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[AIMA JOURNAL EDITORIAL GUIDELINES]

Message from AIMA's CEO

Jack Inglis
CEO, AIMA

I am delighted to share the 125th edition of the **AIMA Journal**, the first publication for 2021. As the world looks ahead to a potential exit from the current pandemic, we are pleased to bring you a collection of in-depth articles on some of the most pressing matters concerning the alternative investment industry. This bumper edition boasts no fewer than 21 articles from members and sponsoring partners. We are extremely grateful to all the contributors and their excellent insights within.

Digital assets and the digitalisation of the investment process remain at the forefront of many fund managers' to-do lists. **BlueCrest Capital Management** provides readers with a comprehensive review of the regulatory landscape for crypto assets in 2021. Meanwhile, **RFA** discusses how the business disruption caused by the COVID-19 pandemic has led to more fund managers embracing new digital solutions.

As part of this continuous process of adapting to a "new normal", the IR function has done an excellent job at accommodating client needs in an online environment. **iConnections** discusses how investor relations found a way forward under lockdown.

Continuing the theme of technology, **Broadridge Financial Solutions** argue the need for private debt firms to invest in technology infrastructure to enhance their reporting. **Laven** writes about the major challenges within the compliance industry highlighting a few technology solutions that a compliance officer can utilise.

Staying on the pandemic theme, **Man Group** takes us back to the Franklin Roosevelt administration and the lessons learned from policymakers back then which could help today's peers navigate the current economic climate.

Interest in ESG continues unabated with no fewer than three pieces in this edition discussing this topic. **KPMG** discusses the opportunities and challenges for alternative investment managers in raising the bar on ESG, while **Portfolio BI** explains how hedge funds are implementing ESG across their businesses and allocation processes. **ACA Group** examines how debt investors are tackling the challenge of incorporating ESG criteria into a private debt portfolio.

Regulatory-related topics remain a high priority for our members with the bulk of this edition dedicated to several regulatory issues. **Dechert** provide an overview of the FCA's areas of focus as it relates to financial crime and regulatory enforcement. **Simmons & Simmons** offers thier analysis regarding what the new QFII/RQFII rules mean for the Chinese financial market when opening to the rest of the world.

And speaking of international markets, **Coremont** looks at the cross border regulatory implications for alternative investment managers, **PwC** explores whether the reform of the Investment Limited Partnership in Ireland provides new opportunities for fund managers and **Walkers** looks at the Cayman Islands alternative investment fund structuring and the regulatory considerations that comes with it.

Elsewhere **SS&C GlobeOp** discusses the opportunities and challenges for hybrid funds while **Maples Group** touches on the fund governance protocols for closed-ended structures and the "new dawn for Irish private funds". Hedge fund reporting requirements set by the CFTC have seen several changes over the past year, **SEI** explains what these changes are and the rationale for doing it. **Larkstoke Advisors** provide updated guidance on the UK's disguised investment management fee and carried interest legislation.

Rounding off this bumper edition, **AB Trading Advisors** revisits issues involved in transferring trading positions examining what issues to watch out for when reviewing transfer provisions in trading agreements. **Larkstoke Advisors** provides useful guidance on the disguised investment management fees and carried interest.

Finally, with US pension funds facing an ever increasing funding gap, **Lombard Odier** make the case for risk diversified portfolios describing some of the features that they believe position risk parity to respond well to current market conditions.

I hope you will enjoy this 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.

Decrypting the crypto regulatory landscape: What lies ahead in 2021?

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With a 2020 performance of almost 300%, the allure of Bitcoin (and other cryptoassets) to both retail and institutional investors is plain to see. Whilst it is argued that investor gravitation to cryptoassets (particularly Bitcoin) has largely been driven by the coronavirus pandemic, there is nonetheless a clear turning of the tide in terms of wider adoption for many reasons, not least as an inflation hedge against the devaluation of fiat currencies as a result of central bank stimulus packages. In fact, in a scarcely believable statistic, 25% of all U.S. Dollars in circulation today were printed in 2020 alone.[1]

It is hardly surprising, therefore, to see the proliferation of institutions concerned with the potential erosion of cash on their balance sheets, reallocating to Bitcoin in order to guard against what is widely perceived as excessive use of QE by central banks. The most widely publicised institutional investment occurred last month, when Tesla revealed in its SEC filing that it invested in $1.5 billion of Bitcoin. But what about the regulatory environment? This article aims to explain some noteworthy aspects of the regulatory landscape in this rapidly evolving space, from a UK and U.S. perspective.

In terms of market development in the U.S., there are numerous crypto exchanges which have opened up to institutional investors and several crypto derivative products have proliferated the market – CME and CBOE first launched Bitcoin futures in 2017 and ICE has also launched Bitcoin futures and options products of its own. The launch of such products was facilitated by the CFTC's order in 2015 in its order against Coinflip Inc., in which the CFTC classified Bitcoin as a commodity (under the Commodity Exchange Act) and thus allowed for its entrance into derivative

1 Dominic Frisby, 'Bitcoin is coming of age: make sure you own some' MoneyWeek (29 January 2021)

markets (like any other commodity). Therefore, any U.S. exchange offering Bitcoin derivatives must comply with the CFTC regulations. The CFTC decision has not been immune to criticism, particularly in that it allows crypto derivatives to be listed on futures exchanges when the underlying spot market of crypto is beyond the CFTC's regulatory purview.[2]

Nevertheless, the unregulated spot market has not put off large asset managers from investing in these synthetic products and joining the bandwagon. In its January filing to the SEC, a leading fund manager stated that it "may" invest in Bitcoin futures, however custody risk remains a deterrent to wider interest in these futures contracts. For physically settled Bitcoin futures contracts, the exchanges are required to hold physical Bitcoins. Given that there is no federal-level investor protection for cryptoassets, Bitcoin held by the exchange (or its appointed custodian) is not subject to FDIC protection. Therefore, if cryptoassets are lost or stolen, it is likely that they will be lost forever with no recourse or insurance fallback.[3] It doesn't appear that there are any immediate proposals to extend FDIC or SIPA protections to cryptoassets.

As mentioned earlier, the CFTC regards Bitcoin as a commodity and, although it has been determined not to be a security, the SEC also plays a role in regulating cryptoassets when, for example, they are offered to retail investors through an investment fund. To this end, there have been calls to develop comprehensive federal cryptoasset legislation to remediate the current patchwork of state and federal regulation in the U.S.[4] Standardising the fragmented regulation in the U.S. will be key in order to provide a clear regulatory regime for market participants, although the timeline is unclear.

Across the pond in the UK, there is arguably a more coordinated approach than the U.S. in tackling regulatory reform in this space. In January, HMT published its consultation on the UK regulatory approach to cryptoassets and stablecoins (the "HMT Publication"). This was in furtherance to commitments announced in the UK Government's March 2020 Budget to consult on the broader regulatory approach to cryptoassets, including new challenges from so-called 'stablecoins' and follows earlier publications regarding the UK's approach and guidance on cryptoassets from the FCA, HMT and the Bank of England. [5]

As noted in the HMT Publication - at present a large proportion of cryptoassets fall outside or are likely to fall outside the regulatory perimeter.[6] Of particular importance was the determination that 'exchange tokens' (i.e. unregulated tokens/assets/coins that are primarily used as a means of exchange – this includes Bitcoin, Ethereum and XRP) are currently not within its regulatory perimeter and therefore not subject to FCA regulation. This means they may not be subject to the same consumer protections or safeguards found in other areas of financial services. However, clearly this is of more relevance to retail investors.

One of the primary considerations of the UK Government outlined in the HMT Publication is whether a new category of regulated tokens may be needed – 'stable tokens' and whether to bring stable tokens into the regulatory perimeter in line with the Financial Policy Committee's expectations as set out in its 2019 Financial Stability Report. [7] By all accounts this would not include Bitcoin, Ethereum or other similar cryptos because they are not pegged to a particular fiat currency (an inherent characteristic of stablecoins). Therefore, BTC, ETH and XRP would remain outside of the FCA's regulatory purview (for now), although that's not to rule out the possibility that they may be subject to regulation in the future. The first proposed legislative changes would therefore cover firms issuing stablecoins and firms providing

2 Sangita Gazi, 'Regulatory Responses to Cryptoderivatives in the UK and the EU: The Future of Cryptoderivatives in the U.S.' <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3737947>

3 Id.

4 Id.

5 See the October 2018 'final report' published by the UK Cryptoassets Taskforce (which comprises the FCA, HMT and the Bank of England)

6 See the Financial Conduct Authority (FCA) publication 'Guidance on cryptoassets' (2019) which described three broad categories of token in relation to how they fit within existing FCA regulation: e-money tokens, security tokens and unregulated tokens. Similar assessments have taken place in the US; the Senate proposed a new Cryptocurrency Act 2020. The draft bill categorized cryptocurrency or digital tokens into three main groups based on its decentralized nature and/or use of cryptographic ledger.

7 Bank of England, 'Financial Stability Report' (December 2019) <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2019/december-2019.pdf>

services related to them (custodians, exchanges etc.). The HMT Publication notes that the UK Government is "proposing to take an incremental, phased approach to regulatory adjustments", meaning the exact timeline with respect to legislative changes remains unclear, as is the case with the U.S. timetable. It also states that the UK government's broader approach is to harmonise with the legislative measures of other jurisdictions vis-à-vis cryptoassets.

Aside from the proposals for future regulation, the UK authorities have already taken actions to address risks of cryptoassets (e.g., implementation of the Fifth Anti-Money Laundering Directive) – bringing custodians and cryptoasset exchange providers into AML and CFT regulation and more recently, banning the sale of derivatives that reference certain types of cryptoassets to retail consumers. No such measures are currently envisaged for fund managers and other institutional investors.

With the current frenzy surrounding cryptoassets and the parabolic rise of Bitcoin and other so-called 'Alt coins' (essentially any alternative to Bitcoin), it seems inevitable that they will attract increased scrutiny of both governments and regulators globally in 2021.

Evidently the current framework in both the U.S. and UK is a hotchpotch which requires significant surgery in order to keep up with innovation in cryptoassets and the blockchain technology underpinning it. There are also broader legal hurdles not discussed in this article that will drive legislative reform globally, for example – legal status of cryptoassets, data privacy, enforceability of smart contract and governing law issues.

Whilst all of this is currently on the radar of governments and regulators, non-crypto priorities may take precedence, specifically the pandemic as well as other local issues (post-Brexit affairs in the UK, for example) which could delay any meaningful regulatory reform in 2021. Furthermore, as seen in the UK, bringing unregulated cryptoassets such as Bitcoin into the regulatory perimeter does not appear to be the immediate concern, rather the primary focus is on stablecoins and protection of retail investors.

However, whilst all signs point towards a phased-approach which may lead to some incremental introduction of legislation later this year, policy makers appear to be ready to step in at any time. As the HMT Publication notes– ‘Should new risks emerge or if presented with evidence of significant consumer harm, the government will take further action’.

Disclaimer: these are the views of the author and not BlueCrest Capital Management

Private Debt: Rising above the rest

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Fuelled by this asset class's strong returns amid a broader yield drought, the tsunami of capital entering private debt funds has accelerated over the last year. According to Preqin, AUM overseen by alternative asset managers as a whole is projected to increase from $10.74 trillion in 2020 to $17.16 trillion by 2025.

Private debt comprised of direct lending, mezzanine, distressed debt and special situations funds – together with private equity are expected to be the main drivers behind the alternative industry's spectacular growth. Preqin added that private debt AUM is forecast to climb by 11.4% annually from $887 billion in June 2020 to circa $1.46 trillion by the end of 2025.

The Preqin data also found that 47% of institutional investors intended to commit more capital to private debt, while 40% confirmed they would maintain existing investment levels. As a result of this, private debt is now the third-largest private capital asset class behind private equity and real estate.

Just as the asset class outperformed its peers in the aftermath of the 2008 financial crisis, private debt is in an excellent position to take advantage of some of the countercyclical opportunities on offer as a result of the COVID-19 crisis.

Consequentially, there is likely to be a significant accumulation by private debt firms of distressed assets with strong long-term fundamentals. Other alternative and asset managers have taken note of the recent success of private debt, with hedge funds being one example.

Although hedge funds outperformed the markets last year and provided investors with solid downside protection, a number of managers are increasingly conscious that they will need to diversify their businesses if they are to weather future crises. In response, many hedge funds are now launching private debt products as they look to widen the scope of their investment returns. As the number of hybrid firms swells, managers need to think carefully about how they run their operations.

How to manage data effectively

To manage operations effectively, private debt firms need to have access to consistent and easy to consume data. This can be achieved by using integrated or centralised systems instead of relying on a multitude of different platforms.

With information readily available in a single place, it will be easier for private debt firms to oversee investments together with vital risk management metrics such as credit modelling, liquidity projections and loss given default scenarios.

In addition to centralising data, managers need to find effective ways of automating their data collection processes, not least because it can help them control costs. Manual processing is no longer acceptable for many institutional investors as it can increase the risk of errors or misreporting, both of which could have devastating consequences.

As a result, private debt firms need to invest in their technology infrastructure to enhance their client reporting.

For instance, more managers are beginning to utilise private debt dashboards to visualise borrowers' data and produce detailed analysis – information that is subsequently shared with investors.

Elsewhere, other managers adopt real or near-real time reporting tools and make investment and risk data available to clients via their smart devices.

Although the private debt market is in healthy shape, fundraising is extremely competitive. Preqin found that 200 private debt managers raised $118 billion in 2020, although 39% of those inflows were secured by the top 10 funds, an increase from 31% in 2019. If managers want to obtain mandates, then they need to show that their client reporting processes are fit for purpose.

At the same time, key decision-makers at institutional investors are getting increasingly younger and tech savvy, making it essential for managers to leverage best-in-class systems.

Investors cannot be taken for granted

Private debt is in a solid position, and it is an asset class poised to deliver strong returns over the next 12 to 18 months.

Inevitably, this is leading to a spike in investor inflows, which in turn is prompting more managers from across the asset class spectrum – especially hedge funds - to launch private debt funds.

