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AIMA JOURNAL EDITORIAL GUIDELINES

Message from AIMA's CEO

Jack Inglis
CEO, AIMA

I am delighted to share with you the 124th edition of the AIMA Journal, the final one of this tumultuous year. We are extremely grateful to all those who contributed to this edition of the AIMA Journal, providing key insights regarding how the industry is reacting to current and future developments.

This edition includes several articles which explore how the industry has been changing from an operational perspective, adapting to the various challenges posed by the pandemic.

JP Morgan Capital Advisory Group discusses the use of Virtual Data Rooms (VDRs), an online repository used to secure, store, and distribute documents to manage the "new normal".

Continuing the theme as to how technology is being used during this time, FINBOURNE Technology describes how alternative data can help industry participants navigate illiquid markets.

Elsewhere KPMG discusses how hedge fund managers are seeking out new opportunities to manage their cost base, highlighting findings from latest research done in conjunction with AIMA describing how hedge funds have been managing their operations during the COVID-19 disruption.

Speaking of new opportunities, Man GLG explores the tailwinds behind Asian equities in the aftermath of the COVID-19 pandemic while MUFG Investor Services provides an overview of opportunities to be found in Latin America's corporate sector.

Prestige Funds asks whether private debt funds can play a role in building a greener UK economy after the pandemic.

Simmons & Simmons argues how a change in the regulatory mindset (which appears to be underway) should hopefully act as a catalyst for new developments by fund providers as well as the acceptance of less liquid products by intermediaries, all of which is necessary if private assets are to find a wider audience.

We also have several articles providing the very latest insights regarding the regulatory landscape for the industry. ACA Compliance asks, “what comes next?” for the UK regulatory regime after Brexit.

Furthermore, Clifford Chance discusses the ISDA IBOR fallback protocols, highlighting why this is an important but incomplete solution to IBOR transition for derivatives.

Meanwhile, RQC Group explores what the Senior Managers and Certification Regime (SM&CR) has meant for the industry, as it marks its one year anniversary.

PwC provides a summary of the new Swiss rules for the offering of funds in Switzerland. The new Swiss Financial Services Act (FINSA) and Swiss Financial Institutions Act (FINIA) have had a considerable impact on offering and marketing of funds.

Additionally, Dechert LLP provides an overview of the EU Taxonomy Regulation, which will impact asset managers that offer financial products with either environmental sustainability as their objective or promote environmental characteristics.

Maples Group discusses the most notable legislative development in the Cayman Islands in 2020 – the implementation of the Private Funds Law 2020 which provides for the registration of private funds with the Cayman Islands Monetary Authority.

Rounding off the legal and regulatory focus of this edition, Arnold & Porter present a scenario that raises a series of concerns for a fund manager exploring the legal considerations that would apply as a matter of law in the UK.

Finally, SS&C Technologies charts how the landscape for fund administration has evolved and the various factors underpinning its future direction.

I hope you will enjoy the latest edition of the AIMA Journal. Please do not hesitate to share your thoughts and let us know if you are interested in contributing to any future editions.

Jack Inglis
Chief Executive Officer, AIMA.

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Introduction

The COVID-19 pandemic has caused disruptions on businesses throughout the world with the alternative fund space being no exception. Despite some firms planning (or starting) to return to the office, Investment managers and allocators are still dealing with various hurdles including travel blocks and pushback on in-person meetings as some people have restricted access to their offices for external parties. Assuming that this scenario is likely to continue for the remainder of 2020 and into next year, it is vital for managers to find new methods to communicate with allocators to conduct due diligence remotely.

With the definition of this new “normal” yet to be determined, allocators are contemplating ways to conduct all of their due diligence remotely. One of the biggest hurdles in virtual due diligence is having an allocator get comfortable with the operational set-up of the underlying manager. Typically allocators review all the necessary documentation prior to the onsite (with some sensitive documents being viewed while onsite); however given the current environment, most managers have been sharing these documents with allocators via screen share during the actual virtual due diligence meeting. In some cases this is okay, but for larger documents, allocators have stated that they would prefer to take a deeper look as part of their desktop review, which would entail a more thorough assessment of the manager and fund documentation prior to the meeting. In June, AIMA hosted a virtual roundtable for managers and allocators to discuss the current environment among other topics. One key metric noted was that screen sharing is still the most common method of sharing information by managers. In particular, allocators expressed a preference for being able to review lengthy documents at their own pace rather than flipping through pages during the actual virtual meeting via screen share.

To avoid the hurdles mentioned above, a key service provider that is finding an entirely new use case are Virtual Data Rooms (“VDR”); an online repository that is used to secure, store and distribute documents. Given the important role VDR’s can play, it is imperative to understand the benefits of using one, key considerations and the potential costs.

1 VDR Benefits

> "To try match the quality of due diligence usually done in person, we have shifted its process to rely more on video conferencing technologies, expanded its document review work, and increased the use of secure data sharing rooms"
>
> - Pension Consultant

There are many benefits to using a VDR, but five of the most important are:

Data Repository

Provides a central location for your data that can be organised, secured and accessed by each allocator

This allows you to securely share documents rather than emailing zip files

Perception

Sharing documents via a VDR presents a professional and institutional look to allocators

Improves communication transparency - essential in virtual world

Customize User Access

Ability to share documents with customized user rights (view, edit, print, etc.). This controls what user can do on an individual basis, allowing for multiple parties to securely use the data room at once

Dashboard & Analytics

Obtain statistics around usage by each party/user, which documents are viewed most, longest viewed documents, and recent searches – allows manager to have better insight into which documents are most important to allocators

CRM Integration

Some VDR's have the ability to integrate directly into your Customer Relationship Management (CRM) system. This allows for more targeted emailing and data tracking

2 Considerations

> "We want to know that a manager thoroughly reviewed their options to leverage technology in today's virtual world"
>
> - Large Asset Management Allocator

With many variables to consider, some that we believe are essential are:

Security

Does the VDR have the proper encryption you require (e.g. 256-bit encryption/Military Grade)

Have the controls been independently reviewed and tested (SSAE18, ISO 27001 certified servers)

Information Rights Management

Ability to customize document permissions related to copying, viewing, editing, etc. to ensure features match your needs

Control each user's entitlements on an individual basis (e.g. timed access to sensitive documentation etc.)

Ease of Use

Need to assess whether the addition of a VDR will seamlessly incorporate into your current workflow and be intuitive for the viewer of the data

Analytics

Does the VDR provide you with the tools and data to better communicate with allocators as well as providing more targeted content

Ex: Click trails, downloads/views per day, most active users, most viewed docs, recent searches

Screenshots

Are there ways to mitigate the risk of someone taking a screen- shot of your documents? Providers have different options here from dynamic watermarking to screen shields

Current Infrastructure

Can you leverage your existing IT set-up as a VDR? Example: SharePoint

Pricing

The pricing of each VDR may vary so you need to review how the cost is determined. Some use different factors to arrive at the cost: managed users, number of data rooms, users/data room guests or a combination of these variables. Some may just look at the number of users – this would include each allocator as a user with replacements, i.e. if an allocator redeems then that slot opens up for another potential user. Some vendors may also charge per document and certain features can also carry an additional cost.

Conclusion

No one really knows what the future holds and what the new normal will look like, but conducting due diligence virtually will be here to stay. Therefore, it is vital that Managers ensure they have the proper infrastructure and communication mechanisms in place to securely and efficiently share information and documentation to allocators. VDR's are one technological way to achieve this, providing transparency, security, control as well as creating the perception of institutionalization that is required by allocators in the current environment. With this in mind, understanding the various features of VDR's is essential given the high level of competition. If you have any questions on VDR's or the various providers in the space, please feel free to reach out.

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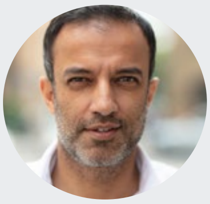
Disclaimer

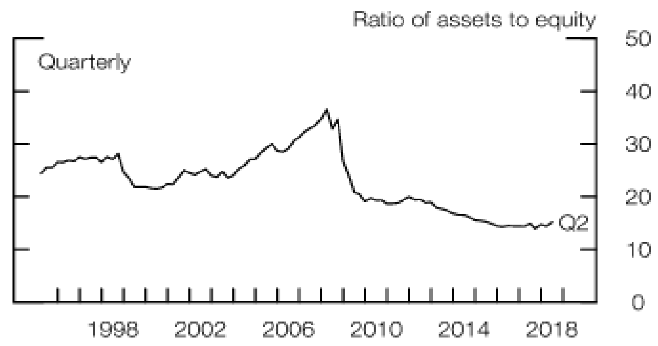
Operating in illiquid markets: How to gather, consolidate and use disparate data sources to enhance returns and more effectively control risk



Gus Sekhon
Head of Product & Marketing
FINBOURNE Technology

The jury may be out on the precise causes, but there can be little doubt amongst market participants in recent times that there has been a steadily growing bid for illiquid asset classes, venues and ownership structures, whether as a core strategy or to enhance returns on more conventional products. The likely factors in this relentless bid are the inevitable effects on the global yield curve of financial repression, the knock-on impact of this on the hunt for returns, changes in investor demographics - most notably mobility - and of course the shift to passive investing which leads in turn to the imperative for differentiation.

3-4. Leverage of Broker–Dealers



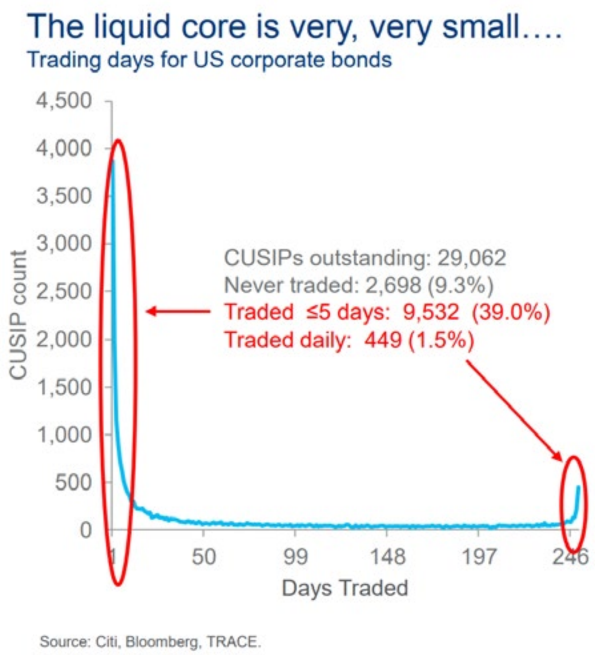
Note: Leverage is calculated by dividing financial assets by equity.
Source: Federal Reserve Board, Statistical Release Z.1, "Financial Accounts of the United States."

This article is neither an exercise in blame nor a lament at the status quo. Instead, we aim to examine the challenges inherent in operating in these illiquid markets and identify necessary improvements in the process of gathering, consolidating and utilising disparate data sources to enhance returns and more effectively control risk. In effect, we propose the toolset you need at your disposal to navigate these markets. Spoiler – we think you are underpowered without data virtualisation, scripting and simulation as standard.

Illiquid markets: the challenges

In deep and liquid markets such as short-dated FX, a constant stream of reference prices can be obtained from numerous brokers. Such markets, with high information density at all tenors and over all periods, lend themselves well to simulation and learning algorithms, narrowing the knowledge gap between participants. But they are becoming rarer as bank leverage continues to fall (see right). As the list of instruments suffering dramatically reduced liquidity widens (e.g. IRS non-linear products), the demand shifts to alternative products and markets each with their own idiosyncrasies.

Illiquid markets suffer wider bid-offers, thinner volumes and higher volatility. Illiquidity can manifest itself in almost any instrument from equity (e.g. alternative micro-cap listings or privately held stocks) to small cap or non-vanilla corporate debt to high yield issuance. In such illiquid markets, the reference information for pricing through replication is often unavailable or stale (see left). Without regular trades to feed the model, a trader needs to imply prices and risk from instruments that are imperfectly related to the target instruments. This necessitates an improved ability to gather information from related data sources and to seamlessly integrate that information into models

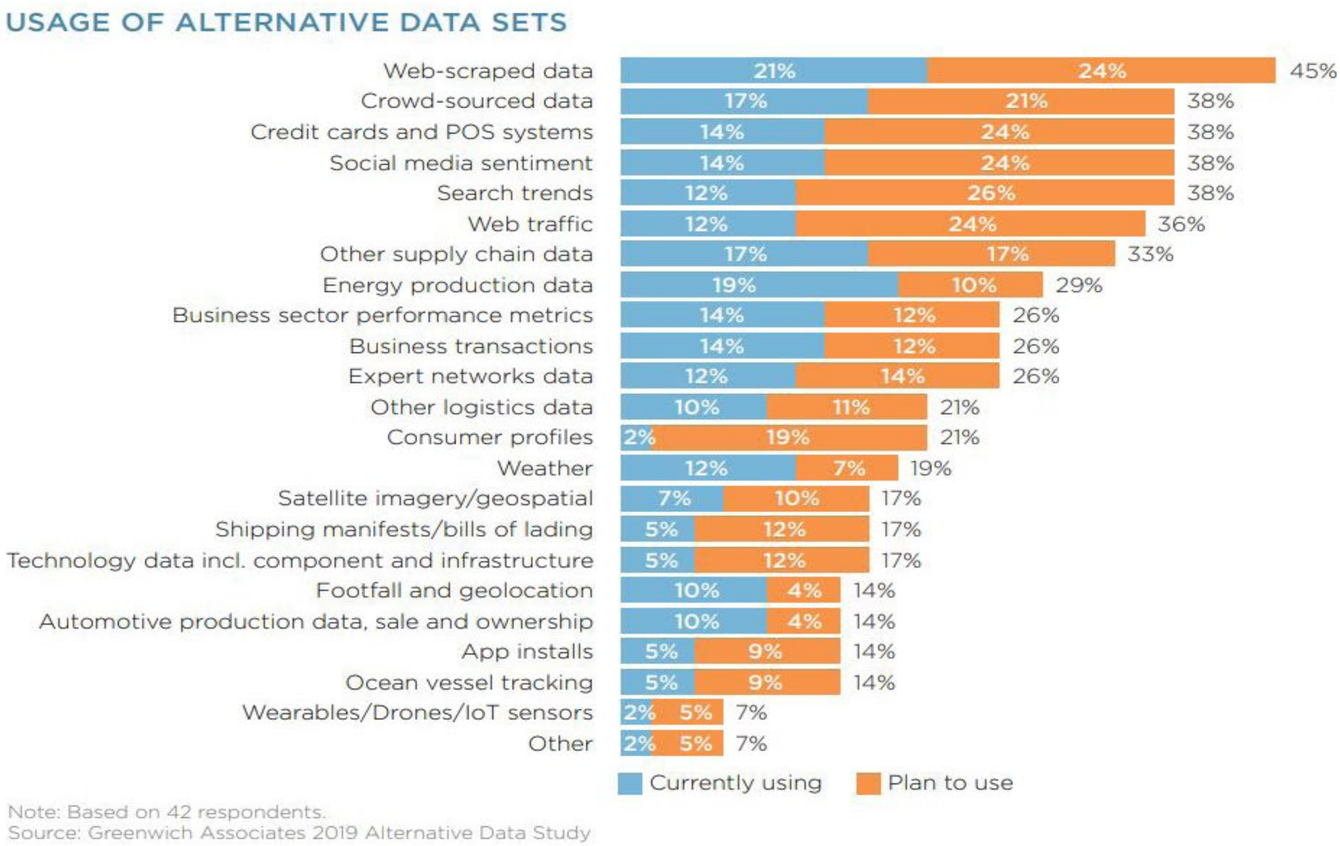


How can you best gather intelligence from additional data sources?

The challenge with alternative data is well known. Whilst it is now the norm (for hedge funds at least) to incorporate alternative data into allocation decisions (see right), fewer than a quarter of funds are doing so for risk management and more than three-quarters had trouble back-testing. Clearly quality and consistency is still problematic. Data is typically a mix of structured and unstructured, inconsistent in format (e.g. something as simple as the meaning of timestamps for non-transacted data), lacking in common identifiers, often without clear ontology or lineage, prone to input errors, non-standardised units and stitching together for meaningful time series is challenging.

Traditionally the chosen solution was the export, transform, load (ETL) process - assume a clear and consistent ruleset and contort the data to fit your target format. Clearly, this process fails in an inscrutable fashion with even minor exceptions as every fix requires code debugging and upgrades. Similarly, a data lake-based process (the solution taking the SaaS market by storm in the US) may not require ETL but does have concurrency issues. Static series of loads with rapid querying layered over the top are not fit for valuation or risk models because of the multi-stage nature of the process.

