.

Historically, profits in 'onshore' (i.e. EU, UK and U.S.) jurisdictions have been subject to higher tax rates. This led to the establishment of multi-jurisdictional structures to help achieve frictionless returns. For example, a holding company would be set up in a jurisdiction that operated a preferential tax regime (i.e. domestic exemption on investment yields - dividends and capital gains and low or nil withholding tax rates). Profits from these jurisdictions would then be repatriated to an entity in a country with a low or nil tax rate.

There was increasing concern at an EU level that such structures created economic arbitrage and did not reflect the true cost of commercial economic operations. The Forum of Harmful Tax Practice (FHTP) was set up in 1998 to conduct reviews of preferential regimes to determine if the regimes could be harmful to the tax base of other jurisdictions. Since the introduction of the BEPS initiatives and EU Commissioner's 2016 'External Strategy for Effective Taxation' low or nil tax jurisdictions are required to implement legislation to address their economic substance requirements to ensure they were not blacklisted.

BEPS Action 5

BEPS Action 5 is one of the four minimum BEPS standards that the EU has made mandatory for all 27 Member States. Action 5 focuses on addressing arrangements that could erode the tax base of other jurisdictions. This is being addressed by this Action through three key parts.

Part I: Assessment of preferential tax regimes

The focus here is on beneficial tax provisions that operate in preferential tax regimes to ensure that treaty access is only granted where there is a true entitlement to income flows rather than an entity acting as an intermediary / conduit. We have recently seen challenges in this area by EU jurisdictions that have resulted in the denial of certain treaty benefits (such as reduced withholding tax rates).

Part II: Transparency framework

The existence of global business operations has necessitated the adoption of tax measures at a global level. The introduction of the Common Reporting Standard in 2016 (which followed FATCA) made it mandatory for financial institutions to report certain information about overseas beneficiaries to local tax authorities. Such information could then be shared globally. This was a major step towards combating tax evasion. This was taken a step further by the introduction of the EU Council Directive 2011/16 (DAC6) in 2018 that requires information about cross-border arrangements that display certain hallmarks, to be reported by the promotor / taxpayer.

Part III: Substantial activities requirements

The third part of the BEPS initiative focuses on addressing tax abuse in non-EU jurisdictions that operate no or only nominal tax rates. In order to address the abuse, the EU mandated that jurisdictions that operate such regimes implement legislation to address economic substance requirements by 31 December 2018 to apply from 1 January 2019. Non-compliance would result in that jurisdiction being added to the blacklist.

The legislation applies to 'relevant entities' performing 'relevant activities. Where an entity falls within this definition, they will be required to complete annual reporting. This reporting includes confirmation of the performance of the relevant activity and the financial year end. In addition, to the extent any income from the relevant activity is generated outside of that jurisdiction, the entity must provide support of tax residence in that jurisdiction.

An entity will be deemed to be a relevant entity where it is tax resident in that jurisdiction. Where there is a relevant entity a determination needs to be made whether that entity performs a relevant activity. A relevant activity includes fund management businesses but does not include investment activities.

When the provisions were first implemented several jurisdictions were blacklisted. Most have undertaken remedial legislative action to remove themselves from the blacklist (e.g. Bermuda).

Consequences of being blacklisted

The new substance requirements need to be taken seriously. Where a country has not implemented the appropriate provisions, EU members states have agreed on sanctions including monitoring and audits, withholding taxes and additional documentation and reporting requirements.

Where an entity in a blacklisted jurisdiction is part of an EU group and would ordinarily receive payments from the EU entity gross due to a preferential tax regime, following the introduction of the economic substance provisions there is a risk that any payments made from the EU entity will be subject to a withholding tax. Therefore, non-compliance could have serious financial as well as reputational implications.

How will these new laws impact asset managers and what should they do next?