Despite this bullishness around private debt, fundraising is not as straightforward as many experts would have you believe.

Investors are very selective when awarding mandates meaning managers need to demonstrate that they can deliver more than just returns.

With clients now demanding regular, timely reporting that can be accessed easily through smart devices, private debt firms will need to improve their data management and data visualisation processes if they are to rise to the challenge.

Revisiting issues involved in transferring positions

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Introduction

This article will revisit issues involved in transferring trading positions. We will begin with a refresh on the legal differences between assignment and novation. We will then consider how different categories of trading positions (or 'asset classes') can be transferred. Finally, we will examine some issues to watch out for when reviewing transfer provisions in trading agreements.

Counterparties will frequently wish to transfer positions for a host of reasons, including acquisitions and restructurings, ceasing to provide a particular service, and tax and regulatory issues. Recently, in the context of Brexit, counterparties may have been novating contracts from a United Kingdom (UK) entity to a European Union affiliate.

From a legal perspective, the transfer of positions can cover a wide spectrum of 'difficulty', ranging from vanilla operational procedures to extremely complex legal projects.

The meaning of "transfer"

"Transfer" is a generic term used to describe the process by which a party's rights and/or obligations move to another party. "Assignment" and "novation" are specific terms denoting techniques under English law used to 'transfer' rights and/or obligations to a third party.

Assignment and novation: how do they differ?

An assignment passes only rights (i.e., benefits) under a contract to a third party, whereas a novation passes both rights and obligations (i.e., benefits and liabilities) under a contract to a third party.

Assignment

An assignment under English law involves a transfer of a party's rights, but not its obligations, under a contract to a third party. The parties to the contract do not change. Assignments can be broadly split into two categories, 'legal' and 'equitable'.

A legal assignment must comply with certain statutory formalities, including the giving of notice of the assignment to the contract counterparty. A legal assignment results in contractual relations between the contract counterparty and the legal assignee, meaning that the legal assignee can usually bring an action directly against the contract counterparty.

An equitable assignment takes effect if the requirements of a legal assignment are not met, including where notice of the assignment is not given to the contract counterparty. This results in no direct contractual relations between the contract counterparty and the equitable assignee, with the result that the equitable assignor continues to be treated by the contract counterparty as its counterparty for all purposes, and any action which the equitable assignee wishes to bring against the contract counterparty will need to be brought through, or jointly with, the assignor.

Prohibitions on assignment under contracts

If a contract expressly prohibits assignments of specific rights – or all rights – under the contract, an equitable assignment may still be valid, the consequence being that the equitable assignee would be able to bring an action against the equitable assignor, but not the contract counterparty.

Different interpretation of 'assignment' in overseas jurisdictions

In certain overseas jurisdictions, the term 'assignment' is frequently used to generically describe a transfer of obligations as well as rights – for example, under New York law, the concepts of assigning rights and delegating obligations may be merged into the use of the term 'assignment' to describe both.

Novation

A novation under English law involves a 'transfer' of both a party's rights and its obligations under a contract to a third party, meaning that the parties to the contract change. One of the parties 'remains', whilst the other party (the transferor) is replaced with a new party (the transferee).

This is achieved by extinguishing the original contract and replacing it with a new contract between the new parties under which the rights and obligations of the transferor are assumed by the transferee, with the transferor at the same time being released from those same rights and obligations. The remaining party is left in the same position as before the novation takes place, it just faces a different counterparty.

The consent of all parties (transferor, transferee and remaining party) is required.

Prohibitions on novation under contracts

Even if a contract expressly prohibits 'transfers', the subsequent written agreement of all parties to the contract to allow a novation to take place will supersede any such prohibition.

Novating derivatives

In the over-the-counter (OTC) derivatives world, novation is a frequently-used process, typically involving template documentation developed by the International Swaps and Derivatives Association, Inc. (ISDA).

ISDA Novation Agreement

The 2002 ISDA Novation Agreement is widely used to transfer by novation rights and obligations under OTC derivatives transactions to a new counterparty. It is structured to effect the transfer of one or more individual transactions, or groups of transactions, from the ISDA Master Agreement between the original contract parties to the ISDA Master Agreement between the new contract parties. In that way, and in keeping with ISDA architecture, the trades themselves move between two different governing agreements. It is also possible, by some redrafting of the ISDA Novation Agreement, to novate the ISDA Master Agreement as well as underlying transactions.

ISDA Novation Confirmation

Alternatively, under ISDA documentation architecture, parties may effect a novation by executing a Novation Confirmation, whereby the novated transactions are subject to the 2004 ISDA Novation Definitions. These Definitions provide the framework governing the novation process and include a template Novation Confirmation, which incorporates by reference the terms of a standard ISDA Novation Agreement. This less popular process adopts similar novation mechanics under the guise of different documentation.

ISDA Novation Protocol

Finally, ISDA has created 'protocols' providing legally-binding mechanisms for parties to consent to a novation. Under the ISDA Novation Protocol, the transferor and transferee agree the terms of the novation of credit derivative and interest rate derivative transactions, subject to the consent of the remaining party. If the remaining party's consent is received by the specified deadline, the novation goes ahead.

If the remaining party's consent is not received by the specified deadline, the novation does not go ahead but instead a new transaction arises between the transferor and transferee on the agreed terms, effectively acting as a hedge for the transferor. The ISDA Novation Protocol was originally created to reduce confirmation backlogs and provide a more efficacious process for novation.

A tailored version, the ISDA Master FX Novation and Cancellation Protocol, was created for the foreign exchange (FX) market.

Novating prime brokerage business

All prime brokers use their own 'house' proprietary prime brokerage agreements reflecting their own internal policy positions, operational imperatives and chosen style of legal drafting.

Pursuant to a fund restructure (for example, a "single fund" to "master-feeder" structural reorganisation), novation can be used to transfer entire books of prime brokerage business from one fund to another, subject to the rights and obligations being suitable for novation. Such operations may typically involve a combination of novation and redesignation of beneficial ownership (for example, redesignation of 'cash' securities positions).

The transferee fund will contract on the same terms as the transferor fund, subject to the prime broker receiving assurances that appropriate consideration at market value has passed between the funds.

However, pursuant to an acquisition, merger or restructuring involving the prime broker, novation can prove trickier. The principle of novating rights and obligations (alongside redesignation of beneficial ownership) can still work, the problem being that the recipient prime broker will wish to take on the transferred business under its own proprietary prime brokerage terms. Whilst theoretically possible, this may become too complicated for practical purposes, the documentation challenge being too time-consuming and resulting in unclear contractual terms.

Novating other trading agreements

The core principles of novation can be applied, in theory, to any contract. However, the practicalities frequently raise complications. It is generally possible to apply novation to non-derivatives asset classes, whilst remembering that novation deals with contractual rights and obligations and will not take care of (for example) transfers of securities and collateral. Novation procedures are also frequently limited by operational imperatives.

In which case, transfers may be undertaken by way of a combination of novation and closing and re-opening of positions.

Transfer provisions: be sure to know your counterparty

Contracts frequently contain transfer provisions allowing a party to transfer some or all of its rights and obligations, either with or without notice, to its affiliate or other third party.

Imagine that, having completed an onboarding process with your counterparty, GoldPlated UK Bank PLC, you one day discover that GoldPlated UK Bank PLC has transferred some or all of your counterparty relationship to an unknown entity established in an unfamiliar jurisdiction.

Provisions purporting to allow such transfers are reasonably common in ISDA Master Agreements, prime brokerage agreements and other relevant trading agreements.

A sell side argument for their inclusion may be focused on an imperative for the swap dealer or prime broker to move positions (whether for one client or all clients) to an affiliate for tax or regulatory reasons. A swap dealer may, in addition, wish to have a free hand to transfer to a non-affiliated party, including to sell/exit positions.

Whilst a perfectly reasonable position for the sell side to take, fund managers should be wary of allowing such transfer provisions without minimum conditions, for example relating to credit standing, regulatory environment and advance notice.

The fund manager may require a window of time in advance of any transfer in which to conduct due diligence on the proposed transferee and its jurisdiction (including anti-money laundering/know your client and other on-boarding checks and procedures, including ensuring that close-out netting is enforceable in any new jurisdiction). There may also be regulatory obligations such as submission of a 'Material Change Notification' to the UK Financial Conduct Authority not less than 30 days prior to "the appointment, removal or change of function of depositaries" (which generally includes prime brokers and custodians).

Finally, the fund manager may require a window of time in which to exit positions, should it not wish to face the proposed transferee.

Opening up China's financial market with new QFII/RQFII rules

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For many years now, China has been working towards opening its securities and futures market to international investors.

Among others, the Chinese authorities issued the long awaited and highly anticipated Measures for the Administration of Domestic Securities and Futures Investment by Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors and its implementing rules (collectively, the **"New QFII Measures"**), in Sep 2020. This marks the yet most important step of the continuous reform to the current QFII/RQFII regime, and showcases the regulators' determination to continue opening up the PRC market to foreign investors. The New QFII Measures has become effective on 1 November 2020.

The highlights of the New QFII Measures include (1) consolidation of QFII and RQFII schemes; (2) further streamlined application procedures (including opening up to hedge fund managers); (3) less stringent reporting requirements; (4) lifting of restrictions on number of brokers/custodians, and (5) the most eye catching of all – the expansion of the scope of investment.
In this article, we focus on the implications of those expanded scope of investment which are particularly meaningful for hedge fund managers, including investment in futures, investment in private securities investment funds, and margin trading and securities lending.

Investment in futures

Previously, without setting up a PRC entity, foreign investors may only invest in stock index futures under the previous QFII/RQFII scheme and a few specific types of commodity futures available for direct investment by foreign brokers and investors (which so far include crude oil, TSR 20 rubber, low-sulfur fuel oil, iron ore, purified terephthalic acid (PTA) and copper).
Under the New QFII Measures, we expect a larger variety of commodity futures and financial futures to be available to foreign investors. It should be noted that the exact categories are subject to the announcement of the relevant exchanges. It would also be possible for a QFII investor to trade Chinese futures not only for hedging purpose but also for speculation purpose.

It is worth noting that, although there are many ways in which the futures trading process in China is similar to those in the western markets, there also certain notable differences that arise due to PRC laws and market practices.
For example, In China, futures trading is structured as an agency model rather than the principal-to-principal model as in some of the European markets. That means that the broker will be acting as an agent on behalf of its client, with the exchange acting as the central clearing counterparty as well as trading counterparty. On that basis, the counterparty's defaulting risks will be very low.

Another example is about margin. Unlike western markets where settlement margin exists, in China, margin is primarily posed for collateral purpose and therefore sufficient margin has to be posted prior to, not after, a trading taking place. Typically, the fund manager will open a futures margin account with a third-party bank, into which margin will be transferred by the fund. And by the operation of law, margin will be held by such margin depository bank as opposed to the broker, and ringfenced as the fund's assets.

In terms of market practice, each broker will have its own form of futures agreement and, although they all broadly cover the same ground, there are differences of detail, so it is worth reviewing each agreement carefully. If one is entering into multiple broker relationships, it can also be worth negotiating these in parallel so that one can conform these to the extent practicable and end up with a set of better and more consistent terms across all its brokers.

Investment in PFM funds

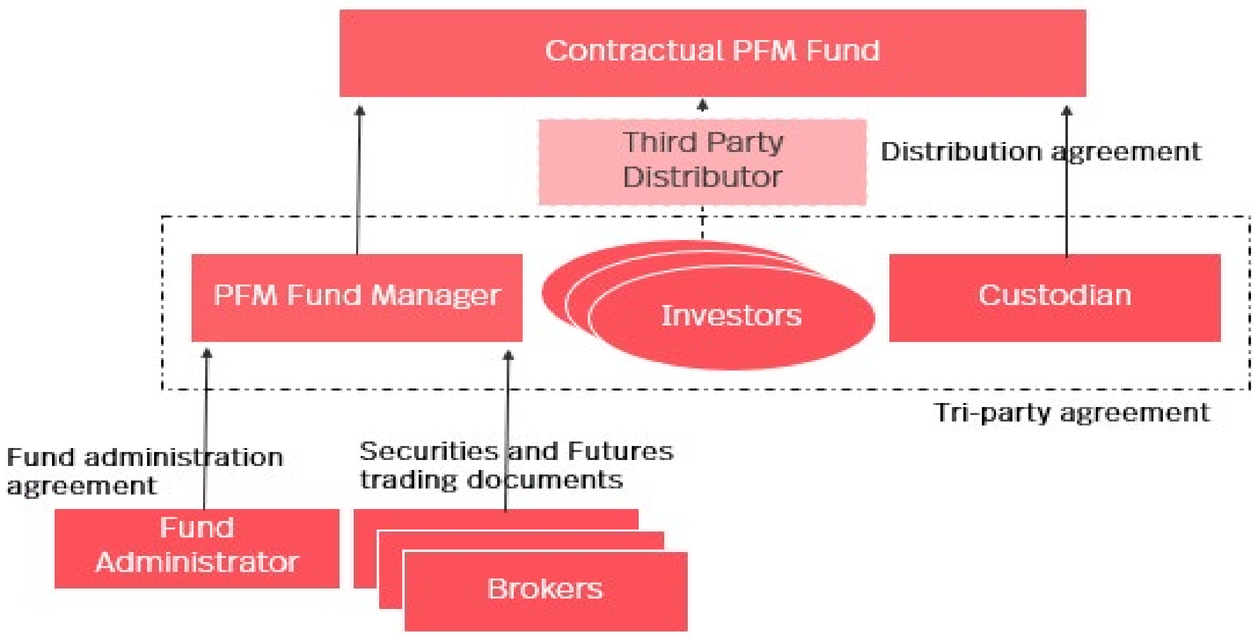
Private securities investment fund (often known as PFM) refers to a privately offered securities investment fund which adopts long-only or hedge strategies in the investment of stocks, futures, bonds, repos, open-ended fund units, derivatives etc. Since CSRC opened the door for foreign asset managers to engage in the PFM fund management business in 2016, there have been approximately 31 foreign managers who successfully obtained the PFM fund management "licence" in China.