By contrast, a virtualisation mechanism, where the 'gather' stage is run as a distributed, concurrent process has the advantage of being real-time and also of surfacing the transformation or model logic, which makes it discoverable to the user and thus pushes the remediation onus back onto the provider.



Once you have that data, how do you organise it into something useful?

Once the data is in place, the next step is to run a set of data cleansing algorithms, each targeting one set of flaws and where the intermediate steps themselves can be easily checked. If your virtualisation process is re-entrant you can run the gather and cleanse stages in one. With effective data partitioning and entitlement (ensuring you specify the correct access levels for each participant) you can also stage the cleansing for different use cases. The output is typically a resampled stream of data where the flaws have, according to some target metric, been removed and where additional tags have been added. These tend to include standard instrument identifiers and datetime units to facilitate discovery and joining algorithms further in the process.

The data is now suitable for the application of learning or optimisation algorithms. If not already done, remaining gaps in the data are filled, for instance using a pricing model to imply a missing set of bond prices from rates and credit spreads or generating additional data such as risk measures.

Combining in liquidity data sources is vital given the inherently diminished liquidity we are already dealing with. The stakes tend to be much higher in these markets, and there are countless examples of experienced traders missing their off-ramp. More specifically, information on monetary activity, market trading regime, whether stressed or calm, and simple seasonal volume data can facilitate modelling of decisions such as callable bond exercise probability. Alternatively, projected earnings might be combined with balance sheet information to enhance calibration of credit curves for valuing debt.

A set of such data streams can then be selected for feeding through an optimisation framework to produce a classifier that can be used to generate trading signals. Alternatively, one might attempt to combine pricing models using maximum likelihood/risk-neutrality with priors obtained from related market state or economic data.

Model: How can you then push that data into a customised/scripted pricing and risk process?

We know markets, particularly illiquid ones, are capricious at the best of times. A novel insight from yesterday may be obsolete today. This necessitates that the creation of models be flexible. The time to organise and model data should also allow the model to evolve or be easily reconfigured. Likewise, if a new data source becomes available, joining it and incorporating it into the risk process should not invalidate previous work. A scripting and configuration layer that allows one to quickly switch the underlying models or integrate a new data source without weeks or months of coding by specialists is desirable. Scripting allows these layers to be separated, and as with the virtualisation process, surfaces the logic to the user, where entitled. In this way model improvements can be identified and implemented rapidly and rolled out to trading strategies by the portfolio manager with immediacy.

To operate successfully in illiquid markets, it is clear that risk management tools and specifically the data input to that process must not be an afterthought to the asset allocation stage. This necessitates holding alternative data ingestion to much higher standards both in quality and immediacy in the gather, join and cleansing stages and in its logical partitioning and entitlement by participant roles and access. This is entirely within the remit of an integrated virtualisation process. Additionally, there needs to be an externalised scripting process that is owned by the client and allows for agile integration to the optimisation and simulation stages. Suddenly your risk process can evolve with your trading strategy, rather than being an afterthought. The industry seems to indicate that combining these tools within the risk process is not a challenge that has been universally met; while this remains true, there is a clear competitive edge in illiquid markets to those funds that take the step.

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The UK Regulatory Regime after Brexit: What comes next?

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A regime in transition

Investment managers are – quite rightly - focusing near-term on the cliff-edge nature of the UK/EU negotiations on future trade arrangements. Their contingency planning will have already considered the likely loss of passporting rights for UK firms exporting their services and/or funds products to the EU, replacing these where necessary with a local footprint.

They will have noted the FCA's provision of a Temporary Permissions Regime (TPR) for firms and funds wishing to continue doing business in the UK. In addition, they'll have considered guidance on their Temporary Transitional Power (TTP) which will effect the phased introduction of on-shored rules during a 15 month period ending 31 March 2022.

But what are the longer-term prospects for the UK regulatory regime? This challenge is not simply crystal ball gazing – it's is a future that must be factored into strategic planning two to five years out.

What we already know

The UK authorities' approach to regulation has been signalled in recent speeches, albeit set against the backdrop of aggressive posturing seen in the UK/EU negotiations.

1. **The UK's legal system is different.** This was highlighted by Andrew Bailey (then CEO of the FCA) in a keynote speech to Bloomberg in April 2019. Historically, the greater use of legal codification and statute across the EU has been emphasised by the shift in approach from Directives, which create minimum and maximum standards, to harmonised and directly applicable regulations. Mr Bailey contrasted this with the UK's common and case law foundations, which allow for evolution based on experience. His observation that "wholesale financial markets are more commonly found in countries with common law systems" is significant.

2. **Outcomes-based equivalence.** Originally mooted as a successor to the "principles-based" regime that was tainted by the 2008 financial crisis, regulation which focuses on outcomes and the consequences of firms' actions, was given new impetus by UK Chancellor Rishi Sunak in an important speech to Parliament in June 2020. As well as underlining the core principles of financial stability, market integrity and consumer protection, Sunak unveiled a determination to protect and promote the UK's position as a world-leading financial centre. In the future, the UK will take care to consider whether EU proposals are sensible for the UK market (e.g. the Securities Financing Transactions Regulation (SFTR)). The FCA will also be more inclined to offer guidance and clarification in areas where previously it was bound by the specifics of EU regulations.

The contingencies – a period of highly-dynamic change

Of critical importance for both the short and medium-term outlook are:

a **The outcome of the UK/EU negotiations:** last minute reconciliation or a descent into recriminations? The tone of how these talks are concluded will be critical to any future relationship. Any agreement which maintains a degree of access for the UK to the Single Market, while offering more certainty, is likely to include an element of equivalence, therefore inhibiting the UK's ambitions in other directions.

b **UK political context – recapturing the centre-ground**: with the lightening rod of the Brexit debate receding into history, will the UK revert to its more traditional battlegrounds? Notwithstanding the free market instincts of the current UK administration, a more electable, moderate opposition party seems likely to drag it back to the middle ground. Hopes of a Singapore-on-the-Thames, such as the development of a private funds regime in the UK, could be reigned back in this scenario.

What's changing, what isn't?

Any line-by-line analysis of the current regulatory regime, leading to predictions about the future of each set of rules, is of course highly speculative and must be hedged by the contingencies previously discussed. Putting this hesitation aside, the following framework may be helpful in considering if and how the UK's rules will evolve:

1. Little change – equivalence still the watchword

a **Market Abuse Regulation.** The EU's harmonised regime is closely aligned to the longer standing UK version and current ESMA proposals to tweak certain aspects (e.g. on market soundings) appear sensible.

b **MiFIR/EMIR transaction reporting.** The importance of accurate transaction reporting to the FCA's deterrence regime for market abuse has been consistently emphasised, as is EMIR reporting of derivative transactions to market stability. Proposals to level the MiFIR playing field across the investment management sector have been flagged for a while by both EU and UK.

2. Moderate change – wait and see

a **ESG and sustainable finance.** The EU's Action Plan on Financing Sustainable Growth (2018) has positioned it as a world leader in encouraging capital flows towards sustainable activities and managing the financial risks of climate change. The Sustainable Finance Disclosures Regulation, coming into force in March 2021, is an important step towards integrating sustainability risks within investment strategy. The UK seems broadly sympathetic to its objectives but has deferred announcements on a detailed timetable for implementation.

b **Investment Firm Directive/Regulation (IFD/IFR).** The EU's proposed reforms on prudential requirements for MiFID investment firms are due to come into force in 2021. The FCA has published a Discussion Paper on its own domestic set of changes to achieve similar objectives as the IFD/IFR, but a full Consultation still awaits. The FCA's relatively lenient attitude in the past to the more controversial proposals on remuneration would appear to signal that proportionality will feature, particularly within wholesale firms in this specific and high-profile regard.

3. Considerable change – divergence and wholesale reform

a **PRIIPs.** The FCA and UK Treasury have expressed their unease with key features of the PRIIPs regime for some time. The Treasury has already declared its intention to replace the "performance scenario" with the less prescriptive, but also less misleading, "appropriate information on performance".

b **Short Selling Regulation.** The UK authorities have been traditionally uneasy about perceived intervention in the free operations of the capital markets, without any proven benefits to preventing economic harm. This was underlined again in March 2020 at the onset of the COVID-19 crisis, when EU jurisdictions were much keener on imposing fresh restrictions on short selling. We would not be surprised if a pro-finance administration watered down or even eventually abolished this regime in the UK.

c **AIFMD and a new UK private funds regime.** AIFMD, first unveiled in 2011, can be seen as a political compromise between the hedge fund loving Anglo Saxon world and the more long-term, dirigiste instincts of much of the EU. The originally promised 'third country' passport for non-EU AIFs and AIFMs has not materialised, instead defaulting to the disparate, and increasingly limited, country-by-country National Private Placement Regime (NPPR).

As the trade negotiations reach their climax, and discussions begin in earnest on an AIFMD II (without FCA participation), the UK - behind the scenes - appears to be actively pursuing plans to create an on-shore regime for private (i.e. alternative) investment funds. This would mitigate the long-term risk to the traditional pattern of EU funds (notably in Ireland and Luxembourg) delegating portfolio management to UK managers, as well as promoting the growth of UK-based funds and fund services, including custody, administration and accounting. Such a regime will require parallel reforms in, inter alia, fund structures, tax and depositary arrangements, but surely will find a receptive audience if the right combination of transparency and investor protections can be achieved.

While the TTP steers round the need for an immediate and rapid overhaul of the existing UK rulebook, the vagaries of the political and economic climate may steer us towards unforeseen (future) directions. However, it is noteworthy that the UK has been highly influential in shaping the regulatory landscape we traverse and the one we approach in the near horizon (the IFD/R being an obvious operative example).

Furthermore, the FCA has expressed an intention to remain highly active on the international stage – contributing to and shaping the agenda. Even with calls from some quarters to create a benign environment to preserve the UK's pre-eminence in financial services, the likelihood of a regulatory big bang appears to be limited. Instead, a sophisticated, robust but responsive regulatory environment would appear to be the desired and likelier destination. Watch this space!

Legal Risk for Fund Managers: A case study

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In this article we present a scenario that raises a series of concerns for a fund manager and explores key legal considerations that would apply as a matter of law in the UK[1]

Scenario

The new general counsel of Wayward Fund Management ("Wayward"), Jemima, calls her lawyers, presents some facts and asks for an assessment of the potential legal and regulatory liabilities facing Wayward.

Wayward is an FCA regulated full scope AIFM and runs a flagship Cayman Islands hedge fund, Wayward Fund (the "Fund"). Through feeder funds the Fund's investor base is global, including a number of high net worth individuals and institutions.

Jemima discloses that the Fund's offering memorandum states that the Fund may not invest more than 10% of its net asset value ("NAV") in unlisted shares. That level has been breached (it is now 20% of NAV). These shares are now worthless and are the main cause of a decline of 10% of NAV this year.

Further, Jemima has discovered that marketing material used by Wayward's third party distributor contained misrepresentations about the Fund's performance, exaggerating its performance record. Jemima has also discovered that one of Wayward's sales team employees, Mr Wiley, has been planning to leave to join another manager, Overwhelming Capital (Overwhelming), and has passed personal details of investors and other trade secrets of Wayward to Overwhelming.

Assessing the Legal Risks

Review Contractual Documentation

When considering potential claims, the relevant contractual documentation must be reviewed. In our scenario this is the AIFM agreement between Wayward and the Fund. It is also important to assess the factual matrix and whether what has

1 As an organization with international operations, Wayward must assess potential legal issues that may arise in non-UK jurisdictions, including the Cayman Islands and jurisdictions in which capital raising activities have been conducted, including the U.S.

occurred amounts to a minor or material breach of contract and/or misrepresentation.

Wayward's AIFM agreement contains standard exclusion clauses excluding Wayward's liability for loss incurred except in the case of fraud, wilful misconduct and gross negligence. In English law the meaning of such terms is a matter of interpretation and depends on the wording and context of the contract as a whole.

The Courts will seek to find the objective meaning and look at the natural and ordinary meaning of the clause together with the documentary, factual and commercial context. Where there are competing interpretations, the Court will give weight to what makes commercial common sense in the context of the agreement as a whole.

It is critical that Wayward assess the relevant contractual provisions with their lawyers at the outset to establish what breaches or claims could potentially be put, and whether those breaches/ claims have any merit and, if they do, whether they will be covered by any relevant exclusion.

Wayward would also need to consider other matters with their lawyers such as ensuring privilege is established and maintained, gathering evidence through preservation of documents, identifying and interviewing Wayward's portfolio managers and service provider personnel and managing initial communications with potential investor claimants, including the basis of those communications and who sends them.

Dispute Resolution Clause

It is important to check the AIFM Agreement dispute resolution clause. Is any claim to be determined by a Court or via arbitration? Is there a provision in the contract providing for negotiation or mediation before any proceedings are commenced? Arbitration proceedings are confidential which avoids the public glare attaching to court proceedings. Having disputes aired in public raises concerns as to reputation and may inform how matters are dealt with at an early stage. For instance, can matters be resolved without resorting to proceedings and the costs associated with that (bearing in mind that in English proceedings the general rule is that the loser pays the winner's costs as well as its own).

Reputation Management

Reputational risk management is key. Reputational damage can negatively impact staff retention and market/investor confidence and can impact value reduction (for example, by the imposition of financial penalties, costs of remedial action and/or loss of future revenue). In a crisis like this it is important that Wayward's leadership and legal teams work together to coordinate communications and put clear protocols in place to ensure no information is leaked, intentionally or otherwise, at any level of the business.

Statutory Regime

As an FCA regulated firm, and a full scope AIFM, Wayward is subject to FCA regulations and the UK Financial Service and Markets Act 2000 ("FiSMA"). In this scenario Wayward and/or its distributor have likely breached FiSMA and FCA rules (the "Rules") which can render them susceptible to action by their investors.

Under section 138D of FiSMA, investors who have suffered a loss as a result of a breach of a Rule might have a right of (derivative) action for damages for those losses. Provided conditions specified in 138D are met, Wayward's investors might be able to recover losses simply by showing that there has been a breach of a Rule causing them to suffer loss. Private persons (generally individuals) have many more grounds for action under this section than other legal persons such as corporations.

Rights of action under 138D are only available for contraventions of Rules made under FiSMA, and generally not for contraventions that fall under the FCA Handbook. However, the FCA is permitted to specify that rights of action are not available for certain of its Rules, and it has done so for example for breaches of the FCA's Code of Conduct Sourcebook.

Breach of FCA Principles and Rules

The FCA's Principles for Businesses 1-7 include obligations for regulated firms such as Wayward to conduct their business with due skill, care and diligence, organise and control their affairs responsibly and effectively with adequate risk management systems and pay due regard to the information needs of clients, and communicate

information to them in a way which is clear, fair and not misleading.

The Principles do not give rise to a direct cause of action for breach of statutory duty, whereas breach of the Rules may give rise to a direct cause of action against a regulated firm.

As an FCA regulated AIFM Wayward must comply with various Rules covering:

- communications with investors in the Fund, including conduct of business rules;
- certain operating duties and responsibilities, including ensuring that the Fund is operated in accordance with its offering memorandum;
- its systems and controls (although contravention of the Systems and Controls chapter of the FCA's Handbook is not actionable under 138D);
- requirements for robust governance arrangements, including an obligation to establish, implement and maintain adequate risk management policies and procedures, including effective procedures for risk assessment.

Jemima should be advised that Wayward may be in breach of any or all of these requirements.

Misrepresentation

The Financial Services Act 2012 (the "2012 Act") defines the offence of making false or misleading statements. In the context of Wayward's distributor, this offence requires that the Fund performance misrepresentations were made with the intention of inducing investors to invest in the Fund. If Wayward or the distributor were charged with making a false or misleading statement in that context, it must be proved either that they knew it was false or misleading, or that they were reckless as to whether it was.

The offence is punishable by imprisonment a fine, or both, the length of the sentence and the amount of the fine depending in whether the conviction is summary or in indictment.

A statement is false if it asserts a proposition that is not true. Whether it is misleading depends on who it is, or is likely to be, made to because different people may draw different inferences from it. For example, some statements might be misleading for private investors, but not for a market professional. The statement must also be false or misleading "in a material respect".

Officers of a corporation and members of a partnership that commits an offence under FiSMA or the 2012 Act with their consent or connivance, or attributable to their negligence, are guilty of the offence as well as their firm, and so Wayward's and the distributor's directors could be in the firing line here.