- The minimum requirements to be adopted by jurisdictions that operate in low or nil tax regimes mean that investment managers with entities in these jurisdictions should review their arrangements to determine if they meet the new economic substance requirements. This should involve reviewing and possibly amending investment management agreements and fund documentation. This may have an impact on the transfer pricing methodology currently being operated. Alternatively, these arrangements may no longer be considered fit for purpose and rationalisation might be a preferred course of action.

- To the extent that investment managers operate in jurisdictions that are caught by the provisions, they should ensure they understand their reporting requirements to meet the first 2020 deadline.
- Currently, investment funds are not caught by the provisions. However, it is important that a watchful eye is kept on any ongoing changes made to domestic legislation.
- Where part of an asset management structure includes entities in preferential EU jurisdictions (i.e. Luxembourg, Malta), it is vital that consideration is given to whether the substance requirements are being met. Following the introduction of the economic substance provisions, where an entity in the structure is in a jurisdiction that is on the blacklist (normally an entity in the structure which owns the shares of the EU country) returns that were previously made gross may now be subject to withholding tax. Even if this entity is in a jurisdiction that is not on the blacklist but operates in low or nil non-EU jurisdiction, they will need to consider if they meet the economic substance requirements imposed locally.
- It is important to note this exercise is likely to be extended to additional jurisdictions and therefore whilst entities may not currently be caught by the provisions imposed, they may be in the future. It is therefore important to keep a watchful eye on any developments.

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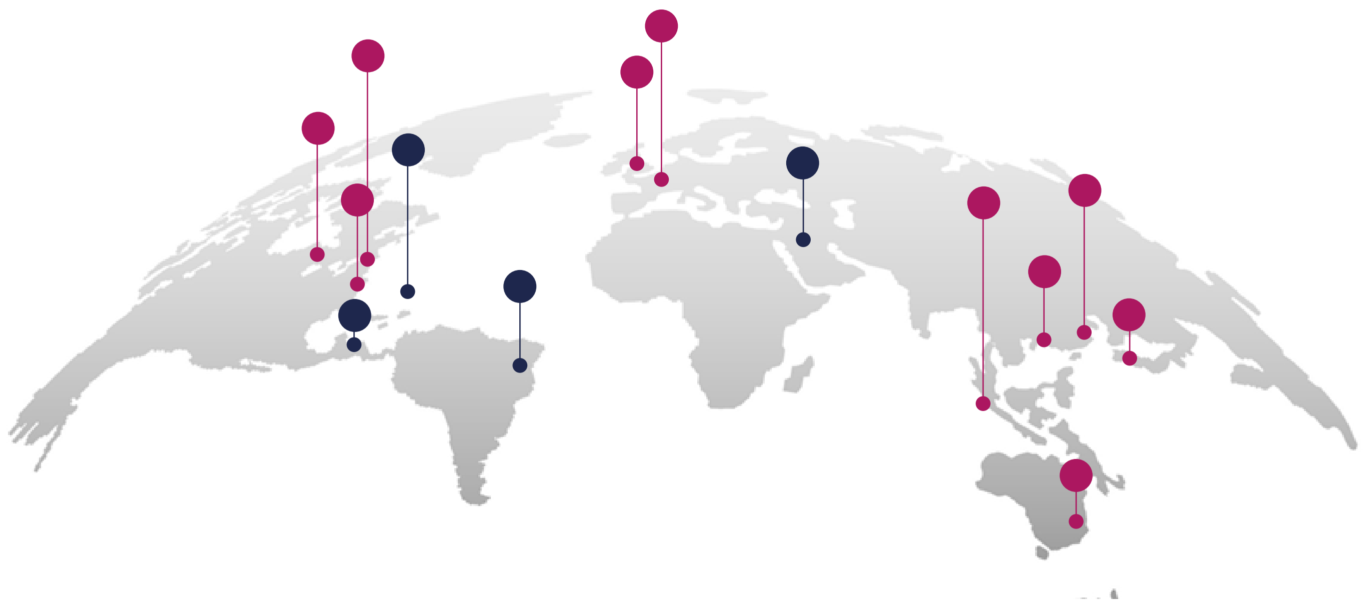

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