According to the New QFII Measures, QFII/RQFIIs will be allowed to invest in PFM funds that conform to the permitted investment scope of QFII/RQFIIs. This will certainly boost the PFM funds market in China and ease the pressure of foreign managers to meet the regulatory requirements of raising capital and launching their first fund in a rigid timeframe.

Under the PFM program, a foreign asset manager usually establishes a wholly owned foreign entity ("**WFOE**") or a joint venture which serves as the private fund manager entity. The fund manager can then raise an open-ended PFM fund targeting at PRC qualified investors. The PFM fund itself is not incorporated but exists in a contractual form. The fund is unitized which allows for the investors to subscribe for, redeem or transfer their fund units. The manager and the custodian are the de facto co-trustees of the PFM fund who will sign a tri-party fund contract with the investors. Such fund contract functions as a mixer of PPM, investment management agreement, custodian agreement and subscription agreement. On the other hand, distributor and fund administrator being delegated by the fund manager with certain duties, enter into separate contractual relationships with the latter.

One important point to note is that the contracting party in the context of the fund administration/distribution agreements and trading documents is the fund manager, rather than the fund. This is because as mentioned the fund is not structured as a distinct legal entity under PRC law and therefore the fund manager has to be the contracting party on its behalf. It is therefore important for the fund manager to satisfy themselves in the PFM context that they have robust indemnification to reimburse themselves from fund assets for any liabilities they may incur in those service provider/trading documents.

We set below a typical PFM fund structure for reference.



Margin trading/short selling and securities lending

Under the New QFII Measures, QFII/RQFIIs are expected to participate in margin trading, i.e., to borrow money or securities from brokers for securities trading in the same way as domestic market participants. It is a big breakthrough compared to the old QFII/RQFII policies (which offered no availability in terms of margin trading) but as expected it would be with constraints.

During the stock market crash in 2015, many Chinese trading firms, under the pressure from the government, halted all stock-shorting activities, and at the same time CSRC discontinued the practice of same-day transaction settlement (i.e., T+0 was changed to T+1). A few years later, margin trading was back in business, but there is still no meaningful short selling mechanism available to the investors in China, due to the following reasons:

- Naked short selling (i.e., selling short a stock without first having or borrowing the shares to sell) is prohibited in China;
- The number of stocks available for short selling is limited, as most problematic stocks will be marked as ST or special treatment in A shares market, and they are not allowed to short sell; and
- No intra-day transaction settlements are permitted (i.e., T+1 for stock trading);

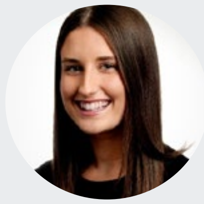
According to the New QFII Measures, QFII/RQFIIs will also be allowed to engage in securities lending activities. In China, securities lending and borrowing (also known as Centralized Securities Lending and Borrowing, "SL&B") is a supplement to brokerage firm's margin trading and short selling business. Under SL&B, brokerage firms can borrow funds and securities from a platform called the China Securities Finance Corporation Ltd (a semi-governmental agency that runs the securities lending and borrowing business, "CSFC") and, in turn, provide them to customers.

Through SL&B, foreign investors will be able to increase liquidity and generate incremental income over the securities that they hold. It is worth mentioning that securities holders may only lend securities to CSFC, and then CSFC will provide such securities to brokerage firms.

In practice, legal documents to be entered between the securities holders and CSFC are far from a satisfactory level for foreign investors in terms of offering adequate protections to the latter. CSFC is revamping its legal documents in order to draw QFII/RQFII investors to the securities lending market.

In conclusion, there is no doubt that the New QFII Measures will largely increase participation in the PRC market in a variety of ways, including those above mentioned. Although certain details still remain open for the exchanges and regulators to clarify on, we will continue to monitor for any further update and guidance that the exchanges and regulators might release.

ESG: Challenges and opportunities in raising the bar



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Regulatory change on the horizon

Whilst appetite amongst investors for integrating environmental, social and governance (ESG) considerations in their investment portfolios continues to gain momentum, corresponding developments in their fund managers have been somewhat slower in pace. Exclusionary screening is no longer enough to meet investor expectations and there is greater demand for funds with tangible ESG objectives and measurable impacts, with a growing recognition that ESG factors can offer a competitive advantage in the market.

Across Europe the industry is grappling with swathes of new regulations and updates to existing obligations, requiring significant changes across the operating model and increased operational burdens. Rules around disclosures, definitions and new taxonomies are difficult to interpret and confused further by a plethora of 'soft' regulation and the decision of the UK to not adopt EU rules.

The implementation of the EU Sustainable Finance Disclosure Regulation (SFDR), the first deadline of which was 10 March 2021, has forced managers to adapt to market developments faster. SFDR requires disclosures at both company and individual fund or portfolio level, whether ESG factors are considered or not. Firms are grappling with many uncertainties and are waiting for the detailed "Level 2" rules to be issued in order to have a better understanding of the requirements. But whilst they wait, several factors are influencing the shape of their eventual implementation; namely:

1. Many UK asset managers are applying SFDR to their UK companies and funds

Despite no onshoring of the EU SFDR rules by the UK Government, most UK managers will make disclosures about their UK companies and funds in line with the EU rules, until such time as any similar rules are introduced in the UK. In part, this is in order to provide consistent information about their investment process and products, but it is also due to pressure from UK investors requesting ESG strategies and information.

2. Cautious approach in the UK to categorising funds

SFDR requires fund managers to categorise their funds between Article 6 (not having a specific ESG investment objective), Article 8 ("light green") and Article 9 ("dark green"). Article 8 can be viewed as a spectrum, ranging from the barest of green products with minimal screening of the underlying investments, to products that perhaps select only the highest ESG-scoring assets. UK fund managers appear to be steering clear of the beginning of the spectrum and are categorising funds as Article 8 only if they fall firmly in the top half. The main reason for this is potential reputational risk. Before the Level 2 rules are finalised and extra guidance is given by regulators, firms are unwilling to put themselves in the position whereby products labelled Article 8 now must be downgraded subsequently to the lesser Article 6.

3. Data quality and availability challenges are prevalent

Firms are struggling to access ESG credentials of relevant portfolio companies especially at the level of granularity needed to meet the EU requirements. This issue is especially problematic when attempting to disclose the principle adverse impacts (PAIs) of investment decisions on sustainability factors, given the breadth of data needed about the underlying assets. Firms will need to rely upon data from multiple data providers and their own engagement efforts, which will be costly and time consuming. ESG reporting is central to regulatory expectations, stakeholder credibility, client demands and the ability to effectively embed ESG considerations across the business. However, knowing "what good looks like" from a reporting perspective is often unclear and is made even harder by the absence of quality data and aligned industry standards.

Making your ESG data work harder

The lack of consistent data quality and the variety of standards means that firms are grappling to understand the ESG credentials of their underlying portfolio companies, often finding that those ESG credentials differ dramatically depending on which data provider is used. ESG at its operational core is, often, a data problem. As the quality of corporate reporting varies, depending on the industry and region that the portfolio company operates within, multiple sources of ESG data are required in order to form a detailed picture of the investment. Moreover, ESG risk exists more broadly in terms of supply chains, investments, people, infrastructure and in products. Failure to understand these new risks can leave firms exposed to material reputational damage.

As a result, managers are increasingly turning to data providers and professional services firms for support to aggregate the multitude of ESG data sources.

Key questions that managers need to ask themselves as part of their ESG data strategy are:

- Is your ESG scoring methodology bespoke to you? There is now a desire for asset managers to be able to control their own definition of "good or green". Does your ESG scoring methodology align to your investors, their investment philosophy and their ethos?
- Can you confidently identify truly "green" investment opportunities? To succeed, Asset Managers must now rely on multiple sources of ESG data to adequately assess ESG credentials. Do you have access to both structured and unstructured data?
- Is this data aggregated into a platform that is useable and helpful to your investment analysts?
- Do you have data lineage and transparency? Asset Managers should expect an increased importance to be placed on their ability to drill down on exactly what is contributing to the ESG credentials.
- Are you just using structured data to inform your analysis? Reliance on self-reported, structured only and often incomplete data sets is not going to provide a rich and current view of the ESG characteristics of a particular investment. Managers need to be able to consume unstructured data, real time news, social media, sentiment analysis, document language, web content and much more in order to provide a true view of a company's ESG credentials.
- Can you adapt consumption of unstructured data? Read unstructured data and make sense of new data formats to accurately paint a reflective ESG picture of your portfolio's? KPMG's own ESG Analytics tool uses a robust transparent and consistent methodology to create a bespoke score that is explainable to investors and regulators leveraging both structured data as well as unstructured data sets, allowing for example, greater transparency over more esoteric investments and private assets.
- New regulatory requirements include the need to demonstrate effective ESG integration, enhanced disclosures and alignment to EU taxonomies. Does your data and reporting capability meet your increasing regulatory obligations?

Success criteria in implementing an ESG 'culture'

Recognising that ESG requires a philosophical mind-shift as well as an operational one is critical. In KPMG's recent Wealth & Asset Management "C-suite" survey, CEOs identified that their organisation's growth will depend on their ability to navigate the shift to a low-carbon, clean-technology economy, both in their company and their portfolios.

Better insight in how to capitalise on these opportunities will be necessary to promote long-term profitability and those firms not taking ESG seriously will face the risks of losing clients, employees and access to financing. With added pressure from regulators, and more importantly their peers, it is critical that businesses include these criteria into their strategy and business model.

These critical success factors are:

- Top down **sponsorship from the CEO** and the board is critical: without it any change will be short lived and will lack credibility.

- Appointment of a **C-Suite sponsor** to drive the end to end transformation and to **'champion' the ESG agenda**.

- Investment into developing a **comprehensive ESG strategy** aligned to your corporate purpose, ethos and goals; **it must be authentic**.

- Engagement with your **clients, your people and your external stakeholders** to understand what matters to them and crucially "why?"

- **Communication, communication, communication**. ESG matters. Avoid treating this as another regulatory box to tick.

- Engagement with specialists; ESG is **far reaching and of critical importance** yet it remains poorly defined with limited standards and common frameworks. **Ask for help**.

- **Investment in execution** of your strategy and ready the business for changes across the organisation; a strategy is only as good as the implementation.

- Understanding your **regulatory obligations**. Whilst meeting regulatory expectations isn't the benchmark of success, it **helps to prioritise** what will be an important and long-term change initiative

ESG matters to your clients, your employees, your stakeholders and your shareholders. Regulators are increasing the expectation and will want you to prove you are acting responsibly and investing sustainably. ESG isn't something you need to do, it's everything you do and how you do it. It's your licence to operate and your opportunity to lead.

Opportunities and challenges in hybrid funds

Meeting investor demand for diversification and return potential

Ian Holden
Managing Director
SS&C GlobeOp

Astute investors are constantly looking for greater diversification with the goal of achieving exceptional returns uncorrelated to the global equity markets. To satisfy this demand, alternative investment managers coming from either the closed-end or open-end school have become increasingly innovative. A prime example is the emergence of hybrid fund structures. Designed to focus primarily but not exclusively on illiquid investments, these vehicles combine the longer-term investment strategies, investor commitments and capital calls of closed-end private equity funds with trading and hedging strategies associated with open-end hedge funds.

Hybrid funds offer investors exposure to a wide variety of asset types, including both publicly listed and private companies, private credit, real estate and infrastructure, as well as derivatives and illiquid investments such as bank debt, distressed debt and CLOs. While they are closer in structure to closed-end private equity funds, hybrids allow investors a greater measure of flexibility in liquidity options due to the mix of assets and duration periods. Managers seek to deliver both predictable income streams for the investor as well as the potential for long-term gains.

An evolving model

Although hybrid funds have reportedly grown in popularity, gauging the market opportunity for hybrid funds is difficult. Alternative industry analyst Preqin, for instance, says it is tracking “186 hybrid PE funds and 261 hybrid hedge funds.” These low numbers relative to the fund universe suggest that, for tracking purposes, most hybrid funds may be classified as either private equity or hedge funds depending on the strategy or the manager’s background. This further suggests that the hybrid model is still evolving and maturing even after a decade of expansion. (Analyst reports on the global alternatives market generally do not break out hybrids as a separate fund type.)

Perhaps more compelling than fund inflow statistics and AUMs is the opportunity to offer investors an innovative product with greater diversification, current income and long-term alpha-generating potential. Not surprisingly, that opportunity has attracted participants from both the hedge fund and private equity worlds. For private equity managers, the hybrid approach frees them from focusing exclusively on private companies that require lengthy investor lock-ups. For the hedge fund firm, it provides some protection against “disorderly” redemption rates.

Making the marriage work

Regardless of the manager’s origins, however, setting up and launching a hybrid fund is no easy feat. The marriage of two distinct investment disciplines calls for a combination of closed-end and open-end expertise that few firms have to begin with. A private equity firm looking to create a hybrid fund needs to acquire hedge fund skillsets and vice versa, typically by hiring people with the requisite backgrounds. And even then, there are the different cultural nuances to consider. Few hedge fund managers are likely to be familiar with the rigorous and deliberative valuation process that goes into private equity investments, or with capital call procedures.

Conversely, private equity firms aren't steeped in the everyday trading mentality that characterizes hedge funds. Simply developing the fund documents has proven to be challenging for many firms. Defining terms and conditions, capital allocations, expense allocations and distribution of proceeds requires agreement on a common "language" that effectively bridges the public and private aspects of the fund. Manager compensation methods can also be extremely complex, combining the performance-based incentives of hedge funds with private equity waterfall fee calculations.

Removing operational impediments

From an operational perspective, there are significant challenges. With a mix of publicly listed securities and private, illiquid or hard-to-value assets, hybrids entail complex accounting methods. Striking a reliable and accurate monthly NAV can be an arduous undertaking. Investor accounting and profit and loss allocations are also more complex than with a straightforward hedge or private equity fund.