Unauthorised Disclosure of Confidential Information

The starting point is for Wayward to determine what confidential information has been disclosed. In our scenario it is personal investor details and "trade secrets," which we take to mean business confidential information. It can be tricky identifying precisely what information is truly confidential, but the fact the information is referred to in a confidentiality clause in Wiley's contract would help, as would evidence of efforts made by Wayward to keep the information secret. There is less ambiguity with identifying personal data, which would include individual investor names and contact details.

Data Breach

The disclosure of personal details represents a serious data breach and could amount to a statutory criminal offence (Data Protection Act 2018). Wayward, as data controller, has a duty to notify the investors, take steps to mitigate the consequences of the breach and possibly report the breach to the Information Commissioner's Office within 72 hours.

Protective Measures

- Wayward could apply to court for an injunction restraining the misuse of the confidential information and personal data. If Overwhelming has encouraged the breach, Wayward would have a claim against them too as well as Wiley.

- Obtain contractual undertakings from Wiley and Overwhelming not to use or disclose the confidential information and personal data. This would put Overwhelming on notice of the unauthorized disclosure. Even if Overwhelming does not provide the requested undertaking, the notice will serve to make Overwhelming potentially liable for any misuse of the confidential information.

- Check for a non-compete clause. This may allow Wayward to delay Wiley starting employment with Overwhelming.

Employment

Mr Wiley is likely to be in breach of an express confidentiality obligation contained in Mr. Wiley's employment contract. If not, common law implies a duty of confidentiality on employees. Therefore Wiley should be suspended pending disciplinary proceedings.

The ISDA IBOR fallback protocols: An important but incomplete solution to IBOR transition for derivatives

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On 23 October 2020, the International Swaps and Derivatives Association (ISDA) launched its IBOR Fallbacks Supplement and Protocol, marking another milestone in the transition from IBORs to risk free rates (RFRs). Relevant to alternative investment fund managers primarily in the context of markets documentation for OTC derivatives, repos and similar, the IBOR Fallbacks Supplement updates the 2006 ISDA Definitions to include new risk-free rate fallbacks for the five LIBOR rates together with eight other IBOR benchmarks.

The Supplement, when it becomes effective on 25 January 2021, will implement these risk-free rate fallbacks into the terms of new transactions which incorporate the Supplement. The Protocol will enable adhering parties to implement these fallbacks into the terms of legacy transactions. The broad scope of the amendments made by the Protocol, the range of agreements it covers and the availability of a series of templates and amendment agreements which can be used to tailor the terms of adherence, confront parties contemplating adherence with a series of challenges.

In this article we will focus on the key issues from the perspective of alternative investment fund managers in relation to adhering to the Protocol. A fuller explanation of the how the Protocol and Supplement work and the challenges they raise can be found in our recent briefing.

Scope

The first key issue is scope, as managers must be clear on what contracts are covered by the Protocol. Since it has been produced by ISDA, it would be easy to assume that the Protocol just covers standard ISDA documentation. However, unlike previous ISDA protocols, the scope of the Protocol has been extended to cover an extensive list of agreements including, for example, repurchase transactions documented under a Global Master Repurchase Agreement (GMRA).

Notwithstanding that the Protocol covers a broad range of documentation, one might nevertheless expect that it would only be relevant where the document incorporates the 2006 ISDA definitions or one of the equivalent earlier legacy ISDA definitions booklets. However, the Protocol will also amend documentation that references a relevant IBOR even where its use is not via an ISDA definitions booklet.

The fallback rates

Pursuant to the terms of the Protocol, if a permanent cessation trigger or (if applicable) a pre-cessation trigger occurs (and assuming linear interpolation is not possible) each of the IBORs will fall back to an adjusted RFR plus a spread adjustment. The adjusted RFR will be the relevant RFR for that IBOR (e.g., SONIA in respect of sterling LIBOR) compounded in arrears over an accrual period corresponding to the tenor of the IBOR (e.g., 1, 3, 6 months). The spread adjustment will be the historic median difference between the relevant IBOR and the RFR over a five-year lookback period.

Timing

The Protocol was launched by ISDA on 23 October 2020 and has an effective date of 25 January 2021. Already over 350 entities have signed-up. If two parties to an in-scope agreement both adhere to the Protocol prior to the effective date, then their in-scope agreements will be amended by the Protocol with effect from 25 January 2021. It is also possible to adhere to the Protocol after the effective date, in which case the amendments will be effective on the later date on which both parties to an in-scope agreement have effectively adhered to the Protocol.

It is important to be aware that 25 January 2021 will not be the day on which an IBOR is actually replaced by an adjusted RFR in respect of any transactions which are amended by the Protocol. Instead, all that will happen on this date is that fallback provisions will be added to the terms of the transaction which provide for the replacement of the IBOR with an adjusted RFR with effect from such later date on which such IBOR is permanently discontinued or (in respect of the LIBOR rates only) becomes non-representative. This is expected to occur in respect of one or more IBORs or IBOR tenors after the end of 2021.

Not a complete solution

The Protocol is undoubtedly a milestone, reflecting the outcome of the industry consultation on replacing IBORs with RFRs and the consequential amendments required in order to prevent excessive value transfer between the parties or a time-consuming repapering process. However, in the context of derivatives trading with asset managers and other buy-side firms, it would be wrong to think that the ISDA Protocol solves all problems.

Reservations have been raised as to whether the ISDA methodology for determining the fallback works as well for non-linear products (such as options and swaptions) as it does for linear products. Similarly, for managers representing clients with a liability driven investment policy, concerns have been raised about the potential pricing implications on the long-dated swaps which will be used in those strategies. This has even led some managers to trade out of their IBOR positions and into RFR based transactions in order to proactively manage their IBOR exposure. Alternatively, some managers are looking for a more bespoke solution than the ISDA Protocol. Managers should diligence their derivatives portfolio ahead of adherence to determine whether their portfolio is appropriate for the ISDA Protocol or whether an alternative or more bespoke solution is required.

Special mention should also be made of linked products. The term “linked product” describes a situation where two products have been sold together, for example a secured interest rate hedge in respect of a loan. The development of market conventions for cash products lags the derivatives market and could follow different methodologies and conventions going forward. In addition, consideration needs to be given to the difference between a hedge and the cash product it supports, in terms of the commercial effect and timing of fallbacks taking effect, as the more differences there are, the less effective the hedge becomes. Again, this is a key due diligence point.

The broader context

Beyond documentation, it is also vital to consider the broader impact of IBOR transition on a manager’s operations. Issues such as upgrading internal systems and analysing the systems of third-party service providers can be harder to identify and solve. Regulators globally are also testing operational resilience of businesses; this comes in the form of an increased level of scrutiny and an assessment on the level of reliance on working with third-party vendors.

Amidst COVID-19, Brexit and the US elections, IBOR transition is probably not the number one focus for alternative investment fund managers at this this point. However, managers should be realistic about the quantity of work that will be involved in identifying where bilateral legal and commercial efforts are going to be required. The complexity around this topic means teams will need a broad range of support in order to have effective conversations with counterparties and clients.

Overview of the EU Taxonomy Regulation

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What is the law/regulation?

In December 2019 the European Council and the European Parliament reached political agreement on the text of a proposed Regulation on the Establishment of a Framework to Facilitate Sustainable Investment – the so-called "Taxonomy Regulation." The Taxonomy Regulation[1] was published in the Official Journal of the EU on 22 June 2020, following its adoption by the European Parliament on 18 June 2020 and entered into force on 12 July 2020.

What is its scope and impact?

The Taxonomy Regulation establishes an EU-wide classification system or 'framework' intended to provide businesses and investors with a common language to identify to what degree economic activities can be considered environmentally sustainable. It aims to *"provide clarity and transparency on environmental sustainability to investors, financial institutions, companies and issuers thereby enabling informed decision-making in order to foster investments in environmentally sustainable activities."* [2]

It is important to note that while the majority of the Taxonomy Regulation will impact asset managers who make available a "financial product" which either (a) has environmental sustainability as its objective or (b) promotes environmental characteristics, the Taxonomy Regulation also states that where financial market participants[3] do not take into account the criteria for environmentally sustainable investments they should provide a statement to this end, meaning that all asset managers are, effectively, in scope.

In defining "financial product," the Taxonomy Regulation refers to the definitions embedded in the Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (the Disclosure Regulation):

- a portfolio managed in accordance with Article 4(1) of Directive 2014/65/EU (MiFID II);
- an alternative investment fund (AIF);
- an Insurance-based Investment Product;

1 For the text of the Taxonomy Regulation as published in the Official Journal, click here

2 https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/sustainable-finance-taxonomy-spotlight_en.pdf

3 The Taxonomy Regulation refers to the definition in Article 2 (1) of the Disclosure Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector. Click here.
"'financial market participant' means: (a) an insurance undertaking which makes available an insurance-based investment product (IBIP); (b) an investment firm which provides portfolio management; (c) an institution for occupational retirement provision (IORP); (d) a manufacturer of a pension product; (e) an alternative investment fund manager (AIFM); (f) a pan-European personal pension product (PEPP) provider; (g) a manager of a qualifying venture capital fund registered in accordance with Article 14 of Regulation (EU) No 345/2013; (h) a manager of a qualifying social entrepreneurship fund registered in accordance with Article 15 of Regulation (EU) No 346/2013; (i) a management company of an undertaking for collective investment in transferable securities (UCITS management company); or (j) a credit institution which provides portfolio management;".

- a pension product;
- a pension scheme;
- a UCITS fund; or
- a Pan-European Personal Pension Product.

The Taxonomy Regulation provides a definition of "environmentally sustainable" economic activities. An economic activity is environmentally sustainable if:

- It makes a "substantial contribution" to one of the following six specified environmental objectives; [4]
    1. climate change mitigation;
    2. climate change adaptation;
    3. sustainable use and protection of water and marine resources;
    4. transition to a circular economy;
    5. pollution prevention and control; and
    6. protection and restoration of biodiversity and ecosystems
- It does "no significant harm" to any of those six environmental objectives (i.e., avoids adverse environmental impacts). An economic activity should not qualify as environmentally sustainable if it causes more harm to the environment than the benefits it brings. [5]
- It avoids violation of minimum "social safeguards" (i.e., avoids adverse social impacts). When complying with those minimum safeguards, undertakings should adhere to the principle of 'do no significant harm' referred to in the Disclosure Regulation.[6]
- It complies with "technical screening criteria"[7] which will be developed using delegated legislation in due course. (The Commission is required to establish a platform on sustainable finance, consisting of experts who will advise on the technical screening criteria).[8]

The disclosure obligations laid down in the Taxonomy Regulation supplement the rules on sustainability-related disclosures laid down in the Disclosure Regulation. Together the Taxonomy and Disclosure Regulations will require firms to disclose the degree of environmental sustainability of funds and pension products that are promoted as environmentally friendly, and include disclaimers where they do not (articles 8 and 9 of the Disclosure Regulation). In addition, firms which are subject to the Non-Financial Reporting Directive (NFRD)[9] will be required to disclose in their financial statement certain indicators of the proportion of their activities that are classified as environmentally sustainable according to the Taxonomy Regulation, such as the proportion of their turnover derived from products or services associated with economic activities that qualify as 'environmentally sustainable'. [10]

The Taxonomy Regulation contemplates that asset managers will use the technical screening criteria to assess a company's economic activities and determine whether each activity does or does not meet the taxonomy criteria – then aggregate the percentage of taxonomy alignment at investment and product level.[11] The Taxonomy Regulation will be supplemented by delegated acts that will contain detailed technical screening criteria for determining when an economic activity can be considered sustainable, and hence can be considered Taxonomy-aligned. The percentages of

4 Taxonomy Regulation, Article 9 "Environmental objectives".

5 Taxonomy Regulation, Recital 40.

6 Taxonomy Regulation, Article 18(2) "Minimum Safeguards".

7 Taxonomy Regulation, Article 19 "Requirements for technical screening criteria".

8 Taxonomy Regulation, Article 20 "Platform on Sustainable Finance".

9 Non-Financial Reporting Directive 2014 (2014/95/EU). For the text of the NFRD as published in the Official Journal, please click here.

10 Taxonomy Regulation, Article 8 "Transparency of undertakings in non-financial statements".

11 The Final report of the Technical Expert Group on Sustainable Finance published in March 2020 contains a full list of revised or additional technical screening criteria for economic activities which can substantially contribute to climate change mitigation or adaptation. Click here.

taxonomy alignment will help firms explain their strategies in a way that is consistent and easily comparable for investors. To ensure consistency between the Taxonomy regulations concept of "do no significant harm" and the Disclosure Regulations concept of "adverse impact indicators", the Taxonomy Regulation amends the Disclosure Regulation mandating that the ESAs[12] jointly develop regulatory technical standards relating to content and presentation of information relating to the principle of do no significant harm.

What is the timeline?

The Taxonomy Regulation was published in the Official Journal of the EU on 22 June 2020 and entered into force on 12 July 2020.
The Taxonomy Regulation states that to give sufficient time to the relevant actors to familiarise themselves with the criteria for environmentally sustainable economic activities[13] set out in the Regulation and to prepare for their application, the obligations set out in this Regulation should become applicable, for each environmental objective, 12 months after the relevant technical screening criteria have been adopted.

The Taxonomy Regulation contemplates a phased implementation, with certain rules set to apply from different dates:[14]

- from 1 January 2022 in respect of the climate change mitigation and adaptation objectives; and
- from 1 January 2023 in respect of the sustainable use and protection of water and marine resources, the transition to a circular economy, pollution prevention and control, and the protection and restoration of biodiversity and ecosystem.

What are the key considerations for asset managers?

The overarching aim of the Taxonomy Regulation is to provide a common language to identify which activities and financial instruments can be considered as environmentally sustainable to be used by investors, financial institutions, companies and issuers.

As a piece of EU legislation, its impact will be felt in the EU by entities such as AIFMs, UCITS management companies, investment firms authorised under MiFID II that provide portfolio management or investment advice, and these entities will need to ensure that they use the 'framework' taxonomy when making disclosures (including, but not limited to, in prospectuses, portfolio management agreements, annual reports, non-financial statements, and on websites). The need to conform investment practices to these disclosures means that the Taxonomy Regulation also could influence the way that many investment firms incorporate ESG into their investment processes.

While the Taxonomy Regulation is a piece of EU legislation establishing an EU-wide classification system, it will also impact non-European asset managers offering 'financial products' into the EU. For example, (i) a non-EU manager that has a structure that incorporates a UCITS may need to assist the UCITS ManCo with making disclosures by providing the ManCo with certain information relating to environmental sustainability, and some of these disclosures will need to consider the framework taxonomy or (ii) a non-EU manager marketing its funds in the EEA under Article 23 of AIFMD will need to consider the framework taxonomy when making certain sustainability disclosures.

Given the size of the EU market, and because the taxonomy is the most comprehensive attempt yet to set regulatory standards for ESG, the taxonomy may also influence ESG disclosures and practices outside of the EU.

12 The European Banking Authority, European Securities and Markets Authority and European Insurance and Occupational Pensions Authority, European Supervisory Authorities (collectively, the 'ESAs').

13 Taxonomy Regulation, Recital 57

14 Taxonomy Regulation, Article 27 "Entry into force and application".

What next?

The impact of Brexit

The UK formally left the EU on 31 January 2020 and entered into a 'transition period' which (at the time of writing) is scheduled to end at 11pm on 31 December 2020. During the transition period EU law will continue to apply in the UK, however once the transition period has ended this will no longer be the case.

Although the Taxonomy Regulation entered into force on 12 July 2020, the key operative requirements (e.g. disclosure obligations) contained in the Taxonomy Regulation only apply after 31 December 2021. Therefore, these requirements will not form part of retained EU law in the UK unless the UK incorporates them into domestic legislation. Consequently, there may be a bifurcation of requirements depending on the location of the asset manager, with asset managers in the EU and the UK being subject to different requirements.

The UK government has explained that it cannot comment at this stage on the extent to which the UK will align with the EU on this regulation after the end of the transition period because the delegated legislation containing technical standards has not yet been published by the European Commission, meaning that the UK does not have clarity as to the exact requirements that it would be agreeing to. The UK government stated that it will continue to monitor the EU's legislative process as it considers the UK's approach but at the time of writing there is no clarity as to what the UK's approach will be.