The enormous influx of institutional capital into the alternative investment arena over the last decade has put pressure on fund managers to provide greater transparency into holdings and meet rigorous operational due diligence standards. Combined with more stringent regulatory reporting and disclosure requirements imposed on private funds since the 2008 financial crisis, fund managers must be able to demonstrate that they have the controls in place to mitigate operational risks. This is especially true with hybrid funds, in which added complexity elevates the risk of errors in fund accounting, investor allocations and fee calculations.

Given the operational challenges, regulatory requirements and accounting complexities involved in launching and operating a hybrid fund, the selection of a fund administrator is a critical decision – one that should be made in the fund's earliest formative stages. The right administrator is one that not only brings domain expertise in both closed- and open-end fund structures, but can also demonstrate effective collaboration between its experts on both sides of the house. The best evidence of that collaboration is a strong track record in administering hybrid funds.

The administrator should also have a proven technology infrastructure capable of supporting a full range of complex fund strategies, structures and transactions, built around a platform that integrates fund and investor accounting, performs fee calculations, and generates regulatory reporting. At the same time, understanding that no two hybrid funds are alike, the administrator's platform should be sufficiently flexible to adapt to a variety of strategies, multi-currency portfolios and unique asset mixes. The technology infrastructure should also incorporate processes and controls to mitigate operational risks that will stand up to regulatory scrutiny and investor due diligence. The right combination of technology and expertise will alleviate much of the operational, accounting and compliance burden from a hybrid fund's managers, enabling them to focus on investment ideas and to take advantage of new opportunities as they arise. Hybrid funds offer fund managers a vehicle for satisfying investor demand for diversification and the chance of exceptional returns. Operational issues don't have to stand in the way of innovation and success in developing a hybrid offering for investors.

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 private equity, hedge and hybrid funds, funds of funds, real estate, real assets and direct investments. SS&C is also the world's largest alternative fund administrator, with around US$1.95 trillion in assets under administration. SS&C serves a worldwide clientele with a network spanning the major financial and commercial centers of North America, Europe, Asia and Australia.

Risk Parity - An allocator's rationale

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Introduction

US Pension Funds face an ever-increasing funding gap (USD1.37 T)[1] even higher than after the Global Financial Crisis (GFC). This is unlikely to improve, as their target return is 7.15% pa,[2] which is looking increasingly difficult to reach. Given the current historical low level of rates, and the prospect that they will likely remain low for the foreseeable future, this 7.15% objective appears more ambitious than ever. So does this mean plans should move their portfolio to 100% equity or private equity investments? We do not think so.

First, liquidity remains an important concern for pension plan portfolios, putting a ceiling on allocations to illiquid assets. Second, an increasing exposure to equity risk modifies the sensitivity of the portfolio to the economic cycle, tilting its performance towards periods of economic growth (the environment most favorable to equities). In other words, their performance will become more pro-cyclical.

Note these plans' current equity exposure, at 47.1% [3] means their sensitivity is already primarily towards growth. Instead, we believe another way is possible, harvesting traditional risk premia in a manner suited to adapt to the challenges of the day. We believe risk diversified portfolios is an underutilized approach, which would serve well the needs of institutional investors in the years to come. Launched in the late 1990s and in the early 2000s labelled under the "risk parity" moniker, risk diversified portfolios have come of age and today encapsulate a broad variety of portfolios,[4] characterized by an allocation of risks rather than capital.

1 As of 31 December 2019
2 As of January 2021. Source: National Association of State Retirement Administrators (https://www.nasra.org/).
3 Source: National Association of State Retirement Administrators (https://www.nasra.org/).
4 In this note, we use "risk parity" as synonymous for "risk diversified" portfolios for simplicity.

The central construct of a risk parity portfolio seeks to maximize diversification. The approach is elegant in its simplicity and derives from the same underpinnings of the broadly accepted Modern Portfolio Theory ("MPT").

Remove the constraints on notional weights, and MPT gravitates naturally to risk parity and higher risk-adjusted returns. The level of desired portfolio risk is a function of the leverage employed, or not employed. Furthermore, the broadly diversified global multi-asset nature of risk parity portfolios is unique in the world of asset management in that it seeks to address the same challenges of the asset allocator and plan sponsor themselves.

The Fairfax County Employees' Retirement System has been implementing a plan-level risk allocation framework since 2002. The System employs a number of risk parity strategies, not only to serve as the core of the broader portfolio, but as strategic partners that can be drawn upon to help Staff be better at their jobs, a concept referred to as "non-performance alpha."

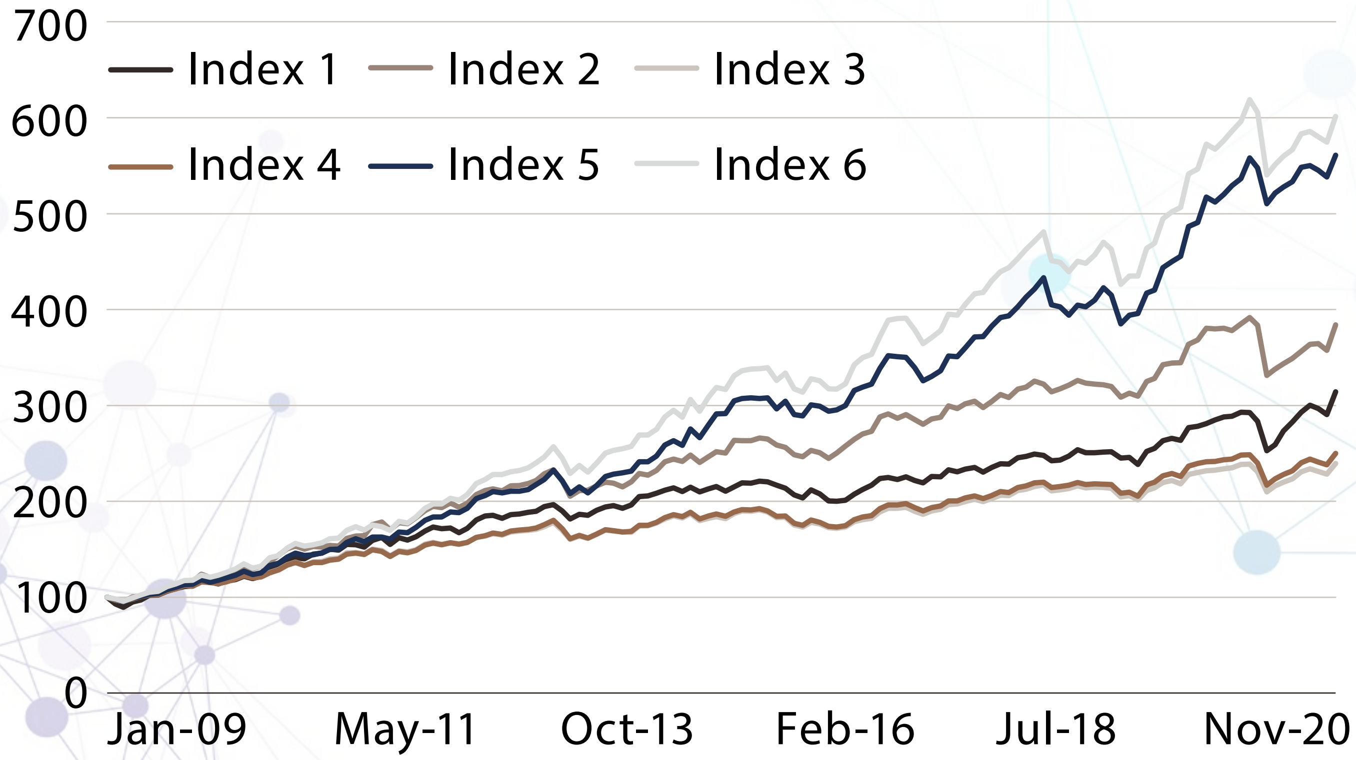
In this note our goal is first to dispel a few myths and misrepresentations about risk parity. Then we describe some of the features that we believe position risk parity to respond well to current market conditions.

Not all risk parity approaches are equal

Unlike traditional capital-based multi asset portfolios (e.g. 60/40), which are relatively homogeneous across investors, risk-based portfolios tend to display much higher heterogeneity, as can be seen in Figure 1, which shows the performance of 6 publically available risk parity indices (all with a 10% volatility target). This is due to the variety of inherent implementation choices: breadth of investment universe, difference in risk models, rebalancing frequency, the presence or not of overlays, etc.

These working assumptions and the customization of these programs make this universe of risk-based allocations more difficult to analyze and compare, but these approaches tend to present common characteristics: - an increased diversification at all points in time. - a more dynamic adjustment to evolving market conditions. - a preference for rule-based systematic and more transparent and predictable portfolio adjustments as opposed to discretionary overlays.

FIG. 1 RISK-PARITY INDEX PERFORMANCE, 2009-2020



Risk parity is not a one-way bet on bonds

A common criticism about risk parity portfolios depicts them as highly reliant on bonds and thus inappropriate in a low yield environment. In our experience, this need not be the case as risk parity strategies can be structured to offer the ability to adapt to evolving risks in bond markets. Should any substantial rise in yields come with higher uncertainty, this would turn into lower allocations, generally – and a more dynamic bond allocation than capital-based portfolios, potentially.

In fact, our analysis shows that, even in low-rate environments, the basic premise of risk-based investing remains true – which is to deliver better risk-adjusted returns than capital-based portfolios.

Risk Parity and leverage

Through their exposure to traditional asset classes and long only nature, risk parity portfolios belong in the core of the portfolio. These are not hedge funds, although they are often described as such, as a criticism. Leverage is by no means necessary in the risk parity approach. Indeed one of the key characteristics of risk parity is to separate asset allocation decisions from risk budgeting. However, when it is used, we believe a necessary condition to apply leverage efficiently is to do so on liquid assets only, that it be continuously monitored and that it be actively managed.

Liquidity matters

As risk-based allocation approaches are challenged to adapt continuously to evolving market conditions, it is a prerequisite to choose highly liquid instruments to implement these strategies. Noteworthy, however, is that some market instruments provide apparently high liquidity but fail when most required: for example, we have observed large ETFs trading with discount to NAV of 5% or more during the Covid shock of March 2020. Futures markets, on the other hand, operated much more smoothly amidst high volumes.[5]

Enhancing risk parity

We believe a number of features can favorably complement the traditional risk-parity foundation.

- Systematic tactical tilts – in our view it makes sense to complement strategic long-term allocations with alternative risk premia components. They can help more dynamically respond to changing market conditions while the longer-term features of risk-parity allocation recalibrate.

- Risk management techniques – risk-parity drawdowns in 2020 have been described as disappointing. But this misrepresents two facts. First, realized drawdowns do depend on the risk profile – just as the drawdowns of capital-based portfolios depend (in large part) to the extent of their equity allocation. Second, the liquid investment universe of risk-parity portfolios allows for an active drawdown management process, aiming to reduce downside risks. Instead of 10-25% (which is the broad range of drawdowns for various risk-based and capital-based portfolio during Feb/March 2020) active risk management in risk-parity portfolios has succeeded in limiting drawdowns to 3-10%, depending on the risk profile.

- Expanding the armory – looking beyond sovereign bonds for tail risk hedging. There is a continuous and interesting debate as to the role sovereign bonds should play in diversified portfolios, often forgetting though that their contribution in 2020 was meaningful, albeit not as meaningful as during the Great Financial Crisis of 2008-2009 – a reflection of the low absolute level of interest rates. Hence, we believe it is important to look at other sources of diversification, including inflation-linked bonds, commodities and gold. We also believe a long volatility exposure can be an interesting diversifier in this regard and our experience shows it can complement sovereign bonds, essentially doubling their performance contribution in shocks.

5 See also "Fixed Income ETFs: a liquidity illusion ?," Maitra, Salt, Lindquist, LOIM white paper, 2020.

Conclusion

In conclusion we believe that risk-diversified portfolios are very relevant today and maybe even more so in years to come: - They are actively and dynamically rebalanced portfolios that adapt continuously to evolving market conditions; - They are agnostic as to the business cycle and don't have any bias by default, including as it relates to sovereign bonds, which could be certainly decreased meaningfully in the future (compared to past allocations), if warranted; - As an agnostic approach, they are well-suited as a core allocation in diversified portfolios, which can be enhanced using medium- to long-term views, or less liquid assets with longer term horizons; - Given the variety of approaches, they may benefit from being diversified across managers (similarly to any active strategy).

Important information

MAPLES GROUP

Advancing fund governance for closed-ended structures

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Investors actively participating in the alternative investment fund space cover the full spectrum, from high net worth individuals, funds of funds, life insurance companies and pension plans, through to sovereigns and governments. While some investors are concerned with portfolio diversification by asset, region or sector, others strive for greater balance between assets and liabilities or are motivated by other external factors.

The common thread, however, is greater investor sophistication. As the race for alpha has become tighter, investors have been drawn to less liquid strategies, better implemented via closed-ended investment fund structures, which include private equity, private credit, venture capital and real estate, among others.

As the use of these structures has become increasingly prevalent, demand for strong oversight and good governance has grown in tandem. Private equity investors have been at the forefront of efforts to advance governance in the industry. The Institutional Limited Partners Association ("ILPA") has provided detailed guidance on fostering transparency, governance and alignment of interests for general partners ("GPs") and limited partners ("LPs").

Similarly, service providers have played a key role in developing innovative solutions that support institutional investors and private equity managers in implementing the appropriate processes and controls to effectively navigate the complexities of the current environment.

Establishing an Advisory Committee

Increased scrutiny of limited partner advisory committees ("LPACs") and the independence of the GP has resulted in a significant increase in the establishment of advisory or governance committees for private funds over the past five years. While the establishment of an advisory committee is not mandated from a regulatory standpoint and has no authority to act on behalf of or to control the private equity fund, a well-appointed committee can be an important asset to the GP, alongside the traditional LPAC.

With advisory committees typically comprised of independent parties who can add real value from a governance perspective, this can bring additional credibility to the GP, particularly for an emerging manager or a smaller fund. The typical responsibilities of advisory committees are outlined in the partnership agreement and generally include voting on change of control scenarios with respect to the manager or investment valuation matters. Evaluating potential or actual conflicts of interest, along with any other partnership matters raised by the manager and / or advisory board members, is another area where the committee will take an interest.

In addition, the committee can answer questions related to ongoing fund operations, as well as accounting and legal matters depending on the particular expertise of its members. Whereas the LPAC is historically comprised of LPs with significant stakes in the limited partnership, these committees represent all investors and can provide considerable benefits to the manager, alongside the LPAC from a fiduciary perspective and in terms of reinforcing the governance structure.

Utilising an Independent General Partner

Limited partnerships, established in Delaware and the Cayman Islands, dominate the private equity landscape. They provide significant flexibility in business structuring for GPs and limited liability for investors, who are removed from day-to-day control and many operational responsibilities. The GP typically has exclusive control over the investments and will delegate certain responsibilities to the manager or advisor and an independent fund administrator.

The use of an independent GP that is not directly affiliated with the manager brings advantages from a governance perspective. A key driver of demonstrating this independence in terms of ownership and control relates to accounting consolidation rules under US GAAP. Holding an equity investment is not the only means by which a sponsor of a closed-ended fund vehicle's GP entity can obtain a controlling financial interest in an entity. If the reporting entity, in this case a private equity fund sponsor, does not have significant influence over the GP vehicle, then it can look past the equity method of accounting for consolidation purposes and instead look to other accounting guidance.

Third Party Independent Valuation

Regulatory change in the industry and the trend towards greater oversight of investment funds have brought robust valuation methodologies into focus. Driven by demands from investors, stakeholders are looking for greater transparency, credibility and consistency in portfolio company valuations. While managers may possess a deep understanding of the intrinsic value of their investments, investors are placing significant importance on valuations by independent parties to provide the assurance they require.

Recently, the SEC has mandated independent reviews of valuation policies and procedures where existing policies are deemed deficient. The Alternative Investment Fund Managers Directive ("AIFMD") in Europe also prescribes an independent valuation process, although it does not require it to be completed by an external valuation specialist.

Despite this, many funds still perform their own valuations internally but are increasingly realising the benefits of using independent valuations for portfolio investments, particularly for material or Level III investments.

Independent valuation also helps to alleviate situations where attachment to an investment may impact judgement regarding valuation, especially if the investment is in distress. Private equity firms also often engage valuation specialists to provide additional support including valuation reports for select assets and corroborating internal pricing calculations or models, acting as a "sanity check" for a deal team.

The work performed by a third party valuation specialist can generally be incorporated into a framework for robust pricing procedures and is particularly reassuring in instances when managers are looking to raise new funds.

Crucially, comprehensive and well-documented valuation policies and procedures send a strong signal to investors that a manager does not operate in a vacuum but rather uses both internal and external resources to triangulate the best and most appropriate fair value indications.

Furthermore, the board or advisory committee would actively engage with the third party valuator or the investment manager to understand the valuation policy and methodology. This provides investors with additional reassurance that valuations are being approached in a consistent manner.

Professional Directors on the Boards of the General Partner

As with any investment fund structure, professional, independent directors on the boards of GPs can provide numerous advantages to managers and investors alike. Well equipped to provide guidance around the ever-increasing burden of legal and regulatory compliance matters that private equity funds encounter on a daily basis, professional directors can also provide independent oversight of the fund and its service providers that cannot be accomplished on an arm's length basis by a manager. The general complexity of private equity funds, with inherently more areas where actual or perceived conflicts of interest may exist, highlights the benefit of using professional directors at the GP level.

Their independence allows them to govern the fund and avoid potential conflicts around valuation, related party transactions, fees and expenses, to name a few. Conflicts involving the manager and / or one or more LPs, can be better navigated by a majority independent board which can ensure appropriate policies are in place and adhered to.

An independent GP board will also make decisions in an acceptable manner, documented accordingly, with transparency and consistency a priority in acting in investors' best interests.

Ultimately, the use of professional directors enables the manager to satisfy investors with a solid governance framework. This simultaneously provides capacity for the manager to deal with issues related to investments and operations.

Further, because professional directors have diverse backgrounds and expertise, the right addition to the board can add value for the manager by bringing specific experience or a different perspective to areas where additional resourcing may be required.

Both regulatory requirements and a strong desire from investors for demonstrably higher levels of corporate governance have created a quantum shift in attitudes and behaviour among leading industry participants. While much of this agenda was driven by issues affecting private equity funds that arose from the 2008 financial crisis, including liquidity constraints on funds, as well as a divergence in the interests of limited partners, leading to disputes and ultimately litigation, it remains as relevant as ever given the uncertainty in the market at present.

Business disruption continues to pave the way for digital transformation

George Ralph
Global Managing Director and CRO
RFA

The term 'business disruption' often comes with negative connotations, but my personal view is that the business disruption we have seen in the last 12 months has actually had a really positive effect on the alternative investment industry in terms of operation and technology specifically. Yes, the situation we find ourselves in has been pretty much entirely unpredictable, but it has brought with it a certain kind of freedom, allowing us to embrace technology and drive our businesses forward to the next level of transformation at a pace we wouldn't have thought possible.

The new way of working, where we are physically disconnected and our approaches to best working practice differs from firm to firm, has pushed risk management even further up the scale of importance for us all. The entire way we do business has changed and it has led to most firms upping the ante with their digital initiatives. We need to redefine our core business models to match and support the way we now work. I think most firms see that they will require increased budget for their digital structure in the short to medium term, particularly on data centralisation and cyber decentralisation which are both key to successful business and workflow.

Cyber decentralisation refers to the need for every firm to protect each user and device linked to its business – and therefore our data - where a standard network and firewall is not now wrapped around the entire IT set up. Every wi-fi connection and device out there that is used for business communications of any sort can become a liability and yet another entry point for a cyber attack. The idea of decentralising security allows firms to monitor and protect their cloud based networks efficiently and effectively. Enhancing protection for businesses also allows firms to start managing and pre-empting bad leavers – allowing behavioural analysis to notify HR teams in advance of an insider threat.

Data centralisation works in the opposite way. Bringing a firm's data together using data management tools effectively harnesses all a firm's vital information in to one central point, or warehouse or lake, to keep it not only safe from cyber attack but also to allow data to be accessed in a more efficient manner, often through a central remote dashboard with core controls and policies – a read only dashboard is far more secure that sending out PDFs or sharing spreadsheets (for example).

Factoring resilience into a digital transformation model is also key. Whereas the BCP's and control frameworks of the past were mostly designed around people led processes, today we manage these frameworks from a 100% cloud based technology perspective. Risk and failure points are very different when we compare a traditional office set up to a fully digital architecture. AI and machine learning advancements allow us to still look at the human centric side of a hybrid business model, while centralised data dashboards support reporting in terms of technology.

Whatever your firms set up, it is vital to stress test against both actual and perceived risk. Cyber attack is cited by far as the largest area of concern in the short and long term amongst the firms we work with. The nature of connectivity can be a problem as well as a solution of course. Security failures can have a domino or ripple effect. Digital resilience is just as important as digital transformation. Security assessments, penetration testing, phishing simulations and ultimately incident response should all be an integrated and regular part of a firm's due diligence. This periodic testing for vulnerability and threat detection is a requirement that must be carried out and certified correctly.

The entire business eco system is expanding rapidly, particularly in our borderless environment. A centralised and rule based approach to vendor checking can provide the appropriate due diligence events to identify and negate any risks. This centralised approach provides an audit trail that regulators and investors alike can understand and respect. Firms need to take advice to make sure they have the correct controls and practices in place to support their 3rd party oversight.

When proactively establishing governance structures and processes to address 3rd party vendor relationships in our new environment, firms should look at strategic and reputational risks as well as operational. Outsourcing services does not outsource the responsibility that comes with engaging with that service. Having full oversight of systems and understanding them is key to having successful vendor relationships. As more firms move towards a centralised data and decentralised cyber model, data and security governance can become less onerous. 3rd party vendors are working with firms more to build cloud-based dashboards that provide the level of oversight both regulators and investors require. This end-to-end strategy means governance is at a level never seen before.

I think it's also important to add some focus to both a firm's daily operations and its teams too. While firms are keen not impede work and deal flow, it is also important to build a culture of compliance in the daily activities of the team. Staff training for security, helping to not only identify but also manage risks at the end point or via emails, links and attachments makes a notable difference to a firm's level of vulnerability and shows vendors and investors that a firm has taken all reasonable precautions to manage external and internal risk.

It is also now possible to containerise whole desktops all the way down to an individual folder, delivering secure systems and or data to specific devices for an individual's use. To maintain operational excellence, firms are also able to specify document specific constraints to manage compliance risk.

Technology is now available, again using AI, that can pre-empt a tech issue before it arises. This is not only efficient in terms of business flow and reporting but provides an enhanced user experience too. These day to day activities are good business practise in a cloud environment.

The drive to collaboration and containerisation will continue across the next weeks and months, and while this has excellent advantages in terms of business and deal flow, it is also very encouraging in terms of regulation and due diligence. Next generation technology advances will only assist us to continue with good business practice as we move in to the future.

Does Investment Limited Partnership reform represent a renewed opportunity?

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The passing of the Investment Limited Partnership (Amendment) Act 2020 (the Act), coupled with proposed amendments to the rules governing closed-ended funds introduced by the Central Bank of Ireland (CBI) has significantly enhanced Ireland's offering for asset managers seeking to set up an onshore private fund. In this article we recap on the current landscape for Irish private funds and consider the impact that changing investor preferences and OECD/EU mandated tax reform are likely to have on interest in the enhanced limited partnership structure.

What are the key enhancements to the Investment Limited Partnership?

The Act makes a number of positive changes which broadly seek to improve the operation of the ILP and align it with other EU legislation such as AIFMD. Some notable amendments;

- The inclusion of additional "safe harbour" activities which limited partners can complete (such as taking part in advisory committees) without losing their limited liability status;
- clarifying that limited partners should not be liable for partnership debts beyond their committed capital;
- modernising capital withdrawal requirements;
- updating registration and record keeping requirements in line with international standards; and
- permitting the ILP to register an alternative foreign name which is helpful for ILPs operating in a non-English speaking jurisdiction.

In addition, confirmation from the CBI that the general partner of a partnership will not require a separate regulatory authorisation will be welcome news to industry. Instead, it is expected that the CBI's fitness and probity regime will be applied to each director of the general partner.

Further, a CBI consultation paper issued in late 2020 which indicates an intent to clarify and/or update the AIF rulebook to cater for closed ended funds. The proposed updates include issue of shares/interests at a price other than net asset value, provision for 'excuse and exclude' mechanisms, allowance for stage investing and clarifications around the ability to implement a carried interest waterfall.

It is with noting in the context of the referenced enhancements to the ILP regime that there has been no change to the Irish tax treatment of the vehicle. ILPs continue to be treated as "look-through entities" for Irish tax purposes, with partners effectively taxed on their share of the partnership profits.

This means partnerships are effectively disregarded for Irish income tax and corporation tax purposes such that no income tax or corporation tax should arise at the level of the vehicle itself. Notwithstanding this look-through approach, there are a number of other tax issues that require consideration in structuring an Irish limited partnership, typically linked to the profile of the investors and/or underlying assets held. In certain cases, investment into the underlying asset may require the use of an underlying holding structure together with the ILP, which may be driven by operational and/or tax needs. Similar to other Irish regulated products, the provision of management services to an ILP should be exempt from Irish VAT.

Private assets - an Irish perspective

Ireland has long been renowned as a domicile for setting up and servicing alternative fund structures, evidenced by the growth from €151bn of alternative assets under management in Irish regulated funds in 2009 to in excess of €770bn at present. The growth in the Irish alternatives industry reflects broader global market trends, where there has been a noted increase in allocations to private markets.

The strategies housed within Irish alternative funds span hedge funds, private equity, private debt, infrastructure, real estate as well as a significant number of aircraft leasing and shipping funds. It is worth noting in this context that while this article focuses on the regulated fund platform and positive developments in that respect, it is acknowledged that many of these strategies are currently housed in other unregulated holding structures (special purpose vehicles, holding companies etc).

In certain cases, these holding structures may also be combined with an Irish regulated product, or equally a non Irish feeder vehicle, depending on the specifics of a structure. Indeed, such holding structures may still be desirable in combination with an ILP, depending on the profile of the investors and/or underlying strategy of the fund.

What is clear is that investor demand for exposure to these asset classes continues to grow, particularly in the institutional space, where the illiquidity premium and long-term nature of the investment strategy are in many instances aligned to the investment objectives of institutional investors such as pension funds, sovereign wealth funds and insurance companies.

Notwithstanding the aforementioned growth in alternative funds in Ireland, and the increasing allocations towards private assets (which are typically housed in tax-transparent structures), to date the Irish limited partnership offering has not experienced a level of growth that market trends would suggest. However, we expect that trend to change on foot of this reform.

In an Irish regulated context, alternative investments have largely been structured into Irish fund vehicles that take a corporate form and are opaque from a tax perspective. From a tax perspective, Irish regulated funds are exempt from Irish tax on income and capital gains derived from their investments and are not subject to Irish withholding tax on payments to non-resident investors (if the fund does not house Irish real estate assets).

Consequently, tax neutrality at fund level is also achieved in a corporate fund context but in a different manner from the tax-transparent treatment afforded to limited partnerships. In this way, although the two regimes follow the same policy principle (i.e. ensuring that investors are not penalised for pooling assets to achieve scale and diversification), they achieve it in different ways.

A tailored approach?

Managers and investors alike have sharpened their focus on the manner in which tax neutrality at fund level is achieved as a result of OECD and EU-mandated reform. While the complexity of the tax and broader operating environment should naturally drive asset managers towards leaner investment structures, that approach does not always align with key investors who want a tailored solution and may require designated holding structures.

The ILP and other tax transparent structures can act as an effective solution in many cases allowing for collective investment together with the option for tailored structuring below the collective investment vehicle for certain investors. This can often be an attractive proposition for investors and managers alike.