Recent developments

The Taxonomy Regulation is notably focused on the environmental aspects of ESG. An investment can be branded as sustainable as long as it meets one of the six specified environmental objectives and does not significantly harm any of the remaining objectives. Following recent statements made by the head of the sustainable finance and financial technology unit at the European Commission, it seems that there is a move to explore whether the Taxonomy Regulation should be extended to cover social issues as well as a wider range of environmental factors ahead of the publication of a new sustainable finance action plan next year. At the time of writing there are no further details but expanding the scope of the Taxonomy Regulation would have an impact on market participants.

The elasticity of management companies: Resilience in an age of disruption

Daniel Page
Head of Asset Management Advisory
KPMG Ireland

As Hedge Fund managers strive to adjust to the new reality, many are starting to ask if they could be adding more elasticity into their management companies operating models.

The COVID-19 pandemic has caused massive disruption to world markets, national economies and the operating models of Hedge Funds. But it's not the first market disruption the industry has faced. It certainly won't be the last.

Current experience aside, disruptive change doesn't always appear as a macro-economic meltdown. The regulatory environment for Alternative Investments changes all the time. Fund managers add new products and they add new people. AUM goes up and AUM goes down. Nothing stays static for long.

The search for scale

The problem is that – in good times when profits are growing and markets are stable – few managers think twice about the 'elasticity' of their management company. Indeed, when funds are flowing in, it's all too easy to think only in 'growth mode'. New fixed costs are added; more vendors are brought into the mix; compensation flows.

When a major shock like COVID-19 occurs, however, managers quickly start to re-examine their cost ratios. They look at their fixed costs and compensation models. They closely assess the evolution of their technology estate. They often realize that their cost base is anything but elastic and worry that their operating models can threaten the viability of their structures in short order.

Perhaps not surprisingly, some Hedge Fund managers are now asking whether they could be making their management company more elastic. What they are looking for is the ability to scale both ways – up and down – and across the enterprise in an efficient way.

Finding flexibility

In part, that will likely mean more (or smarter) use of outsourcing. In a recent survey report of Hedge Fund managers conducted by AIMA and KPMG International, Agile and resilient: Alternative Investments embrace the new reality, 61 percent of respondents said they were likely to outsource their administrative services and 55 percent said they will likely outsource their tax and accounting services.

As one manager interviewed for the AIMA/KPMG report aptly noted, "those that get the balance to outsourcing right will be able to scale their costs both during this disruption and going forward."

It may also lead to the more effective and productive use of cloud technologies. Half of all the firms in the research shared that, while their current cloud technologies allowed them to operate effectively during the initial phases of the pandemic, they are now re-evaluating their firm's cloud strategy to see how they can improve their use and leverage their scalability benefits.

It will almost certainly catalyze difficult discussions about fixed costs – particularly real estate costs which (with virtual working proving successful in many quarters) seem out of alignment with current operating requirements and investor expectations. Fixed IT structures are also expected to come under the microscope.

The point of these exercises is to move the management company to a place where it can scale up and down as needed. It's about getting more elasticity in your management company's operating margins which, in turn, can make you a more resilient organization and a more attractive place to work for high-performing professionals.

Focused on the fundamentals

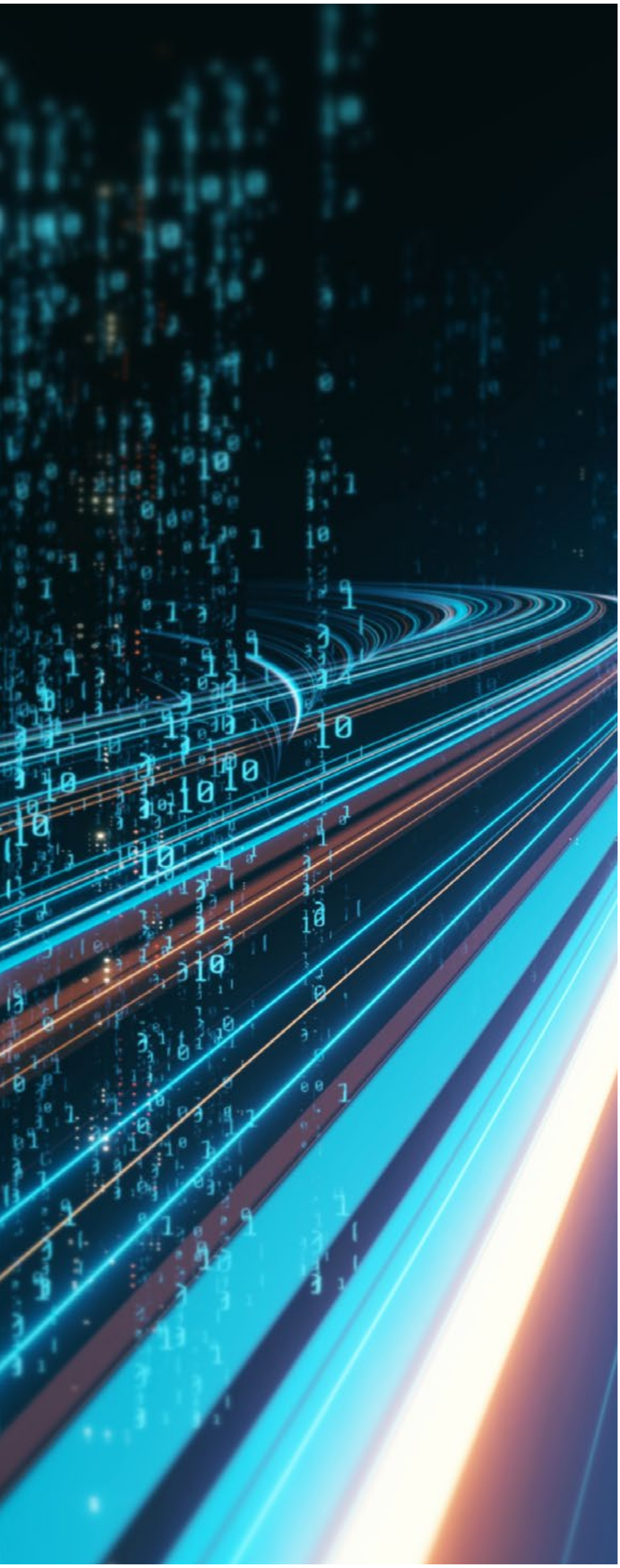
Of course, all of this must be managed against the realities of the business. Managers still need to compound good returns for the long term to their investors; they still need to reward and retain their high-performing staff; and they still need to ensure they abide by relevant laws and regulations. Those three pillars must remain protected.

At the same time, managers must be able to ensure their management company stands up to regulatory rigor and review. They must also pay particular focus to how they manage their vendors – a task that has become acutely more challenging in today's virtual environment.

Current health and safety considerations will also need to be taken into account. More than 60 percent of the respondents to the AIMA/KPMG

> "We specialize in helping Alternative Asset Managers of all sizes address these issues and have done so over many cycles and our first question is always the same – do you know your partnership tolerance to running the business in the absence of all income for 12 months and what is truly key to you in that situation? We then work together to build back from there."

– Dan Page, Head of Asset Management Advisory, KPMG in Ireland.



survey say they are considering modifications to the workplace in order to meet the social distancing guidelines being imposed.

Is your Management Company's operating model elastic?

That Hedge Fund managers need a management company with margin elasticity is obvious. Fund managers spend all their time building market neutral hedge products; they specialize in creating financial products that can perform in any market. Yet, they rely on a management company that cannot operate in any market. The irony is clear.

At KPMG, we work closely with Alternative Investment managers of all sizes to help them enhance the elasticity of their management companies. What we have learned is that there is no blueprint to success; every management company will need to make their own unique set of decisions and create their own unique processes and models.

Throughout this article, "we", "KPMG", "us" and "our" refers to the global organization or to one or more of the member firms of KPMG International Limited ("KPMG International"), each of which is a separate legal entity.

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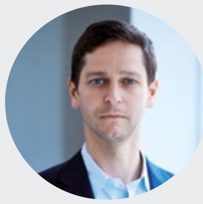
Tailwinds: Asian Equities after the Coronavirus



Andrew Swan
Head of Asia (ex-Japan)
Equities, Man GLG

Edward Cole
Managing Director
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As the global economy recovers, we foresee three factors driving returns in emerging-market Asian equities, two from alpha and one from beta: increased stock dispersion, higher levels of earnings surprises and potentially a weaker, more supportive US dollar.

Introduction

2020 has been an exceptionally tough year by the standards of any investor. Corporate earnings have taken a significant hit as the world economy has headed into recession. However, we are seeing the signs of a recovery and as the data improves, it is likely that corporate earnings will start to follow. In such an environment, active management can come into its own.

Furthermore, idiosyncrasies in specific equity markets offer some hope. In our view, Asian equities may benefit from three tailwinds: two for alpha and one for beta. The level of single-stock dispersion in emerging Asian equity markets is relatively high and the level of earnings revisions is likely to increase given the impact of the coronacrisis, in our view. Both increase the opportunity set for active managers to generate alpha, giving them a broader canvas to apply their deeper awareness of the stock-specific factors that dictate earnings. From a beta perspective, Asian economies may be further supported if the US dollar does weaken.

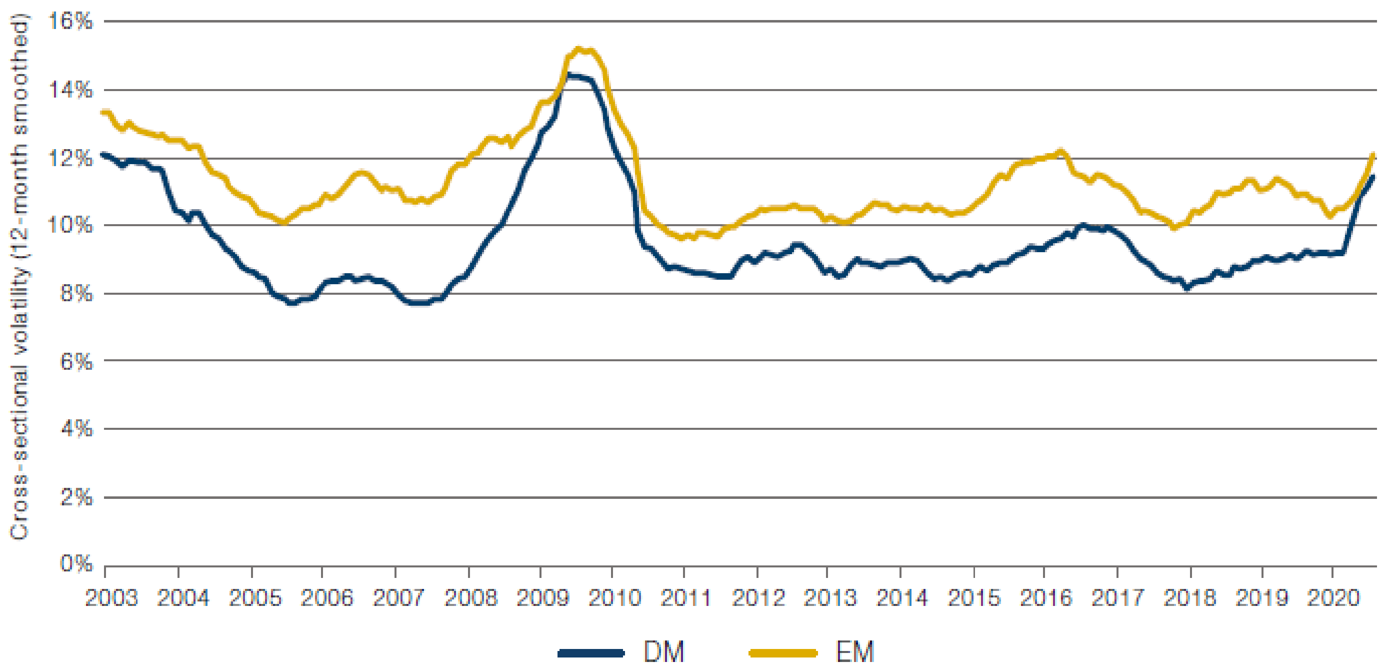
> " Emerging market equities – of which emerging Asia is the overwhelming majority – have consistently shown higher levels of dispersion than their developed counterparts. "

Cross-Sectional Dispersion

A key driver of returns to alpha in Asian equity markets is cross-sectional single-stock dispersion – or the distribution of returns of all the securities over a given timeframe. The higher the dispersion, the lower the correlation among the stocks. Conversely, when stock dispersion is low, stocks exhibit a tendency to trend together. A high level of stock dispersion creates an opportunity set for active managers, allowing them to more easily capture the fundamental drivers of equity performance, and isolate alpha through stock picking.

Emerging market ('EM') equities – of which emerging Asia is the overwhelming majority – have consistently shown higher levels of dispersion than their developed counterparts (Figure 1). Indeed, whilst the roughly 2% higher level of dispersion enjoyed by EM over developed markets ('DM') tends to dissipate during times of market stress – such as during the Global Financial Crisis ('GFC') and the coronacrisis – this market stress naturally creates higher levels of total dispersion for both geographies, enhancing the opportunities available to active managers.

Figure 1: Cross-Sectional Single Stock Dispersion – EM Versus DM



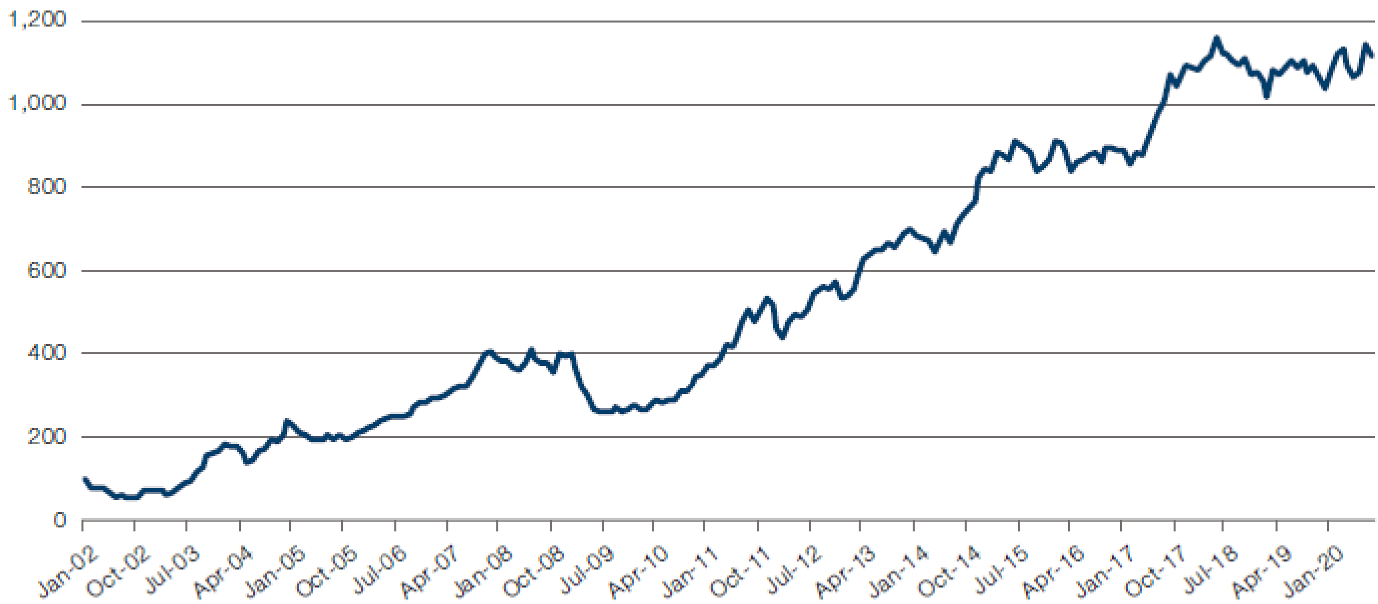
Source: Man GLG; as of August 2020.

"The correlation of returns from earnings revisions to factors is quite unstable and time varying. This instability presents another source of potential alpha."

Earnings Revisions: The Joy of Surprises

The second persistent source of alpha in Asian equities is the exceptional returns from earnings' revision strategies. Based on almost 19 years of data for MSCI Asia ex Japan, a simple strategy of buying the best decile of 3-month change in 12-month forward EPS and selling short the bottom decile yields an annualised return of almost 15% (Figure 2). In some respects, the persistence of these returns is the other side of the dispersion coin: Asian markets are less efficient than major developed markets, securities research coverage is less deep and company management is less practiced in polishing earnings guidance. All of these factors tend towards a greater degree of surprise in earnings. So, a manager that can accurately understand where the consensus is wrong has great scope to extract alpha.

Figure 2: Asia ex Japan Inter-Decile Spreads, 3-Month EPS Revisions

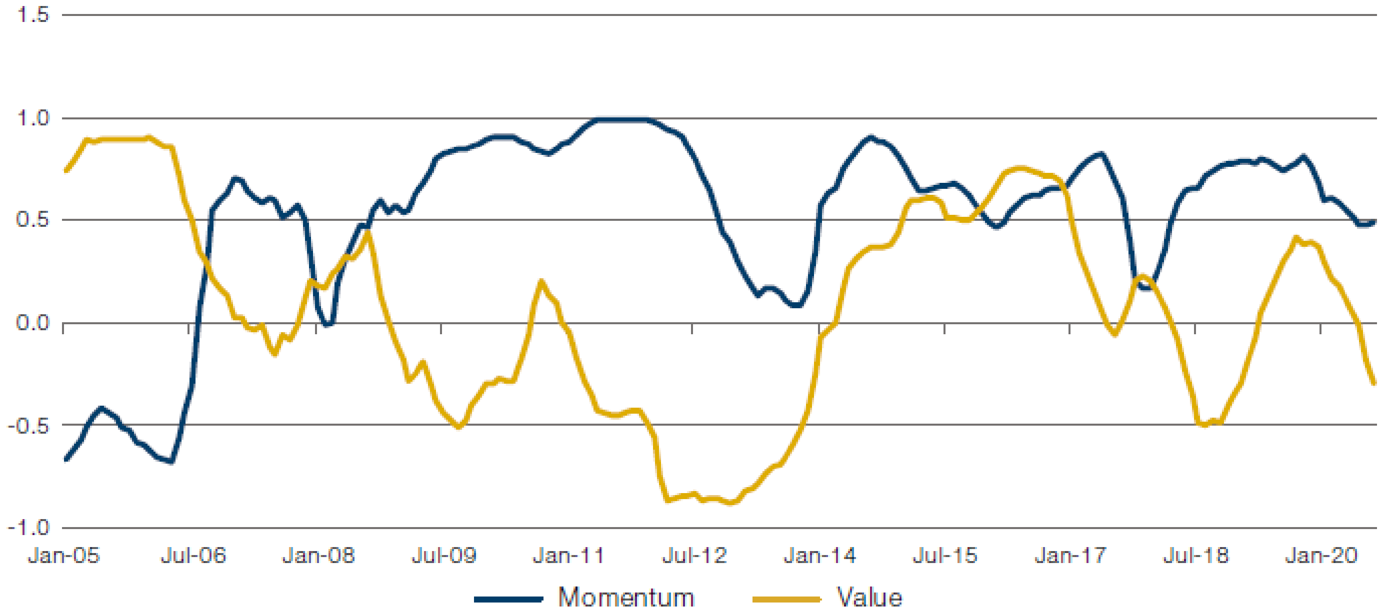


Source: Man Group, MSCI, Bloomberg; as of 31 August 2020.

It is also the case that the correlation of returns from earnings revisions to factors is quite unstable and time varying. This instability presents another source of potential alpha. Figure 3 shows the 2-year rolling correlation of the 12-month returns from the long/short earnings revision strategy shown above, to Fama-French Momentum and Value ('winners minus losers' and 'high minus low', respectively, in Fama-French terminology). While the correlation to Momentum is mostly positive over time, it collapses to almost zero periodically, driven by moments of risk aversion, and changing leadership in fundamental factor regimes. This can be understood through the highly variable correlation to value (as illustrated by the orange line in Figure 3): as factor leadership changed in Asia in 2013/14 from Quality-led to Value-led, momentum in earnings revisions collapsed before recovering. For a discretionary manager with a well-developed factor toolkit, understanding and pre-empting these changes in factor regimes, and understanding where leadership in earnings revisions will show up next, can be a highly rewarding strategy.

At Man GLG, we are heavily engaged in building out this toolkit, which will be discussed in forthcoming articles.

Figure 3: Two-Year Rolling Correlation of Value and Momentum Factor Returns in Asia ex Japan to Returns From Earnings Revisions



Source: Man Group, Kenneth R. French Data Library, Bloomberg, MSCI; as of 31 August 2020.

Can the Dollar Weaken?

Indeed, the relative strength of the US dollar is the beta factor in dictating the returns to Asian EM.

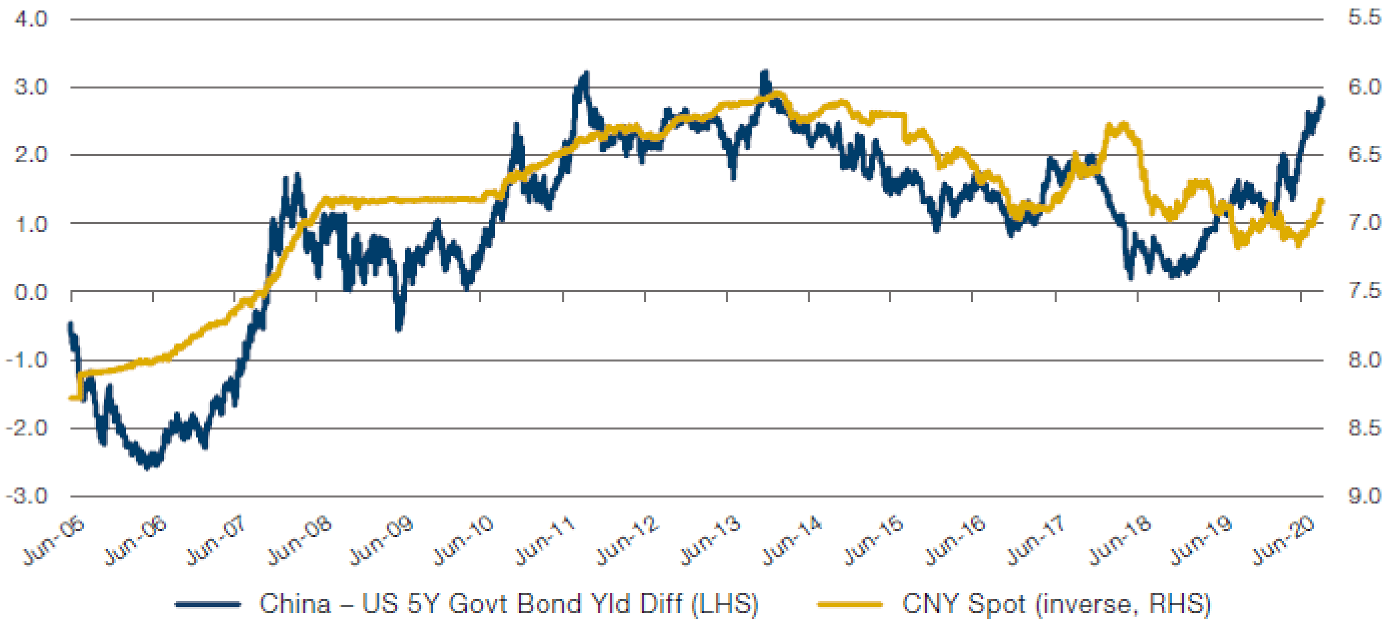
We would stress here that predicting the path of currencies is not our aim here. We believe that the cross-sectional dispersion and earnings revisions provide ample opportunities to generate alpha in Asian equities. However, there have been some key macro developments in 2020 that suggest the case for dollar weakness has developed. And should the dollar weaken (and we outline below why it may), this may provide another tailwind to Asian equities.

> " There have been some key macro developments in 2020 that suggest the case for dollar weakness has developed. And should the dollar weaken, this may provide another tailwind to Asian equities. "

The first factor is the Federal Reserve's decision to cut US interest rates to almost zero. This has removed the interest rate differential between the dollar and the majority of DM currencies. It is our experience that the US dollar weakness is broad-based: the median Asian currency during a period of dollar weakness behaves much like the euro or the Swedish krona.

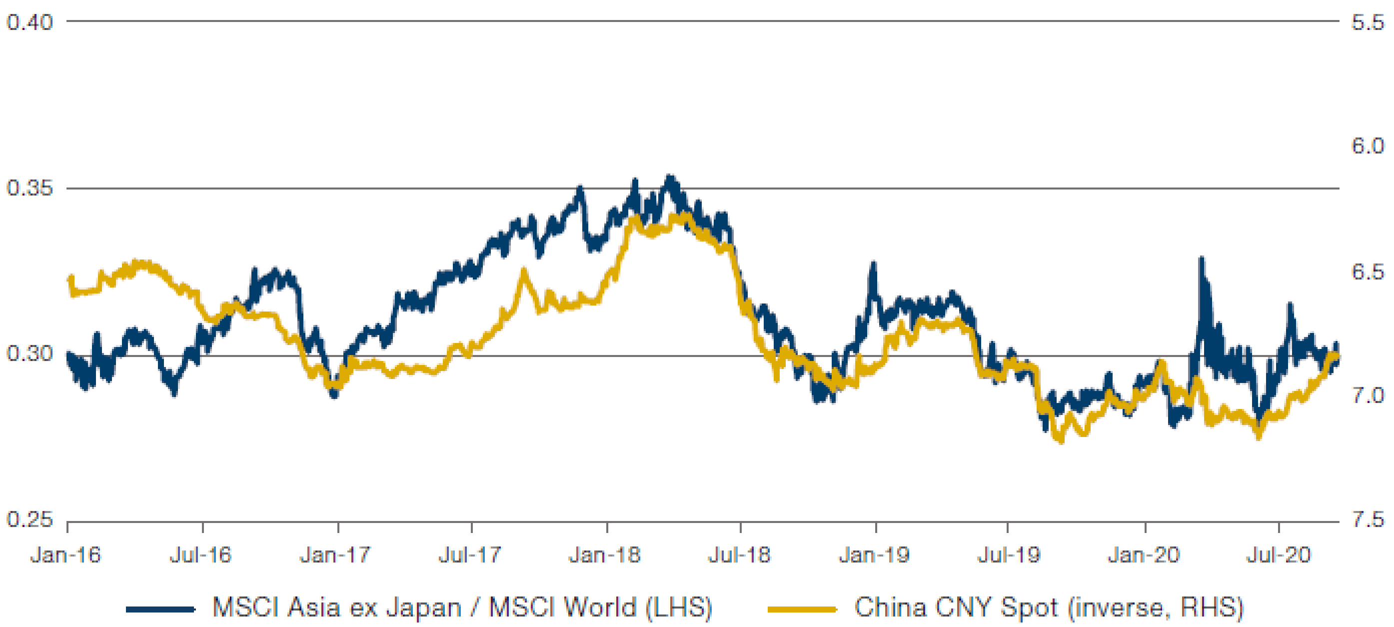
Similarly, the interest rate differential between China and the US have historically been a significant determinant of the level of the Chinese yuan. Figure 4 shows the correlation between the spot level of Chinese yuan and the spread between the yields of 5-year Chinese and US government bonds: as the spread increases – as is the case currently – the yuan tends to strengthen appreciably. This acts as a tailwind for Asian equities, with positive implications for equity returns in relative terms (Figure 5).

Figure 4: CNY Spot Versus Generic 5-Year Chinese-US Government Bond Spread



Source: Bloomberg; as of 10 September 2020.

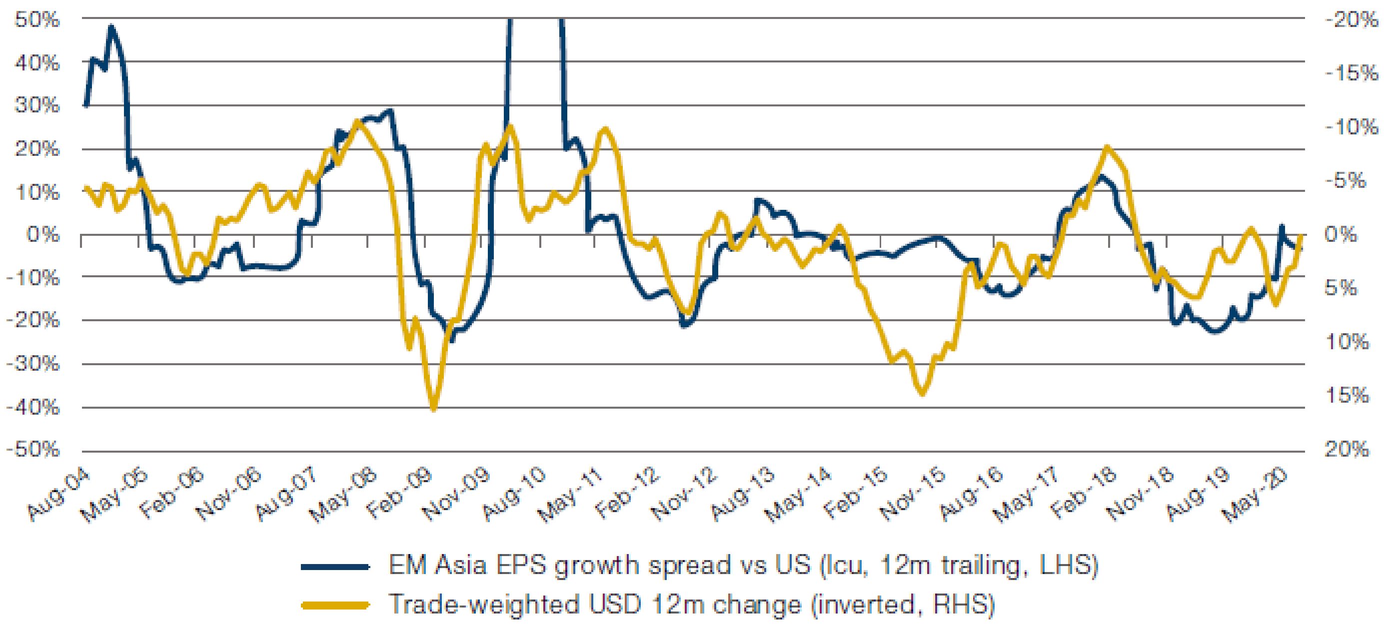
Figure 5: CNY Spot Versus MSCI Asia ex-Japan/MSCI World



Source: Bloomberg; as of 10 September 2020.

Perhaps most significant, given our belief in the centrality of earnings revisions, is that there is a meaningful historical relationship between the trade-weighted US dollar, and the spread of EM Asian EPS over the US. Crucially, this relationship is in local currency terms, meaning that the benefits of US dollar weakness are far more than a translation effect – weakness of the dollar drives operational gains for Asian companies (due to the region's export orientation, and inherent cyclicality), and vice versa.

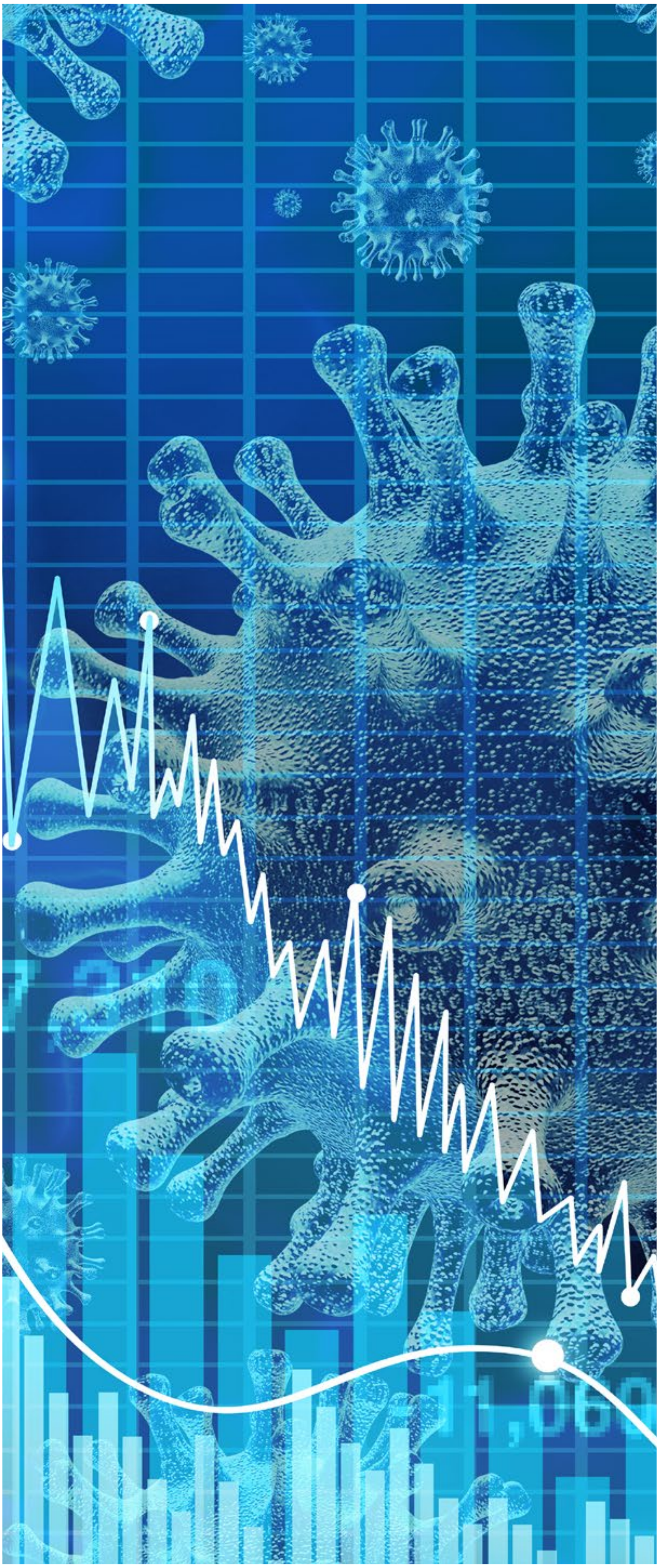
Figure 6: Trade Weighted USD Versus the Spread Between EM Asia and US EPS



Source: Man GLG; as of 30 September 2020.