A further notable development in this context is the increasing focus on tax sustainability from investors and particularly European institutional investors. It is now common for institutional investors to have tax sustainability/transparency/reputational questions within their standard investment due diligence questionnaires. Similarly, the ESG agenda more broadly is requiring a departure from the status quo in terms of structuring new products in many cases.

Increasingly, investors expect asset managers to incorporate ESG principles into their investment strategies and this is having an impact on the product which is chosen to house these strategies. Transparent structures can lend themselves well to these initiatives in that they facilitate direct exposure to the underlying asset class for an investor.

That is not to say that tax transparent structures such as the ILP will be the structure of choice in all cases going forward, and clearly assessing the impact of any OECD and EU mandated reform requires a more holistic review of the entire structure (including that of the investor and where an underlying holding structure is used as referenced above) to determine any impact.

What is clear however is that there is no "one size fits all" approach and, consequently, it is welcome news that Ireland will now have a full product suite available to managers in both corporate and transparent form to service the needs of the market.

Flow-through treatment and double tax treaty access

Using a transparent structure to house private assets has proven to be an attractive proposition from an investor perspective, particularly in light of the ability for the underlying return to retain its natural form. Where a capital gain is realised on the disposal of the underlying asset held within the limited partnership structure, that gain is deemed to be directly attributed to the limited partners and therefore the return typically retains its natural form. The very nature of these real-asset-type investments (such as infrastructure for example) means that the return on investment tends to be by way of capital uplift as opposed to income; the ability for this to be taxed as a capital gain in the hands of the investors has been an attractive feature and has fuelled the growth in transparent structures.

This point can be particularly relevant for sovereign wealth fund investors, which, along with typically being exempt from taxation in their own right, are generally in a position to avail of double tax treaty (DTT) or domestic exemptions at the level of the portfolio investment (e.g. exemption from source-country withholding taxes/capital gains taxes).

Direct sight of this investor class by portfolio-jurisdiction tax authorities is therefore of utmost importance.

Arguably, one of the most significant changes introduced by the Multilateral Instrument (MLI) under the BEPS Action Plan was the introduction of a principal-purpose test (PPT) into Ireland's DTTs. This general anti-avoidance clause, providing tax authorities with the ability to deny benefits available under a DTT if obtaining the treaty benefit was "one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit", will clearly be influential in the choice of investment vehicle going forward.

Undoubtedly, the PPT has raised the bar in terms of the ability to access benefits in most of Ireland's DTTs, with corporate funds and opaque structures no less affected. Aside from the increased threshold that has been introduced by the MLI, DTT access for investment funds was already challenging under existing rules, notwithstanding the policy objectives with which they were established.

Despite the OECD commentary and draft guidance released to address the relevant issues for collective investment schemes and non collective investment schemes, significant uncertainty remains, and uncertainty remains in the market about how treaty partners intend to interpret and police the PPT in the future.

Contrast this with the impact that the same rules are likely to have on a limited partnership structure.

The tax-transparent nature of a limited partnership is helpful in this regard, given the look-through approach that typically applies for income tax, corporation tax and capital gains tax purposes. Jurisdictional consolidation throughout a structure is another important trend in this context, particularly where fund vehicles are used in conjunction with underlying holding structures.

Increasingly, we are seeing an appetite to consolidate the fund and holding structure into the same location for commercial reasons and this also helps to bolster presence in a particular jurisdiction. In this way, having a full product suite is crucial for the competitiveness of any domicile.

What's next?

The updates to the ILP regime significantly enhance Ireland's product suite for private fund managers at a time when tailored investment structuring is of paramount importance. As asserted throughout this article, due to a variety of both operational and tax driven investor requirements, a "one size fits all" approach to structuring investment in private assets will be unsustainable into the future. Consequently, the availability of a full product suite (in both corporate and transparent form) to adopt a tailored approach will be crucial.

Going forward, asset managers and their advisers will need to take a more holistic approach to structuring investment platforms and, in doing so, critically assess and weigh up the pros and cons of each layer in the structure. The broader asset management infrastructure will need to have the flexibility to service these tailored solutions in an efficient and effective manner.

The enhancement of the ILP means that Ireland has taken a very positive step in its continual evolution to meet the needs of an ever-changing market.

How to beat a depression: Lessons from Franklin Delano Roosevelt

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Introduction

The biggest economic challenge for policymakers today seems abundantly clear – free developed economies from the shackles of secular stagnation, raise inflation expectations (within reason) and restore the dynamism of the post war period. In assessing this, we find it interesting looking at history to see how a similar challenge was overcome in the past.

We are not looking for a precise recipe here: no historical analogue is ever perfect, but the 1930s does contain striking parallels with the economic situation in which we now find ourselves.

To this end, we recently read Robert Dallek's acclaimed single volume biography of the architect of America's salvation from the Depression. In *Franklin D. Roosevelt – A Political Life (Penguin, 2018)*, we find a blow by blow account of what it took to raise a great nation from its despair, in terms both of his economic policy and his personal and political outlook.

It is remarkable how many of today's politicians seek to embrace Roosevelt's legacy, from President Joe Biden's comment that the Covid-crisis "may eclipse what FDR faced" (quoted in the Guardian, 22 May 2020), and his recent visit to Warm Springs, Georgia, where FDR recuperated from polio; to Alexandria Ocasio-Cortez's Green New Deal; to Boris Johnson's levelling up agenda.

What follows is not a book review, rather our notes of what seemed to be the most important elements of the Roosevelt reflation as relayed by Dallek. We divide them into observations of economic policy, first, and of the personality traits of FDR the man, second. Quotations are direct from Roosevelt's speeches and letters, as quoted by Dallek, unless marked (Dallek), in which case they quote the text of the book itself.

Economic Policy

We can arbitrarily think about FDR's economic policy response in six broad categories, some more crucial than others, but all of which played their part in the recovery. Here, we list those categories and fill in some of the more important actions undertaken:

1. **Inflate, not deflate**

    - "It is simply inevitable that we must inflate and though my banker friends may be horrified, I still am seeking an inflation which will not be wholly based on additional government debt".

2. **Secure the banks**

    - Declares bank holiday 9 March 1933 as prelude to new banking bill – backstops the banks, but doesn't nationalise them;

    - After the first fire-side chat on 12 March 1933 when banks re-opened the following Monday, people queued to put their mattress money back on deposit;

- June 1933: signs the Banking Act to regulate Wall Street, containing the Glass-Steagall laws separating commercial and investment banking, and creating the Federal Deposit Insurance Corporation ('FDIC'), which guaranteed deposits up to USD5,000 (99% of all deposits being covered).

3. **Apply monetary stimulus**

    - April 1933: took the dollar off the gold standard by signing up to the Thomas Amendment for cheaper US dollars – which his own budget director, Lewis Douglas, declared "the end of Western civilization"; embargoes dollar exports and outlaws the private ownership of gold. Dollar value of gold rises from USD27 to USD35 – a 30% dollar devaluation;

    - July 1933: FDR refuses to verbally back the external value of the US dollar at the London Conference of Nations;

    - January 1934: FDR signs Gold Reserve Act that fixes the dollar 41% below prior gold parity.

4. **Apply fiscal stimulus / put people to work**

    - Legalised 3.2% proof beer and light wine – ending Prohibition, getting people to go out again;

    - March 1933: creates the Civilian Conservation Corps ('CCC') to put 250,000 young people between ages 18-25 to work immediately so they did not become used to being on the dole. They earned USD1 a day (very low wage), but were required to send the bulk of the wage home to their families. "Over the next nine years, 3 million young people would cycle through the CCC, planting three billion trees, creating 800 state parks, stocking one billion fish in the streams and lakes, containing scores of forest fires" (Dallek p148, paraphrased);

    - April 1933: Agricultural Adjustment Act ('AAA') aimed to raise farm prices and income by paying farmers for reduced production – farmers were 30% of the labour force;

    - April 1933: appropriated USD500 million for state budget relief via the Federal Emergency Relief Administration ('FERA'), which was the successor to the TERA of 1931;

    - May 1933: creates the Tennessee Valley Authority ('TVA') to construct dams on the Tennessee River to avoid seasonal flooding and associated topsoil erosion that had decimated farmers' livelihoods; and to provide electricity to the 90% of farms that lacked it in the seven southern states covered;

    - November 1933: creates the Civil Works Administration ('CWA'), employs four million people in manual labour rebuilding the country's infrastructure;

    - August 1934: FDR's budget director Lewis Douglas resigns in protest at his unbalanced budgets.

5. **Raise real incomes**

    - May 1933: signs the National Industrial Recovery Act ('NIRA') into law, creating the Public Works Administration ('PWA') backed by USD3.3 billion to finance infrastructure projects; and reducing production in certain industries while raising workers' wages via industrywide agreements.

6. **Restore the sense of a just society**

    - August 1935: FDR signs the Revenue Act which raises federal income tax rates to 75% on income of more than USD 1 million and introduced an inheritance tax. Known colloquially as the 'Soak the Rich' tax;

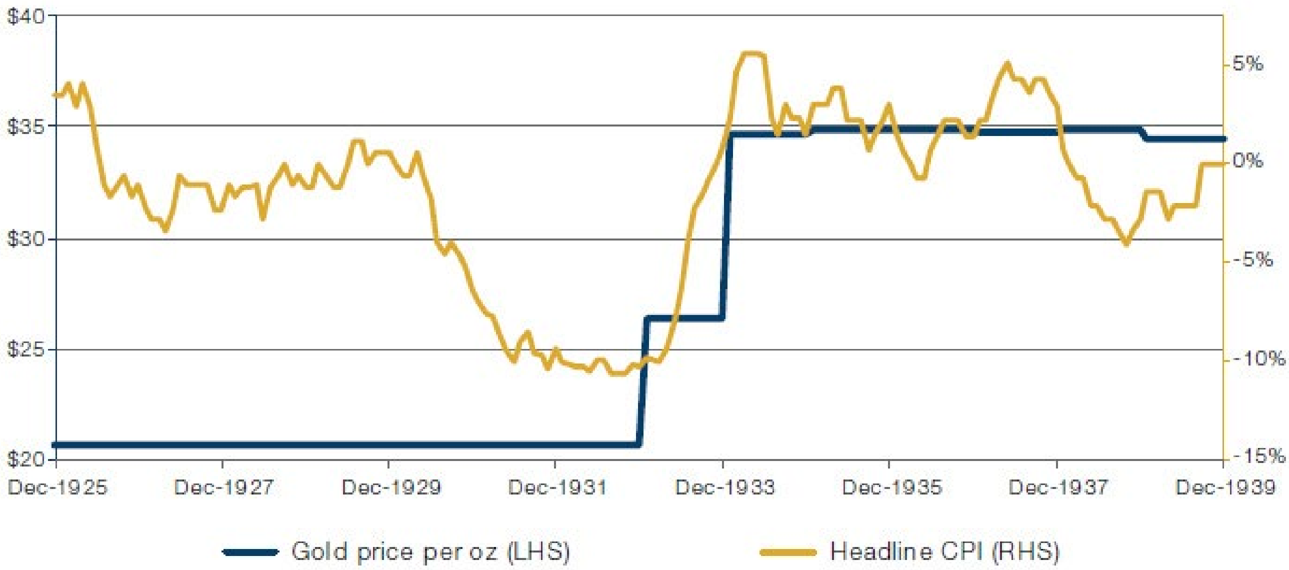
    - August 1935: signs the Social Security Act into law, instituting welfare payments for unemployed workers and pensions for over 65s. Twenty-six million people sign up in the first four months.

Personality Traits

Arguably, none of this would have been possible without Roosevelt's unique set of personal attributes and mantras, which enabled him to carry the electorate with him, winning not one but three landslide elections (the races for New York state Governor in 1930 and for President in 1932 and 1936). These characteristics defy classification but well bear listing. They include:

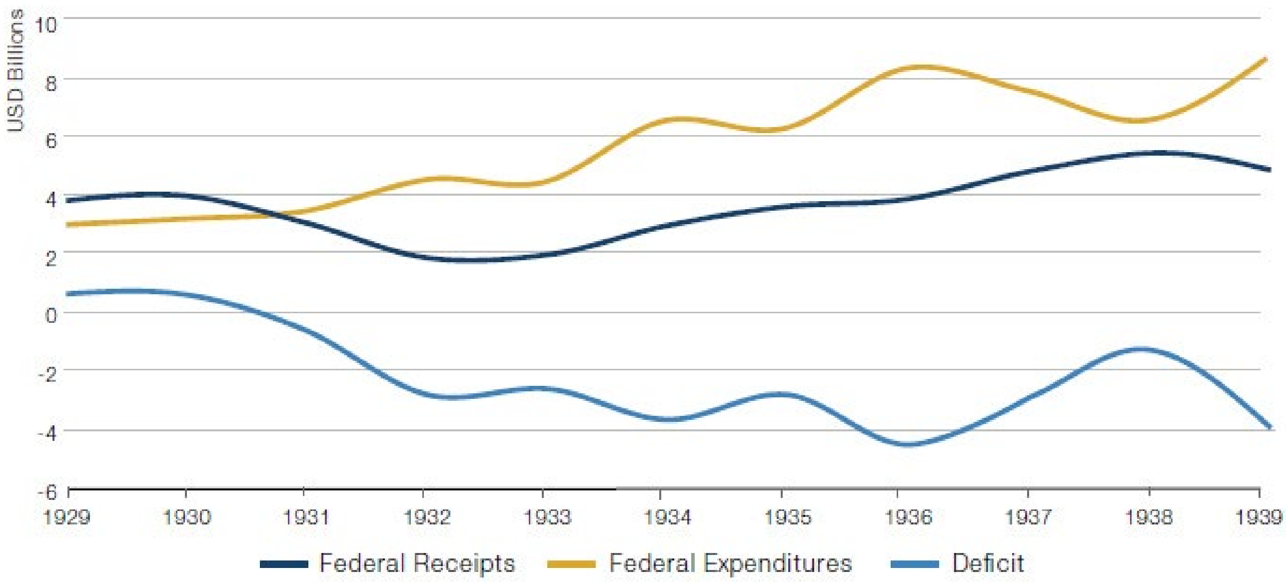
- **Be bold, be active, be honest**
  - "The country demands bold experimentation. It is common sense to take a method and try it: if it fails, admit it and try another. But above all try something";
  - Inauguration speech 1933 – the nation "cries out for action, and action now";
  - In the first 100 days, he signed 15 major bills into law – to create a sense of movement towards restoring national prosperity;
  - "Everything he learned about economics at Harvard was wrong" (Dallek p51);
  - February 1937: FDR proposes expanding the Supreme Court from nine to 15 justices in order to overcome judicial opposition to the New Deal after the court had overturned sections of the Agricultural Adjustment Act.
- **Communicate!**
  - July 1932: "I pledge you, I pledge myself, to a new deal for the American people";
  - March 1933: instituted twice-weekly press conferences;
  - Instituted his fire-side chats 12 March 1933 (eight days post inauguration).
- **Be optimistic**
  - Inauguration speech: "the only thing we have left to fear is fear itself – nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance";
  - Theme song for the 1932 Presidential campaign – "Happy Days are Here Again".
- **Show compassion**
  - "Aid to jobless citizens must be extended by government, not as a matter of charity but as a matter of social duty ... and to preserve our democratic form of government ... Modern society ... owes the definite obligation to prevent the starvation ... of any of its fellow men and women who try to maintain themselves but cannot because of conditions beyond their control". This stood in sharp contrast to Mellon's admonition to Hoover to "liquidate the farms, liquidate the banks, purge the rottenness from the system".
- **Don't scare the horses**
  - Most interestingly, FDR encourages the nation to balance its books! "Liberal governments have been wrecked on the rocks of loose fiscal policy"; "He judged intuitively that initial policies that echoed traditional means and ends would do more to advance subsequent progressive actions than bold strokes at the start" (Dallek p142). Importantly, he then went on to run deficits in every year of his Presidency!