Conclusion

The coronavirus pandemic has already forced the global economy into a recession, but as the recovery begins, investors in emerging Asian equity markets can be reassured by the likelihood that opportunities for alpha generation may expand: emerging market stock dispersion has consistently been higher than developed markets and tends to increase during recessions. Additionally, earnings surprises may likely increase due to similar factors. Finally, Asian economies may be further supported if the US dollar does weaken.



" The coronavirus pandemic has already forced the global economy into a recession, but as the recovery begins, investors in emerging Asian equity markets can be reassured by the likelihood that opportunities for alpha generation may expand. "

Private Funds Law, 2020

Julian Ashworth
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The most notable legislative development in the Cayman Islands in 2020 has been implementation of the Private Funds Law, 2020 (the "Law") which provides for registration of certain closed-ended collective investment vehicles (termed "private funds") with the Cayman Islands Monetary Authority ("CIMA"). More than 12,000 private funds were registered under this new regime during a short transitional period that concluded in August 2020.

What is a private fund?

The statutory definition of a private fund reflects certain characteristics that are consistent with the features imputed to collective investment schemes in other jurisdictions, notably the requirement for capital to be pooled and managed. The definition captures a managed, closed-ended fund (however structured) that offers or issues, or has issued, non-redeemable equity interests to two or more external investors that has the purpose or effect of pooling investor funds with the aim of enabling investors to receive profits or gains from such fund vehicle's acquisition, holding, management or disposal of investments.

The definition excludes certain vehicles that are otherwise regulated in the Cayman Islands, notably, CIMA licensed banks, trusts and insurance vehicles. The definition also expressly excludes a list of 25 scheduled 'non-fund arrangements', such as holding vehicles, joint ventures or private funds whose equity interests are listed on an approved stock exchange.

Certain types of commingled closed-ended fund vehicles routinely structured in the Cayman Islands, such as main funds, parallel funds, feeder funds, co-investment funds and alternative investments vehicles (including those vehicles which are formed for the purpose of making a single investment), will invariably fall within the ambit of the registration regime.

Registration Process

The Law sets out a registration process for private funds which involves the filing of prescribed details with CIMA and payment of an annual fee.

A registered private fund which intends to prepare an offering document or any other documents used to solicit investors ("marketing materials") is required to comply with certain CIMA prescribed rules on the contents of marketing materials (the "Content Rules"). The Content Rules will only affect existing registered private funds which prepare new or updated marketing materials or new private funds required to register with CIMA under the Law.

Continuing Requirements for Private Funds

Once a private fund is registered and has drawn down capital contributions from investors for the purposes of investment, the private fund will become subject to certain ongoing obligations which can be summarised as follows:

- **Valuation of Assets.** The Law requires that a private fund implements appropriate and consistent valuation procedures and that it carries out valuations at least annually. Such valuations can be performed by the manager or operator of the private fund (subject to functional independence or conflicts management and monitoring requirements), or by an independent valuer or an administrator.

- **Safekeeping of Fund Assets.** As a default position, the Law requires a custodian: (i) to hold private fund assets which are capable of physical delivery or capable of registration in a custodial account except where that is neither practical nor proportionate given the nature of the private fund and the type of assets held; and (ii) to verify title to, and maintain records of, fund assets. Where having a custodian is neither practical nor proportionate given the nature of the private fund and the type of assets held, title verification can be carried out by the manager or operator of the fund (subject to functional independence or conflicts management and monitoring requirements), or by an independent administrator or other third party.

- **Cash Monitoring.** The Law requires that monitoring of a private fund's cash flows, checking of cash accounts and receipt of investor payments be carried out by the manager or operator of the private fund (subject to functional independence or conflicts management and monitoring requirements), or by an independent administrator, custodian or other third party.

- **Identification of Securities**. The Law requires a private fund that regularly trades securities or holds them on a consistent basis to maintain a record of the identification codes of the securities it trades and holds.

- **Annual Audit.** The Law requires that a private fund file audited accounts with CIMA within six months of its financial year end and that the audit is performed by an approved Cayman Islands-based auditor (of which there are in excess of 40, including each of the main globally recognised audit firms).

CIMA has issued certain rules to be followed by private funds which expand upon the above operational requirements. These rules mandate requirements with respect to the valuation of a private fund's assets (the "Valuation Rules") and the segregation of assets (the "Segregation Rules"). Most registered private funds will likely already have policies and procedures in place to ensure compliance with the matters covered by the Valuation Rules and the Segregation Rules, particularly where such private funds are managed or advised by an entity subject to 'custody rule' requirements pursuant to onshore regulation such as the US Advisers Act.

Valuation Rules

The Valuation Rules require a registered private fund to have in place a net asset value calculation policy (a "Valuation Policy") that ensures the fund's valuation of its assets is fair, reliable, complete, neutral and free from material error and is verifiable, with the methodology used to perform the valuation to be based on applicable accounting standards.

Unless otherwise required by applicable accounting standards, the Valuation Policy must require the private fund to value investments on the basis of 'fair value' . In estimating the fair value of an investment, the private fund should apply techniques that are appropriate considering the nature, facts and circumstances of the investment. Valuations must be carried out at a frequency that is appropriate to the asset held by the private fund and, in any case, on at least an annual basis.

A private fund must ensure its Valuation Policy is applied unless there is satisfactory reason not to do so. Where deviations from the Valuation Policy are likely to have an effect on the reported valuation of the private fund, they must be disclosed to the private fund's investors in advance of the determination of the valuation and agreed to by the private fund's general partner or operator.

A private fund's constitutional documents or marketing materials must explicitly describe the limitations or potential limitations of the Valuation Policy and any material involvement by the investment manager in the valuation of the private fund's portfolio and any conflicts of interest caused by such involvement.

The private fund's general partner or operator has ultimate responsibility for oversight of the entire valuation process, and must approve and review at least annually, the Valuation Policy utilised by the private fund.

Segregation Rules

The Segregation Rules require a registered private fund's portfolio to be segregated and accounted for separately from the assets of the general partner, operator, investment manager and any other service provider appointed to ensure the safekeeping of the fund's portfolio, and they also require a private fund to ensure that none of such persons use the fund's portfolio to finance their own or any other operations.

The Segregation Rules also require a registered private fund to establish, implement and maintain strategies, policies, controls and procedures to ensure compliance with the Segregation Rules that are consistent with any disclosures made in the private fund's offering document and that are appropriate for the size, complexity and nature of the private fund's activities.

Sanctions for Non-Compliance

In addition to criminal and monetary sanctions for non-compliance set out in the Law, CIMA also has the power to impose additional administrative fines for breaches of prescribed provisions of the Law committed by entities and individuals that can exceed US$1 million for 'very serious' breaches.

The introduction of the administrative fines regime reinforces the need for all private funds and their operators to understand their obligations under the Law and to ensure that they maintain appropriate systems and controls to meet these obligations, as failure to do so could now potentially result in the imposition of significant fines.

Conclusion

The Law introduces a proportionate regulatory overlay for closed-ended funds and is responsive to recommendations made by international partners. The Law reflects the Cayman Islands' commitment as a co-operative jurisdiction that has been recently affirmed by the EU and other international organisations and covers similar ground to existing or proposed legislation in a number of other jurisdictions.

The Law also provides several benefits that include: (i) allowing Cayman Islands private funds to be distributed more broadly, including to investors who are only permitted to invest in regulated products (whether, for example, due to internal policies or the securities laws applicable in their jurisdiction of domicile); (ii) streamlining set up and registration formalities for Cayman Islands private funds by way of simplified compliance procedures; and (iii) facilitating more efficient regulator-to-regulator communications.

This article is intended to provide only general information for the clients or professional contacts of Maples Group. It does not purport to be comprehensive or to render legal advice.


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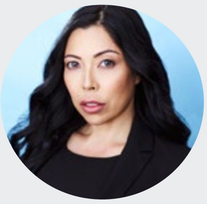
Finding opportunities in Latin America's corporate sector



Charina Amunategui
Executive Director
MUFG Investor Services

Over the past seven months, the grim specter of COVID-19 has thrown a wrench even into the best-laid – and most thoroughly considered – plans for growth and expansion. Companies of all sizes struggle to expand, and the global economy has taken a huge hit, pushing it into a recession.

While the adverse impact can be felt throughout the global economic sphere, the developing economies of Latin America and the Caribbean are feeling it more keenly than many. Slow economic growth, socio-political unrest and mounting national debt contributed to preventing an overall growth surge throughout the 14 national economies that make up the region. With coronavirus cases still rising at this point in time, the gross domestic products (GDPs) of Peru and Brazil – both of which have been hit hard by the pandemic – have experienced a sharp drop, with the former forecasted to be down 12% compared to being up 2.2% in 2019, and the latter down 8% compared to 1.1% in 2019.

Who's Feeling the Crunch?

Tourism, one of the region's biggest revenue earners, took a nosedive after shelter-in-place restrictions took effect in the spring to help prevent the spread of the virus. According to Monica Busch, Export Development Canada's Senior Regional Manager in Brazil, this has had a domino effect on related industries, particularly airlines, the hospitality sector and entertainment. Small and medium-scale enterprises (SMEs) and other highly leveraged companies have been impacted as well.

But Busch also notes that certain industries are still up and running, and the pandemic has not really affected their operations. IT companies and those producing essential goods are seeing the least impact or none at all – so far. This also goes for companies that transport critical goods or offer critical services.

The United Nations – Economic Commission for Latin American and the Caribbean (UN-ECLAC) has made note of this point in its regional economic survey for 2020 (download required). It calls attention to the fact that previous economic crises led to the goods sector suffering more than the services sector as global trade fell. In this COVID-19 crisis, it is the services sector suffering from the economy's downturn, and it may end up with a larger fall in trade than the goods sector. This plays out in the form of freight services for international trade losing demand because demand for goods has fallen.

According to Busch and Christian Daroch, EDC's senior regional manager in Chile, foreign companies that have investments or operations in Latin America are currently facing the following challenges:

- Foreign exchange is highly volatile at present, but this primarily impacts exporters and companies that import parts for their operations.

- More companies have been applying for commercial/industrial insurance due to the increased risk of nonpayment by buyers.

- Shelter-in-place/community quarantines have constrained operations because most companies have had to close down, go on with a skeleton workforce on a staggered schedule, or consider arrangements enabling employees to work from home.

- Chile, in particular, has experienced constraints regarding the availability of working capital, which can affect the payment of office rents and employee salaries, as well as loan refinancing and liquidity in general.

What Needs to Be Done?

Surprisingly, some experts believe that the shot in the arm that the region needs in the recovery period is environmental, social and governance (ESG) compliance. Unfortunately, there is not as much focus on ESG within Latin American companies compared to other parts of the world. According to David Feliba of Standard & Poor Global Market Intelligence, taking advantage of the ESG momentum that has been moving through the corporate world can help temper the negative impact that COVID-19 has had on both the regional and individual national economies. It can also help strengthen their recovery.

This is particularly sobering when you realize that only 0.5% of equity assets under management in Latin America have at least some focus on ESG, and that domestic ESG investments haven't exactly been robust. A good example here would be how ESG-focused equity funds in Brazil only manage 0.12% of the country's market – a country where for years conservationists and eco-centric investors have been negotiating with the government to curb the impact of deforestation in the Amazon.

Green finance specialists from the Inter-American Development Bank (IADB), however, insist that this is the way to go. IADB specialist Maria Netto points out that ESG is a trend Latin America can use to attract global investors.

The opportunity, she observes, is that the market share is currently small, with plenty of potential to grow. It is possible that this shift toward heightened ESG compliance will lead to increased investments in sectors like sustainable agribusiness, sewerage management, garbage disposal and green infrastructure.

Likewise, we need to have a keen eye out for opportunities within the region that will have a positive impact regardless of circumstances and start creating crisis-proof development plans that can change the economic sector for the better. This may involve any of the following:

- Rethinking your target markets because the pandemic may have shifted their focus – and yours.

- Keeping an eye out for possibilities that your company may not have considered prior to the pandemic.

- Revamping your business plan with relevant contingency measures that will ensure business continuity – and longevity – regardless of any further quarantines or lockdowns.

- Ensuring that your corporate infrastructure within the region is sturdy with regard to finances, staffing and physical resources.

As we all remain uncertain as to exactly when this crisis will end, vigilance and foresight are two qualities that we as business development leaders need to either cultivate or boost within ourselves. This would entail staying abreast of economic and financial developments within Latin America through reliable sources such as corporate research hubs, meeting up on a regular basis with colleagues or contacts located within or assigned to the region, and staying in touch with other industry leaders. Together, leaders can exchange insights on recovery and post-pandemic growth. There are opportunities to be found after COVID-19 and leaders would be wise to stay informed as they arise.

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A different world, a greener world?

Can private debt funds play a role in building a greener economy after COVID-19?

Craig Reeves
Founder
Prestige Funds

In July 2020, UK Chancellor Rishi Sunak unveiled a GBP 3 billion stimulus package as part of his Summer Economic Update to Parliament. This was targeted specifically at the UK's 'green' economy and was composed of a combination of grants, subsidies and loans. This included GBP 1 billion for a Public Energy Fund that is intended to decarbonise public sector buildings.

The UK, like other countries, is very focused on the reduction of greenhouse gas emissions, and sees this process as being one of key strategic importance. Chancellor Sunak's measures alone are hoped to slice UK greenhouse gas emissions by half a megaton while at the same time creating more than 140,000 new jobs in the sector.

The package demonstrates that the UK government recognises the important of re-greening the economy as part of the post COVID-19 recovery in the country. While government funding is going to play a critical part in this, private finance also has a role to play.

A different world, but will it be a greener world?

We will be emerging from the current pandemic into a very different world, but the climate challenge is one priority that will not have gone away. The fund management sector should have an important role to play at a time when there is more emphasis on ESG criteria in the way money is being managed by the industry. Indeed, next year will see an upgrade to MIFID2 rules where product providers and financial advisers will be required to demonstrate the 'sustainability' of an investment.

Investment into the private lending sector was one theme that had been expanding rapidly last year.[1] Within that, we are seeing more lending capital being allocated to important small scale clean energy projects. The UK is considered a leader in this area.[2] Beyond the advice to householders on how they can make their homes more energy efficient, there is going to be a bigger story around the ongoing development of critical green energy infrastructure, be it wind farms, solar farms, or biogas plants.

That use of the word 'farm' is apt, as it is the farming industry in the UK which has been taking the lead for many years now in the development of on-farm clean energy. This trend has occurred as farmers have been faced with rising electricity prices at a time when governments have also imposed higher taxes on landfill. Farmers have the advantage of space and, in many cases, ready sources of organic waste. While the presence

1 Financing SMEs and Entrepreneurs 2019, OECD Policy Highlights.

2 'UK renewables prove a shining success during pandemic', Financial Times, 17 May 2020

of marquee wind farm projects has generated considerable media interest, many farms have been diligently developing their own on-farm clean energy resources.

Biogas and anaerobic digestion

Biogas has come to the fore as a key component of on-farm energy. Biogas has the double utility of delivering sustainable energy while consuming organic farming waste and turning this into fertiliser. Biogas is not a new technology, but it is becoming more sophisticated and is in much wider use in the UK than historically.

Also called anaerobic digestion, the technology can be deployed as small, localised plants that can also generate sufficient surplus electricity to earn additional income when sold back into national grids.

Anaerobic Digestion (AD) is a proven technology which could deliver a staggering 30% of the UK's carbon budget in 2030, while also providing green heat to 6.4m homes.[3] During the pandemic lockdown in the UK, AD plants proved themselves to be extremely resilient, and all the operational plants funded by Prestige Funds remained fully functional. Prestige via its dedicated, specialist Finance Arranger has operated in this space for almost a decade.

If the UK is going to reach its government's 2050 target of net zero emissions, this technology has an important role to play. The potential carbon savings are massive. According to ADBA (the Anaerobic Digestion & Bioresources Association), at its full potential, AD provides emissions savings equivalent to the emissions of all the HGVs currently operating on British roads.

Financing of biogas on a national level requires considerable expertise, especially when focusing private capital in the important ESG role of funding green energy infrastructure. In effect, private lending in this space mirrors the important higher level financing the UK government is carrying out, but at a more localised level.

Specialist private lending funds have the advantage of the local networks and expertise required to manage large loan books within the agricultural and clean energy brackets within the UK.
This is not something achieved overnight.

UK agricultural sector has remained robust during lockdown

SMEs within the agricultural sector also have the advantage of having continued to function at close to or at maximum capacity as food demands within the UK have not lessened during lockdown. Many agricultural businesses face challenges as a consequence of COVID-19, but these are rarely down to a lack of demand.

Making these businesses more productive and more energy efficient, essentially more robust, is

3 *Biomethane:* The Pathway To 2030 (ADBA research report, 2020)

part of the role of commercial lenders like private debt funds. There is an important social role to be played here, as these SMEs have faced a dearth of borrowing options as big banks have pulled out of the sector post-Great Financial Crisis.

Now we have another crisis on our hands, and it remains important for private debt funds to remain fully engaged with smaller businesses and advise them on how they can capitalise on the shift to a greener energy infrastructure and the benefits that can accrue from this.

This means playing a far more consultative role than simply assessing credit risks and carrying out initial on site visits. Technical expertise is required to help farmers and other rural SMEs to implement biogas or other clean energy generating facilities. Ongoing support and advice may be needed to ensure such plants are both meeting the needs of the farms they serve, while potentially also generating further wattage for local communities.

Conclusion

Local energy projects are going to be essential if the UK and other countries shift post COVID-19 towards a greener economy. Financing such infrastructure is not the role of governments alone, many of which have been stretched with the need to support economies through the coronavirus crisis. But what we do have here is an opportunity to create new jobs within the energy industry, many of them within local communities. Small scale projects are already proving that they can replace electricity being generated with fossil fuels.

Over the next two decades we anticipate that private lending funds will play a very important role in financing the expansion of clean energy infrastructure in the UK and further afield. More importantly, they have a role to play in the effective deployment of capital to SMEs in the immediate aftermath of the pandemic. There is an opportunity here to accelerate the transition to a greener economy through the effective use of private investment within the lending sector.

New Swiss rules at the "point of sale" for the offering and marketing of funds in Switzerland

Martin Liebi
Legal, Switzerland
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The new rules in a nutshell

The new Swiss Financial Services Act (FINSA) and Swiss Financial Institutions Act (FINIA) have materially changed since 1 January 2020 the Swiss regulatory requirements for the offering of funds in Switzerland. FINSA imposes on the one hand new obligations for the distribution process and the distributor of funds, and persons involved in the distribution of funds. A transition period until 31 December 2021 applies to most of these new obligations, the obligation to affiliate with an ombudsman and to register with a client advisor register enter into force however earlier.

New categories of clients

FINMA approval of fund documentation is still required and a fund representative and paying agent must be appointed if funds are distributed to non-qualified investors. Qualified investors are either professional investors, private investors that have opted-out, or private investors having concluded an unlimited asset management or investment advisory agreement with a regulated entity. No FINMA approval of funds and neither a representative nor a paying agent is required in case of an offering of funds to "per se" professional investors. A fund representative and paying agent is however still required if funds are distributed to private investors that have opted-out to become professional investors. The opt-out right is granted if the investor has a net wealth of at least CHF 2 mio. in eligible assets or of CHF 500'000 in eligible assets and sufficient knowledge about financial services and financial instruments.

Fund distribution is a financial service under the new regime

Fund distribution qualifies as offering of financial instruments and is now at the point of sale generally subject to the same rules and regulations as the offering of any other financial instruments. The distribution of funds at the "point of sale" to clients in Switzerland will trigger the following new obligations:

- Client advisor registry: Client advisors of financial service providers, meaning any natural person that distributes funds to clients in Switzerland must be entered into the newly established Swiss client advisor registry no later than until 19 January 2021. An entry is required in case of prudentially supervised fund distributors – meaning that they are comprehensively supervised at their place of incorporation - if they are distributing funds to private clients in Switzerland. Non-prudentially supervised client advisors must be entered into the client advisor registry independently of the classification of their clients in Switzerland (institutional, professional, and private). Sufficient knowledge of fund distribution and knowledge of the behavioural rules with regards to fund distribution under FINSA must be shown[1], a professional liability insurance with the minimal legally required coverage must be concluded[2], and the client advisor to be entered cannot have a criminal record with regards to criminal acts against property or be prohibited from engaging in a financial services activity.

1 see https://www.webassessor.com/finsaclientadvisortest for further information
2 see https://www.g-e-a.ch/finsa

- Financial services ombudsmen: Fund distributors must affiliate with an ombudsman for financial services no later than until 23 December 2020. This obligation applies independently of whether there is a legal obligation that client advisors must be entered into the client advisor registry. There are multiple financial services ombudsman recognized to deliver ombudsman services.[3]

- Duty to segment clients: The clients of the fund distributor must be segmented into institutional, professional, and private clients. There are different obligations attached to each client category.

- Duty to inform: Financial service provider must inform prior to the distribution of funds or when they enter into a contract with a client about the risks, costs, financial services provided, and financial instruments offered in the context of the financial service provided.

- Duty to document: The fund distributor must document all the actions taken, information provided, and documents provided related to FINSA in a corresponding client file. The client has the right to request a copy of this file at any time.

- Duty to render account: Financial service providers must render account upon request of each client about the financial services that have been provided.

- Retrocessions: Payments that have been made in the context of the provision of fund distribution services by third parties belong generally to the client. The client can however waive these payments if the client has been sufficiently informed about the size of these payments.

- Organizational obligations: Financial service providers distributing funds must be adequately organized and employees must be adequately monitored and trained.

- Best execution: Although in case of fund distribution activities of subdued importance, FINSA prescribes also that a best execution policy must be created.

- Conflicts of interests: Conflicts of interests must also be adequately addressed in a policy that can at any time be requested.

New Key Investor Document (KID) requirements

Creator of funds that offer funds in Switzerland that address private investors must like under the old regime appoint a representative, a paying agent, and must also have the fund documents approved by FINMA. A key investor document (KID) must also be created in case of distribution to private investors.

New rules about advertisement

Advertisement is preceding the offering of funds and must be designated as such in the marketing documentation. The difference between advertisement and an offering of funds is that advertisement is sufficiently generic in nature and not an offer, meaning no invitation to acquire a financial instrument that contains sufficient information on the terms of the offer and the financial instrument itself.

3 see https://www.efd.admin.ch/efd/de/home/das-efd/ombudstelle-nach-fidleg.html for more information

Many Happy Returns, SMCR

Matthew Raver
Managing Director
RQC Group

- **First 12 months; first real test for SMCR**
- **The bigger picture – SMCR, culture, conduct, governance and social trends**
- **Why the Conduct Rules matter**

This December sees the first anniversary of the commencement of the Senior Managers and Certification Regime ("SMCR") for 'solo-regulated firms'.[1]

SMCR was a long time in the making. Following the 2008 financial crisis, a UK Parliamentary Commission looked into banking standards, including making individual responsibility a reality. Thereafter, the UK regulators (the Financial Conduct Authority **("FCA")** and the Prudential Regulation Authority (**"PRA"**)) **introduced SMCR in March 2016**. Initially the regime was rolled out for credit institutions and major investment firms. Insurance companies followed in 2018 with the requirements taking effect for the remainder of FCA regulated firms on **9th December 2019**.

SMCR is an integral component in a major regulatory initiative to improve conduct and culture at financial institutions. The FCA and the PRA consider SMCR to be a 'game changer' within the industry. Among other considerations, an improved framework governing the behaviour of individuals is expected to mean that the financial services industry is better placed to respond to future crises; both systemic and within individual firms.

When a new regulatory regime takes effect, typically the first 12 months represents a 'bedding down' period. Firms, regulators and other stakeholders adopt the requirements and new industry standards develop. Regarding SMCR, requirements have included procedural aspects such as: establishing protocols for the take-on and training of employees; assigning responsibilities to senior managers; obtaining references from former employers; conducting criminal checks; and ensuring that disciplinary procedures are fit-for-purpose.

More pertinently, senior individuals within financial institutions have been encouraged to change their mind-set. There has been a transition from an emphasis on collective responsibility to recognising the importance of **individual responsibility**. The concept of the 'tone from above' has a sharper focus. Fostering the right culture within an organisation is becoming more

1 Firms that are authorised and regulated by the UK Financial Conduct Authority. Almost all UK investment firms and asset managers fall into this category.

of a competitive advantage. It is perhaps these aspects of the framework rather than the minutiae of the rules that makes SMCR so impactful.

Barely 3 months into the new regime, disruption caused by the onset of COVID-19 started to take effect. For many firms and senior managers, this was the first real test under the new SMCR framework.

At this time, senior managers were in the nascent stages of establishing personal responsibility over particular business areas. As permitted by the regime, senior managers could delegate tasks to more junior staff members but – crucially – they retained the personal responsibility to appropriately supervise the staff working under them.

The swift transition to extensive working from home presented the unprecedented challenge of not having physical proximity to delegates on an ongoing, every day basis which made it more difficult to supervise others and to effectively delegate tasks. Moreover, this came at a time where senior managers were also busy enacting contingency arrangements and making strategic and commercial assessments.

In this way, COVID-19 could be considered to be part of a wider heading - transition management. And whilst this year has been somewhat overshadowed by the virus, 2020 has many other moving parts. Brexit is one such example. The juxtaposition of COVID-19 and Brexit might create a 'perfect storm' for some firms. Under SMCR, a firm may elect to ascribe a responsibility related to transition, or business change to a senior manager. Given current circumstances, this would arguably be as important a responsibility as one that relates to a particular business unit – IT, human resources, administration, and so on.

In tandem with these developments there is an initiative which is gaining increased traction within the financial services industry – **ESG**. This refers to the three central factors in measuring the sustainability and societal impact of an investment in a company or business, namely Environmental, Social, and Corporate Governance. Regulatory initiatives are underway with respect to ESG investing conducted by investment firms, including transparency requirements and the classification of environmentally sustainable activities. Receiving less attention, but also important, are the measures that investment firms are taking *internally* when reviewing operations and factoring ESG considerations. There is an imperative for an investment firm to align this with its SCMR framework.

Consider, for example, the 'S' within 'ESG'. Movements such as '#MeToo' and '#Black-Lives-Matter' have prompted an enhanced focus on diversity and equality. It has raised questions about how fair treatment is supported within a firm culture and upheld in individual conduct. As such, it prompts the need for recognition under SMCR.

Then there is the 'G'. Governance arrangements perform an integral role in the regulatory initiative to improve conduct within financial institutions. Whilst SMCR does not focus on specific governance arrangements per se, the two concepts are inextricably inter-linked. How the senior managers exercise stewardship over the firm, the composition of boards and sub-committees, the management information received by such forums, and the deployment of non-executive directors align with key characteristics of the senior managers regime, such as: individual responsibility; personal accountability; being fit and proper; and leading by example.

Reflecting upon COVID-19, Brexit, ESG and other factors, SMCR's 12 month 'bedding down' period has certainly been eventful

How should firms further develop their SMCR frameworks? Perhaps due to the piecemeal introduction of SMCR-related requirements, the focus to date has been on the more senior individuals within an organisation. However over the coming years, the conduct rules will become more prevalent. In a speech from 2017, Jonathan Davidson, a Director of Supervision at the FCA, expressed a desire for a financial institution's customers to be aware of the conduct rules and to know when these have been breached, similar to suspecting that the Trade Descriptions Act has been breached.

From 31 March 2021, the conduct rules will apply to everyone working in the financial services industry aside from 'ancillary staff' (such as catering staff and security guards). This is the first time that a wide-scale code of conduct has applied

consistently across the financial services industry. This is surprising when one considers that other professions – medical practitioners, social workers, solicitors and many more - have had a code of conduct for some time. The FCA has advised that it expects conduct rules training to be sufficiently robust. For many staff there are only five conduct rules (for example: 'You must act with integrity'); pasting these into an email with a message that 'these now apply' is unlikely to pass muster with the FCA. Instead, it is important for a staff member to understand the context of the conduct rules and how they relate to that staff member given his or her role and responsibilities.

Many firms will face challenges when determining whether or not the conduct rules have been breached. There is a regulatory requirement to report breaches to the FCA, and in some circumstances the breaches – plus potentially issues related to an individual's fitness and propriety - must also be reported to a prospective new employers (for a 6 year period under the 'regulatory references' requirement). If a firm's disciplinary processes are inadequate, or have not been properly thought through, then litigation risk might increase. For example, if an individual has not had the opportunity to refute a firm's assertion that he or she has breached the conduct rules then they may take action against that firm.

2021 could be another eventful year. The COVID-19 crisis may abate and many of the Brexit related issues might be resolved. However there remains the possibility of a sustained economic downturn. The last time this happened, after the credit crunch, the conditions uncovered a spate of poor behaviour that – eventually - led to the introduction of SMCR. There could be a repeat scenario but with a sturdier framework in place. This might coincide with the FCA turning its supervisory attention towards SMCR – the 12 month 'grace period' having expired and having an imperative to take its own disciplinary action against individuals, as a signal that SMCR is effective. The FCA might set an example at all levels, and so the sanctions could include some 'big scalps', and also more junior staff and staff at smaller organisations.

SMCR is neither a stand-alone concept nor a box ticking regulatory exercise. Firms that are ahead of the curve will continue to refine their internal SMCR systems and controls, including ensuring **that good practices** emanate from the top and permeate within an organisation. The FCA has stated that it wants firms to develop a **'culture of accountability'** at all levels. Firms that are more adept in educating their employees on the appropriate behavioural standards and articulating this as a key 'tone from above' message may well find that this will be to their advantage, from both a regulatory and a commercial perspective.

Private Assets - a popular revolution?

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The retail investment universe is changing, driven both by direct and indirect investor demand and the public sector need for support from private capital. However, the current "cult of liquidity" and resulting monolithic regulatory regime has created an environment where the necessary democratisation is hard, if not impossible, to achieve. A change in regulatory mindset (which appears now to be beginning to take hold) will hopefully catalyse new developments by fund providers as well as the acceptance of less-liquid products by intermediaries – all of which is necessary if private assets are to find a wider audience.

Investors seeking diversified, enhanced returns have increasingly looked to grow their allocation to "alternative" investments. While traditional 'institutional' investors have led the way, retail investors face significant barriers to entering the world of private assets, with exposure limited by regulation designed to "protect" them from the complexity and, especially, illiquidity of such assets.

Recent events, though, have re-focussed minds. The public sector spending necessary to aid the post COVID-19 recovery must be funded somehow and the need to boost public sector stimulus with private sector capital seems clear. While some regulatory fears remain relevant, the need for new sources of investment capital is unarguable.

Demand for broader access to private assets now comes from several areas.

- **Pension funds**, facing reduced traditional returns coupled with increasing life expectancy, are moving towards longer-term, alternative investments.

- **Funds-of-funds,** which create a more diversified portfolio by spreading risk across multiple funds, and so cater for more risk-averse investors (assuming management costs can be kept reasonable).

- **Direct retail investors who**, facing low interest rates, are increasing demand for exposure to longer-term assets, provided this is not accompanied by an unacceptable increase in risk or out of step with their personal time-horizons.

One of the key issues holding regulators back from allowing wider access to private assets has been the "liquidity mismatch" between those assets and the (perceived) necessity of easy liquidity for the retail universe.