Figure 1: Devaluation and Inflation under FDR



Source: Bloomberg; Between 1925 and 1939

Figure 2: Nominal Federal Government Expenditures, Revenues, and Surplus/Deficit (1929-39)



Sources: Federal government expenditures, revenues, and surplus/deficit are series Ea584, Ea585, and Ea586 from Wallis (2006, pp. 5-80 and 5-81).

Conclusion – Fire All Bazookas

Our over-riding sense is that it was the combination of determined monetary and fiscal stimulus applied simultaneously that really made the difference. Interestingly, there is no real scholarly consensus about the precedence of monetary or fiscal policy as the key ingredient of the recovery. Maynard Keynes himself visited the White House in 1934 and urged the President to maximise all possible government spending financed by loans, not by taxes – i.e. to increase the money supply. While M1 money growth did indeed accelerate from a 13% contraction in 1932 to over 10% growth in 1934-6, the government deficit was modest throughout the 1930s by today's standards, being between 2% and 4% in nearly every year.

The three key lessons seem to be: 1) deploy every weapon in your arsenal to avoid deflationary slump; 2) re-jigging existing government spending to provide incomes for those with high marginal propensity to consume can provide a high multiplier fiscal boost, so very large deficits are not necessary; 3) keep applying the stimulus long after the crisis – the policy tightening of 1937 prompted a mini-depression and is widely seen as a mistake.

Let's hope policymakers today can muster similar levels of conviction as FDR. We could all use some optimism.

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Cross Border Regulatory Implications for Alternative Investment Managers

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Since the financial crisis of 2008, there has been a shift away from internationally agreed standards and principles. De-globalisation has picked up pace with COVID 19 and events such as BREXIT, resulting in regulators and policymakers becoming increasingly focussed on national legislation.

Alternative Investment Managers now have to perform a detailed analysis of the cross border implications of licensing, regulatory reporting, compliance monitoring and marketing rules, even if their sole activity is managing an offshore hedge fund. This article will consider these topics in turn and will provide clarity to Alternative Investment Managers grappling with numerous and sometimes contradictory requirements.

Licensing

It makes sense that as soon as an Alternative Investment Manager plans to manage external money that they obtain the appropriate regulatory licensing in the jurisdictions in which they are located. Alternative Investment Managers located in the US will need to register with the SEC as Investment Advisors as soon as they meet the threshold AuM. Until then, reliance can be placed on applicable state registrations. It is the same situation in Hong Kong and Singapore with the SFC and MAS respectively being responsible for the licensing of Alternative Investment Managers.

Also, there is an expectation by these regulators (and all major regulators) that there will be an individual located in the jurisdiction, responsible for compliance oversight.

In the European Union, it is a little more complicated. Alternative Investment Managers need to be licensed either as an Alternative Investment Fund Manager (“AIFM”) with MiFID ‘top ups’ or as a MiFID Firm. AIFMs that are responsible for portfolio management and risk management of an Alternative Investment Fund (“AIF”), which is any fund that is not a UCITS, will be currently out of scope for real time and T+1 MiFID reporting.

However, Alternative Investment Managers require an AIF if they are to be licensed as an AIFM. If there is no AIF, Alternative Investment Managers need to be licensed as MiFID Firms. Interestingly, the French regulator is allowing AIFMs up to a year to launch an AIF, which may be an option for Managers who would like valuable ‘passporting rights’ that are only available to EU domiciled funds without the reporting obligations.

One of the implications of BREXIT is that Alternative Investment Managers with EU UCITS funds, who are licensed as MIFID Firms, have lost their MiFID passports, and must therefore ensure that any UCITS funds that they manage are ‘passported’ into the relevant EU country, or use a local intermediary to sell the UCITS in that country. UK Managers are no longer able to act as UCITS Management Companies and most Managers have opened an office in the EU if they did not already have an EU presence.

Alternative Investment Managers, at the same time as organising local licensing, must register as a Commodity Pool Operator (“CPO”) with the CFTC pursuant to CFTC Rule 4.7 (a) if the fund is trading more than a de minimus level of specified listed derivatives and swaps. This requirement applies if there is a single underlying US investor in the fund. Even if the manager can rely on an exemption, because initial margin and premiums and net notional value of positions do not exceed 5% or 100% respectively of the liquidation value of the fund, there is still a requirement to file a 4.13 exemption annually.

It should be noted that derivatives on single name securities fall under the jurisdiction of the SEC and it is common for an Alternative Manager to be regulated by both the CFTC and SEC.

Also from a US perspective, an Alternative Investment Manager with no US presence must register as an Exempt Reporting Adviser with the SEC when reaching a certain threshold in respect of US investors and will be subject to the same US requirements on areas such as Pay to Play and the US Advisers Code of Ethics.

It should not be forgotten when considering licensing whether any trading or sales staff are working overseas during the COVID 19 pandemic as there may be licensing, legal and tax implications if staff are working overseas even for a fairly short period of time.

Regulatory Reporting and Compliance Monitoring

Alternative Investment Managers are subject to numerous regulatory reporting requirements, even to regulators in jurisdictions where they have no physical presence or investors. This includes the reporting of short and long positions to the regulator of the jurisdiction in which a security is listed, including US 13F and 13G reports. Regulators are able to sanction Alternative Investment Managers directly, or work with the home regulator in respect of any fines.

These can be sizeable and also result in reputational damage. Regulation SHO, in respect of US short positions, applies to US Investment Advisors and indirectly to foreign investment advisors dealing with US Broker Dealers who are subject to these requirements in respect of marking short positions.

Depending on the instruments being traded, there may also be position limits dictated by the exchange on everything from BitCoin (with futures on some crypto assets being treated as commodity interests by the CFTC) to corn derivatives limits. These limits are at the manager level and must be aggregated and monitored closely. Similarly, market abuse surveillance should be implemented using the relevant regulatory requirements considering the jurisdiction of listing.

For example, the UK standards should be followed when trading UK listed instruments. Generally, the Alternative Investment Manager should adhere to the highest applicable standards and perform automated monitoring as per the UK rules even if there is no UK presence or UK investors.

If the Alternative Investment Manager is a CPO, quarterly CPO PQR will apply.

If the Alternative Investment Manager is an AIFM in the EU, then EMIR reporting (which is often delegated to brokers) will apply but SFTR reporting (the equivalent of EMIR for Securities Financing Transactions (SFTs)) will only apply if the UK manager has EU domiciled funds.
Form PF is only applicable to US based managers and AIFMD Annex IV is only applicable to AIFMs (even non-EU AIFMs) that are marketing funds within the EU and the UK.

Marketing

Increasingly marketing needs to be reviewed on a country by country basis. Even within the EU, there are different definitions of marketing within AIFMD. The UK and the Netherlands have narrow definitions of marketing, so that marketing only takes places when providing offering documentation. Other EU countries such as Spain and Italy have much wider definitions. As well as the definition of marketing, MiFID passports, or lack of them, need to be considered before reviewing product-specific directives such as UCITS and AIFMD.

Just as the definition of marketing varies, ‘reverse solicitation’, where an investor approaches the manager of its own accord, is not recognised in some jurisdictions in Europe.

Regulators are increasingly paying attention to Alternative Investment Managers who rely on reverse solicitation, which falls outside of AIFMD marketing rules. Indeed, ESMA commented recently on “questionable practices”.

As mentioned above, UK managers are having to use local intermediaries where a fund is not passported post BREXIT. It should be noted though, that in some countries such as Finland, unregistered UCITS are prohibited from being marketed irrespective of MiFID passports. Looking across the Atlantic, US (Rule 506(c)) (part of Volcker Rule / Dodd-Frank) prohibits general solicitation of any private fund (most alternative funds) including press releases without being referenced in an ADV.

Most Alternative Investment Managers rely on Regulation D in respect of funds but there are still various Blue Sky rules at the state level where filings must be made each time a fund receives a new investor.

To conclude, it looks like the situation will become even more complex in the future. Although financial services regulation did not receive significant attention during the 2020 election campaign, the Democratic control of congress is likely to bring new regulatory and enforcement priorities in respect of Alternative Investment Managers.

In Europe, UK regulation will continue to diverge from the rest of the EU and it is unclear as to how regulation will evolve in Asia especially in respect of the situation in Hong Kong. Managers are advised to ensure they continue to invest time and energy in navigating an ever evolving, complex regulatory landscape. Please contact Michelle Bedwin to understand how Coremont helps its clients address these challenges.

Disguised Investment Management Fees (DIMF) and carried interest – In search of guidance?

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My last article for the AIMA Journal on the UK's disguised investment management fee (DIMF) and carried interest legislation was featured back in Edition 111, where I described the rules as "a riddle, wrapped in a mystery, inside an enigma". Whilst little has changed since then in terms of the legislation, in that article I noted that we were due updated guidance.

Finally, in October 2020, HMRC published the aforementioned updates to their guidance in the Investment Funds Manual, a five-year gap after the rules came into force in 2015. Whilst draft versions of the guidance had been in circulation since October 2016, the extended wait before official publication hints at the level of subjectivity involved and the deliberations as to how the legislation could or should be interpreted. In the absence of any case law on the subject the guidance has been widely welcomed.

By way of recap, the legislation seeks to ensure that remuneration from funds attributed to individuals as a result of investment management services being performed in the UK is taxed as either employment income or trading income, unless those amounts relate to carried interest. Amounts categorised as carried interest are then taxed at either special capital gains tax rates or (if they are determined to be income-based) at the standard income tax rates. Traditional management and performance fee models will typically see all receipts from the fund treated as fee income.

The legislation is complex, being updated twice in the year of its release, meaning some managers either misunderstood or overlooked the rules when first implemented. The revisions, which the guidance discusses in detail, mean that any arrangements (structural or otherwise) that sit between the fund and the individual may be disregarded. Furthermore, income and gains that may otherwise be regarded as outside the UK may be deemed to be UK-based or UK-situs respectively.

The result is that the individual providing those investment management services in the UK is required to consider what obligation they have personally to report a charge under the legislation.

Similar to other anti-avoidance legislation in the UK, the rules require personal tax advisors to understand and analyse the corporate structure through which an individual (who is providing investment manager services) is remunerated. This requires a significant level of investigation and a level of detail that the individual taxpayer may not readily have available.

Logically advice at the corporate level often focuses on fee flows and tax liabilities recognised in the financial statements, therefore the potential for the topic to fall in a gap between personal and corporate advisors is high.

Complicating matters further, the rules potentially cut through personal planning that individuals may have undertaken as part of becoming deemed domicile in the UK. Taxpayers acting in good faith hoping to fall within the carve-outs afforded by the UK Government may be inadvertently caught out by the rules.

Additionally, if there is any non-compliance pre-April 2017 then the UK's requirement to correct legislation could lead to some particularly costly outcomes for taxpayers.

Another angle to consider is the fact non-residents can also be caught by the legislation. Whilst occasional visits to the UK should not lead to a tax liability, frequent visitors or those establishing a pattern of behaviour that could be regarded as trading from the UK will have an exposure.

Double tax treaties do provide some protection, but those individuals with a UK focal point to their work or seeking to manage their UK day count in order to stay non-resident should review their position carefully.

If they personally create a permanent establishment as a result of their UK activities then the business profits articles typically found in double tax treaties will not provide protection.

Increasingly, individuals in the asset management sector are finding that their tax position is being scrutinised in detail by HMRC, usually as a result of declaring income out of a non-UK vehicle, e.g. dividends / partnership allocations. What starts as a relatively benign round of questions can escalate into an enquiry that spans the corporate structure and other individuals in the business.

Naturally, inconsistencies between the filing positions adopted by taxpayers will lead to tensions between the parties, noting there may be a divergence in the advice received at a personal and corporate level, or indeed between different advisors. Such tensions can only compound the alarm that unexpected enquiries, tax bills and advisor fees will raise.

The newly released guidance addresses the key changes introduced on 22nd October 2015 that impact the taxation of most management and performance fee structures. This clarification, as it was positioned at the time, advanced the already complicated rules to the status of weapons-grade legislation, stacking the deck clearly in favour of HMRC.