Retail investors are regarded, en masse, as having shorter term horizons, needing the ability to redeem at short (often daily) notice. This primary liquidity requirement does not fit well with less liquid assets, which take time to sell. A real estate asset, say, may not be quickly realisable without destroying value. This "liquidity mismatch" has received much attention in the context of daily dealing funds that hold a small proportion of their portfolios in illiquid assets – funds which Mark Carney famously referred to as being "built on a lie".

Likewise, whilst a manager could hold cash against redemption demands, this is inefficient and fundamentally against the wishes of investors seeking access to private assets, not cash holdings.

However, **primary** liquidity by redemption is not the only solution. Investors can already access illiquid assets through listed investment trusts, which offer secondary liquidity.

With management of the fund vehicle regulated and supplemented by the relevant exchange rules, these provide an established route for retail access to private assets.

The "listed closed-end" sector is dynamic - the International Property Securities Exchange (IPSX) offers investors a dedicated platform for real estate investment, with its "prime" market offering the possibility of access to the public.

But secondary liquidity doesn't always mean public markets – one option for more sophisticated investors could lie in private secondaries – or even tokenisation of illiquid fund interests.

Secondary liquidity, though, is not a universal solution. In order to drive real democratisation a more sophisticated approach is required from regulators, recognising that liquidity is not always a prime determinant of retail suitability. Regulatory change combined with sensitive product development and appropriate advice and management decisions from intermediaries offers a more comprehensive answer.

Fortunately, regulators and industry in several countries are taking active steps to address these issues.

UK

Industry has lobbied hard for changes to allow more product innovation with moves ongoing to try to develop a more flexible regime for an onshore alternatives vehicle for the professional investor in the form of aProfessional Investor Fund (PIF) which could offer a solution for the highest end of "retail" and UK institutional investors looking to invest in long-term assets – particularly, real estate and infrastructure.

Of broader retail potential application is the Investment Association's (IA) proposal for a Long-Term Asset Fund, a new type of non-UCITS retail scheme and therefore an FCA authorised fund, expressly designed to invest in long-term assets. The likely target market comprises Defined Contribution pension schemes, professional investors and discretionary portfolio managers but marketable to retail investors, where appropriate. The IA has been working closely with the FCA to develop its proposal and, while the final form remains unknown, the regulator is expected to be supportive.

EU

European Long-Term Investment Funds (ELTIFs) were designed to help the EU's real economy by providing "finance of lasting duration" to infrastructure projects, unlisted companies and listed SMEs, thereby generating a steady income stream for entities seeking "long-term returns within well-regulated structures".

While sitting within the AIFMD regime offers advantages for ELTIFs, the level of regulation to which they are subject has stifled their development - since their introduction in 2015, only 22 have been established. Crucially, market perception is that the current ELTIF structure offers no advantage over traditional institutional-only funds.

However, there is hope. As part of the European Commission's review of the ELTIF framework, its High Level Forum notes the EU's "chronic shortage" of financing for long-term investments necessary for environmental sustainability and recommends amendments (including a broader range of eligible investments) to encourage retail participation, while taking investor protection 'into due account'. The Commission is currently consulting on proposals to amend the ELTIF framework and aims to finalise new legislation by mid-2022.

Meanwhile, the German investment funds association, BVI, has proposed a new structure, the European Impact Fund (EIF). EIFs would invest not only in equity and debt instruments issued by

EU SMEs but also in long-term projects via new "European Impact Bonds" - green or social bonds issued by the Commission, tied to individual "impactful" projects. Over time, the scheme could be extended to the private sector, with private enterprises issuing similar bonds.

Though targeted primarily at retail investors, EIFs could also be attractive to institutions. Although the BVI envisages EIFs as part of the UCITS framework (with obvious "democratic" advantages), it is unclear whether they would meet current UCITS liquidity requirements and whether those requirements would be unduly restrictive for truly long-term investment.

Italy

Italian schemes investing more than 20% in illiquid assets must be closed-end AIFs and are usually reserved to professional investors. Although they can also be structured as retail funds, in practice, few such funds have been established since they are subject to strict operational, governance and investment restrictions.

Moves, though, are afoot to amend the regulatory and tax regime for Italian AIFs.

First, a consultation is pending on facilitating investment by retail investors into reserved funds. Second, 2020 saw the introduction of Alternative PIRs (*Piani Individuali di Risparmio*), offering a favourable tax regime for Italian tax resident individuals and pension funds. These can take a variety of forms, including closed-ended AIFs, such as Private Equity funds and ELTIFs.

Returns from Alternative PIRs are exempt from income and inheritance taxes provided (among other things) at least 70% of the portfolio is invested in Italian and European SMEs for at least eight months each year.

Alternative PIRs cannot invest more than 20% of their portfolios in any one issuer while individual investors can only subscribe up to EUR 300,000 per year and in one Alternative PIR at any time, with a five year minimum holding period. (These limits do not apply to pension funds.)

US

While US investment firms are not specifically prohibited from including illiquid assets in defined pension contribution plans, managers have traditionally held back from including access to private equity investments in individual account plans as part of the overall portfolio mix. Regulators have now signalled greater willingness to allow access to products previously limited to institutional investors.

The Department of Labor recently clarified that

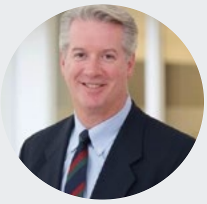
- ERISA fiduciary responsibility provisions do not prohibit fiduciaries of 401(k) and other individual account plans from including diversified investment options with private equity exposure, provided various requirements are met; and

- private equity investments that are part of professionally managed, multi-asset class vehicles can be offered to retail investors and form part of a prudent investment mix, provided a proper analysis is conducted by the plan's fiduciaries.

Some, though, have called on the DOL to reconsider, arguing that illiquidity and the lack of standardised performance calculations for private equity funds could be problematic for plan participants.

The SEC, too, has considered increasing retail access to private companies, seeking comments on proposals to amend current restrictions on private equity funds offering interests to retail investors, expanding the definition of "accredited investors" and allowing qualification based on defined measures of professional knowledge, experience or certifications as well as existing income or net worth tests.

Hedge fund administration: Past, present and future



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The adoption of the "Ten Commandments[1]" in 1968 spawned the development of the offshore fund administration industry for US-based hedge funds. The Ten Commandments required a US-managed fund to have 10 administrative functions performed outside the US in order to avoid U.S. taxes on its offshore income. Required offshore functions included communicating with shareholders, accepting subscriptions of new shareholders, and maintaining the principal corporate records and books, among other provisions.

Under this regime, until 1997, offshore third-party administrators were located in tax haven jurisdictions and lightly staffed. They provided fund accounting, NAV calculations and some fund legal and regulatory reporting. By today's standards, the Cayman, BVI, Curacao, Bermuda and other offshore administrators did very little other than complete the fund books and records and issue statements.

The 1997 Taxpayer Relief Act repealed the Ten Commandments and ushered in the modern world of fund administration as we know it today. From 1997, hedge funds were allowed to self-administer their offshore funds. More importantly, fund managers and investors could consider outsourcing this function to other more expert and experienced on-shore independent third-party administrators.

Third-party administration then grew rapidly to include varying degrees of technology, middle- and back-office outsourcing.

Over the next 20 years, investor demand for third-party governance, control and transparency, along with fund manager requirements for outsourced services, provided the environment for growth.

The US onshore market for fund administration services created an enormous competitive advantage by deploying Wall Street trained financial and technology experts instead of the previously geographically constrained pool of offshore, tax haven-based accountants.

Since 2008 (post Madoff), all hedge fund investors and most financial regulators have a mandatory requirement for independent, third party administration. Hedge fund AuM has since migrated entirely away from in-house (self-managed) administration. The role of independent administrators matured dramatically. Investors have come to rely on administrators not just for NAV calculations and statements, but for transparent, independent governance, fund control and reporting.

1 Before 1997, Tax Code section 864 provided that a non-US corporation would not be treated as engaged in a US trade or business and would not be subject to US tax on all of its income if it: traded solely for its own account; was not a dealer; and, did not have its principal office in the United States. The US Treasury listed ten activities (the Ten Commandments) all required to be performed by the non-US corporation outside the United States to avoid US taxation.

Efficient processing of data has become the core task

Today, efficient administration with central governance and control is about building robust technology, managing data and running processes for the use of that data. Administration workflows centre on loading large data files over a 24-hour period. The administrator is responsible for cleansing, enriching and reconciling the data to third parties and producing on- demand, real-time exception driven reports on the results.

Fee pressure and expenses

Along with a rapid increase in hedge fund AuM came pressure on net returns, combined with a downward drift in management and performance fees. Administrators responded to fee pressure by offering complete outsourced services as part of the administration function at efficient and scalable costs.

The combined trends towards lower fees and increased investment in technology drove more AuM into the hands of the largest, most cost-effective administrators. As a result, the last 15 years have been driven by the wholesale consolidation of assets under administration to the largest bulge bracket providers.

The concentration in administration assets occurred through a process of roll-up mergers and acquisitions, along with individual hedge fund managers moving their own funds to more efficient, scalable, higher quality providers.

Sustainable growth supported by flawless fund conversions

Whether gaining clients and AuA through acquisition or hedge funds changing fund administrators of their own volition, the largest administrators must be consummate experts in rapidly converting each fund's books and records to the accounting system of the acquiring entity. Fund conversions are now the lifeblood of large administrators. SS&C alone, as one of several bulge bracket administrators, has converted hundreds of billions in assets to its general ledgers and data hubs.

By partnering with large administrators, asset managers are able to rationalize services and technology providers, control costs, and future-proof their operations while relying on scalable technology to support growth in increasingly complex and sophisticated investment strategies.

The future of hedge fund administration

Over the years, hedge fund administrators have dealt with changes in the industry they serve. Increased regulations, diversity of products, and trade volumes have required fund admins to transform their business. In one example, fund managers saw an opportunity with statistical arbitrage strategies which forced fund admins to find ways to accommodate their changing needs. For some funds, the average daily trade volume went from 10,000 to millions of trades per day.

Fund admins that wanted to stay relevant had to turn to technology for the answer. Faster processors, less expensive storage and the coming of cloud technology into financial services is accelerating this technology transformation.

Keeping up with client demands is the primary objective of fund admin technology initiatives. To compete in the fund administration industry, flexibility in dealing with clients is now just table stakes. Firms that cannot support its hedge fund clients' changing needs will quickly fall behind. This has changed the typical hedge fund admin from a purely "services-first" organization to a "technology-first" organization.

Administrators rely heavily on innovations in technology to enhance their offerings. Capitalizing on these innovations and rapidly turning them into client advantages is the key differentiator within the fund admin world. Fund managers are acutely aware of this and have made technology capabilities a top consideration when selecting a new fund administrator. At the table, a fund admin now has to prove its tech prowess to prospective clients in order to win the mandate.

The added imperative of resiliency in the case of a large-scale business continuity planning (BCP) issue is now also in the forefront. The "Live Experiment" that hit the Financial Services Industry in March of 2020 put extra emphasis on process and efficient connectivity of staff. Can you achieve your deliverables even if your firm is forced to work 100% remotely? This question, which previously sat somewhere low in the BCP section of everyone's RFP is now highlighted and raised to the top of the list.

> **Over the next 20 years, investor demand for third-party governance, control and transparency, along with fund manager requirements for outsourced services, provided the environment for growth.**

Direct client requirements aside, the next wave of transformation for fund administration firms will be defined by the need to transition to a highly process-efficient and remote organization. After the 2020 pandemic in which many firms operated with large parts of their organization working remotely, the question of the importance of real estate will need to be reviewed.

Will expensive office space still be expected after the demonstrated ability to deliver remotely is evaluated? With the availability of tools that bring artificial intelligence and remote connectivity into the forefront, fund admins need to turn inward and look for ways to gain deep process automation across a connected labor and client base. Service delivery will become faster and with lower error rates.

A fund admin's knowledge workers will be spending more time adding value by being consultative to their clients rather than performing repetitive processing tasks.

To accomplish this transformation, fund admins will need to go back to business process reengineering techniques that started in the early 2000s. Lean for Service reviews of the fund admin business, combined with new artificial intelligence technologies, will yield some of the greatest process improvements for the fund admin business.

The ability to automate what previously was considered only a manual process is far greater now with artificial intelligence (AI) techniques such as machine learning and natural language processing. Fund administrators that make the investment of looking inward and changing their process workflows with these new tools will gain efficiency and accuracy never before experienced.

Clients demand administrators deliver more data with increased speed, accuracy and integration with their core systems. Post pandemic, all data delivery must be supported by staff working remotely for clients also working remotely. Fund managers and administrators will become highly integrated through technology as a way to drive increased value. These tight partnerships will provide enhanced transparency, reduced complexity and lower costs within the fund manager's business.

Current practices such as shadow administration will no longer be needed. However, not every fund admin is well positioned to make this technical transformation. The future of fund administration will be owned by those that recognize these imperatives and create business-aligned technical strategies that deliver on the full capability of the most current technology for clients.

About SS&C

SS&C is a leading innovator in technology-powered solutions and operational services for the global investment management industry, with particular expertise in the full range of alternative investments, including hedge funds, private equity, funds of funds, real estate, real assets and direct investments. We are also the industry's largest global fund administrator. SS&C serves a worldwide clientele with a network spanning the major financial and commercial centers of North America, Europe, Asia and Australia.

The global leader in hedge fund administration

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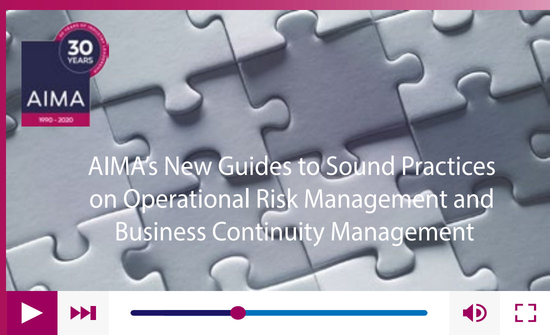

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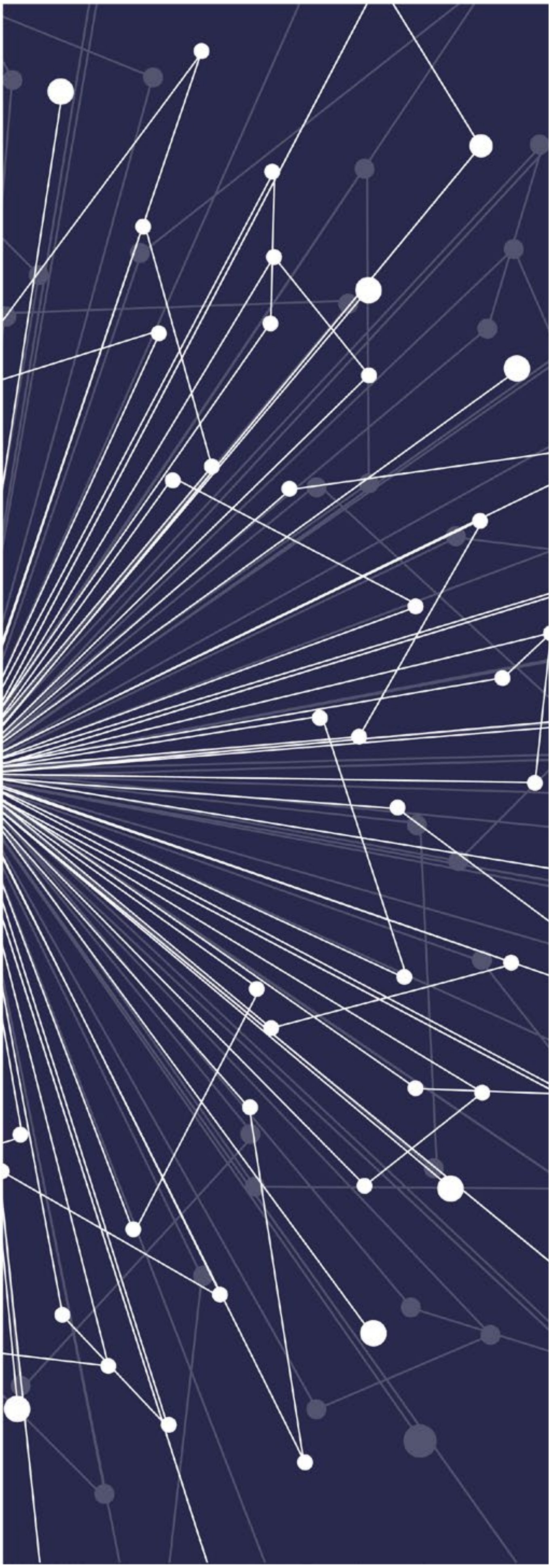

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