Specifically, from this date certain 'enjoyment conditions' were imposed (borrowed from some of the UK's other anti-avoidance legislation) to attribute fees directly to individuals, thus creating a 'deemed trade' in the UK.

Whilst exemptions exist to disapply the enjoyment conditions, there are also barring conditions that disapply the exemptions. The exemptions are barred when (a) it is reasonable to assume that, in the absence of those arrangements, amounts would have arisen to the individual performing the service or an individual connected with them; and (b) it is reasonable to assume that the arrangements have as their main purpose, or one of their main purposes, the avoidance of tax.

When analysing clause (a) HMRC guidance sets out a long list of things to consider, including fund structure, tax advice received, management company structure, the size / international spread of the management team, whether it operates on a commercial basis and if the individual receives an arm's length rate of remuneration.

It also cites the need to have sufficient economic substance to support the arrangements in place, an area that many jurisdictions have had to focus on in recent years. Importantly no one factor is deemed to be decisive as the analysis depends on the facts and circumstances.

The point of contention when interpreting this rule is whether an individual in an owner-managed asset management business is entitled to be able to treat their remuneration for services rendered separate from the return they may receive as an equity owner in the business. The argument made by equity owners is that they should legitimately be able to expect an equity style return on surplus profits (i.e. after remuneration) without sums being recharacterised as trading income.

Whilst there is clear logic in this argument, a wholly UK business operating as an LLP would not be afforded such treatment as the mixed membership rules essentially force 100% profits that individuals can 'enjoy' to be taxed as trading income.

For clause (b), tax avoidance includes the avoidance of a liability to pay UK income tax, capital gains tax, inheritance tax, or corporation tax. However, the most contentious and notable feature of this test is the fact that fees re-invested back into a fund will automatically be regarded as meeting this requirement.

Given that co-investment is often viewed by investors as somewhat of a mandatory requirement such a clause seems entirely at odds with the commercial position.

In essence, the legislation creates a higher threshold in compliance terms for individuals working in asset management than any other industry in the UK (a fact that many in the general public may not appreciate). Conceptually that in itself is not a concern, indeed some would argue that it was necessary to rebalance the relationship after HMRC continuously found themselves one step behind the industry.

However, for others the level of uncertainty surrounding the application of the legislation is a deterrent, acting as a potential barrier for those seeking to move to the UK, and also a catalyst for them to leave.

Such concerns come into sharp focus at a time when UK competitiveness is under increased scrutiny, particularly around financial services, as such the release of the guidance now can only be viewed as a good thing. Furthermore, HMRC are increasingly supportive of helping taxpayers outside of the standard self-assessment regimes, an approach that is actively encouraged, either directly through non-statutory clearance procedures, or more commonly indirectly through advisors.

The message from inside the corridors of power is clear: "We are here to help". How the relationship between asset managers and HMRC evolves on this topic will be key to driving sentiment across the industry. Historically taxpayers have been reluctant to actively engage so this is a change in mindset. Greater transparency needs to be rewarded with greater certainty, although some would argue the reverse. Either way, trust has to be earned.

Finding leverage: How debt investors are tackling the challenge of ESG

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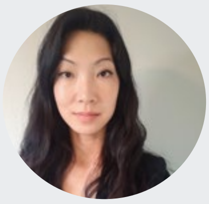

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With an abundance of optimistic growth projections centered around credit markets, 2021 is predicted to be a banner year for portfolios weighted in private debt. Couple this projection with a growing global recognition of the need to embrace a transparent commitment to ESG criteria within an investment portfolio, it seems an easy step to combine private debt investments with ESG commitments to land on a high-performing, socially and environmentally sound investment strategy.

But just how easy is it to incorporate ESG criteria into a private debt portfolio? In a world that is working to evolve how the finance industry defines accountability in terms of environmental, social, and governance metrics, what tools does a private debt-based portfolio manager have to create an incentivizing framework to promote implementation of ESG-related principles, policies, or even benchmarked reporting across their suite of investments?

ESG precursors to private debt

Implementation of ESG-related principles as a leveraged component in the debt structures of a funding mechanism is not necessarily novel. Take, for example, large infrastructure projects, which are subject to a range of unique ESG risks and opportunities due to their scale, relatively long lifespan, and potential for promoting socioeconomic growth and development. Since projects of this nature are often financed via non-recourse project finance arrangements whereby lenders look to the earnings of the project for repayment, lenders have a vested interest in the performance of the project, and in the environmental, social and reputational risks that could affect such performance over the lifetime of the project.

As such, lenders have been imposing ESG requirements in project finance agreements beginning in the 1990s[1] , with rapid development of various environmental and social risk management frameworks in the 2000s. The Equator Principles (EPs) and the IFC Performance Standards, which are embedded within the EP framework, are among the most widely applied.

Financial institutions that elect to incorporate EP governance into their financing structure are certified as Equator Principles Financial Institutions (EPFis), committed to only financing EP-compliant projects.

As of February 2021, there were 116 EPFIs in 37 countries, including major U.S. lenders such as Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo.[2]

1 Davis Polk. 2017. Environmental & Social Standards in Project Finance: Overview, Current State of Play. Available at: https://www.davispolk.com/sites/default/files/2017-08-07_environmental_social_standards_in_project_finance_overview_current_state_of_play.pdf

2 Equator Principles. 2021. EP Association Members & Reporting. Available at: https://equator-principles.com/members-reporting/

Much success has also been seen in the fixed income market through development of green bonds. First issued by the World Bank Treasury in 2008[3] , green bonds, also known as climate bonds, provide a dedicated funding instrument to promote the development of climate-related projects.

The green bond product evolved through collaborative efforts between the finance and scientific communities and envisioned an inclusionary approach to facilitate investment in environmentally sound projects within a traditional investment portfolio.

These investments are guided by the Green Bonds Principles (GBPs), which provide the overarching framework to step issuers through the bond certification process. The GBPs also incorporate an impact reporting process to further facilitate project transparency and allow both the investor and the local community to see the impact of the investment.

Green bonds are often tax-incentivized to further improve the risk-return profile of the investment, making this option attractive for all parties involved in the transaction. In proof, green bond issuance peaked at $64.9 billion - a 21% increase over the second quarter of 2020 and the highest third quarter issuance on record[4] - further underscoring the value perceived by the investment community in this market.

The green bonds market has paved the way for other funding mechanisms for ESG-related projects, with the emergence of social bonds, available to support projects that positively impact community stakeholders. This is in addition to sustainability bonds, available to support a broader context of environmentally-beneficial projects as well as projects with blended ESG impact.

ESG in private debt – today and tomorrow

ESG integration in private debt has also been in place as a practice for a long period of time. Debt investors have historically considered certain ESG elements in core fundamentals, though not always referring to them as such. Currently, the majority of private debt investors implement ESG as a risk analysis prior to making an investment decision. As a pre-transaction screening activity, ESG factors can be weighted based on materiality and applied to the basic credit-worthiness of the underlying investment.

Monitoring of ESG characteristics over the term of a private debt investment is developing as a practice. With the proliferation of ESG integration across asset classes and markets, private debt managers have begun tracking ESG developments in investments over time, leveraging internal and external data approaches to do so.

While this process is becoming more standard, taking action on monitoring data is far less prevalent. Most private debt investment managers lack the kinds of leverage that the bank-funded investments — discussed previously— may enjoy, such as tranches of funding, boilerplate ESG covenants, etc. As such, many debt investors recognize these challenges and see monitoring as one of the key areas of evolution for ESG integration.

3 The World Bank. 2019. 10 Years of Green Bonds: Creating the Blueprint for Sustainability Across Capital Markets. Available at: https://www.worldbank.org/en/news/immersive-story/2019/03/18/10-years-of-green-bonds-creating-the-blueprint-for-sustainability-across-capital-markets

4 Climate Bonds Initiative. 2020. Green Bonds Market Summary, Q3 2020. Available at: https://www.climatebonds.net/system/tdf/reports/cbi_q3_2020_report_01c.pdf?file=1&type=node&id=54810&force=0

Evolution of ESG strategies

Though not yet being widely executed today, strategies being discussed and tested by many in the space include:

- Additional reporting requirements – additional levels of reporting on given topics triggered by poor ESG performance in monitoring.
- Interest rate adjustments – incentives (rate discounts) and penalties (rate increases) tied to ESG performance.
- Other fee flexibility – relaxation of other fees or more flexible covenants tied to positive ESG performance.

While integration of ESG-related principles into the lending process isn't necessarily a new concept, the market is evolving to make space for broader, more dynamic ESG-based investment opportunities.

Present circumstances are facilitating a shift in the overall ESG conversation, allowing socially-focused topics, such as modern slavery practices, environmental justice, and diversity, equity and inclusion, to take center-stage alongside emerging disclosure requirements in the carbon and climate change space.

Coupled with a strengthening self-directed desire of investors to prioritize ESG-based investment behaviors, the continued momentum driving impact investment will serve to not only create space for new and innovative investment opportunities, but to also support furthering improvement in tracking ESG-related performance for existing assets.

Over the next 12-24 months, we expect to see additional uptake of these concepts and indeed further testing and integration of rate and other fee-aligned ESG covenants in debt agreements.

Cayman Islands Alternative Investment Fund Structuring and Regulatory Considerations

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This article considers the range of vehicles available in the Cayman Islands for alternative investment fund ("**AIF**") structures designed for financial institutions, pension funds, sovereign wealth funds, family offices and (U)HNWs (as opposed to retail investors), as well as the legal and regulatory considerations that may influence the structure of an AIF. A summary of the key similarities and differences between the regulation of closed-ended and open-ended AIFs in the Cayman Islands is also considered.

Cayman Islands AIF Vehicles

There are five types of vehicles that are commonly used in the Cayman Islands for AIF structures: exempted companies, segregated portfolio companies ("**SPC**"), exempted limited partnerships, trusts and limited liability companies ("**LLC**"). The appropriate vehicle, or combination of vehicles, for an AIF structure will be driven by a number of considerations, including the target investor base and strategy, as well as the ability to replicate the terms of investment across multiple vehicles in the structure (which may be domiciled in different jurisdictions). It will also be important to ensure that, as far as possible, the fund structure does not impose an additional layer of tax between the investor(s) and the target investment(s).

When it comes to choosing a Cayman Islands AIF vehicle, the principal considerations are set out in the table below:

Structuring Consideration	Exempted Company	SPC	Exempted Limited Partnership	Trust	LLC
Tax Neutrality	Yes	Yes	Yes	Yes	Yes
Separate Legal Personality	Yes	Yes[1]	No	No	Yes
Investor Limited Liability	Yes	Yes	Yes	Yes	Yes
Statutory Segregation between Classes	No	Yes	No	No	No
Constitutional Documents	Memorandum and Articles of Association	Memorandum and Articles of Association	Partnership Agreement	Trust Deed	Limited Liability Company Agreement
Local Operator Requirements	None	None	The general partner must be registered in the Cayman Islands, e.g. a Cayman vehicle or a foreign registered company	A Cayman Islands trustee must be appointed	None
Local Substance Requirements	Registered Office	Registered Office	Registered Office	Trustee	Registered Office

Registration with CIMA and Regulatory Structuring Considerations

Once the appropriate form of AIF vehicle has been determined, the liquidity rights will define the appropriate path to registering the AIF, if required, with the Cayman Islands Monetary Authority ("**CIMA**"). Generally, closed-ended AIFs (i.e. those issuing non-redeemable equity interests or "**Private Funds**") are required to register with CIMA in accordance with the Private Funds Act, and open-ended AIFs (i.e. those issuing redeemable equity interests or "**Mutual Funds**") are required to register with CIMA in accordance with the Mutual Funds Act.

However, there are some exceptions, which may also be relevant to the structuring of an AIF, as follows:

- *Single Investor Vehicles.* By definition, all Private Funds and Mutual Funds require pooling of investor capital. In addition, "investor" is defined in the law: under the Private Funds Act, the definition excludes the operators, the promoter and all proprietary investors; and, under the Mutual Funds Act, the definition of "investor" excludes the operators and the promoter.

- *Non-fund (closed-ended) Arrangements*. The Private Funds Act includes a substantial list of 'non-fund arrangements' which are excluded from the definition of "private funds" and therefore fall outside of the scope of the Private Funds Act altogether. This list includes: officer, manager or employee incentive, participation or compensation schemes; separately managed accounts; holding vehicles; joint venture vehicles; structured finance vehicles; preferred equity financing vehicles; sovereign wealth funds; and single family offices. The Mutual Funds Act does not contain an equivalent list.

Regulation of AIFs

While there are two distinct registration regimes, CIMA regulates Private Funds and Mutual Funds in materially the same way. In addition, the associated rules and regulation of AIF business in the Cayman Islands generally also treats Private Funds and Mutual Funds in a like manner. For example:

- There are no pre-approval requirements by CIMA and the registration process is a straightforward online filing of the prescribed details with CIMA for both Private Funds and Mutual Funds. Provided the application is complete (and the relevant CIMA registration fee is paid), the date of registration with CIMA will be the date the application is made, and AIFs may carry on business from such date.

- The CIMA registration fees are substantially the same for both Private Funds and Mutual Funds.

- There are no statutory investment restrictions.

- There are no limits on the number of investors.

- CIMA generally requires two natural persons to (ultimately) operate the governing body of the AIF according to its 'four-eyes' principle, e.g. on the board of directors or the board of directors of the general partner, as the case may be. However, there are otherwise no local requirements regarding the composition of the board or other governing body. Typically, non-Cayman Islands legal, tax and commercial considerations will influence the constitution of the board.

- Both Private Funds and Mutual Funds are required to have their accounts issued or undertaken by an auditor approved by CIMA, which in practice will generally be the Cayman Islands branch of the AIF's (onshore) auditor. Aside from the audit (and the registered office), there is flexibility from a Cayman Islands legal perspective regarding the appointment of service providers required as a commercial matter.

- All Cayman Islands AIFs, including entities through which an AIF directly or indirectly invests or operates (such as general partner entities) are not subject to any substance requirements in the Cayman Islands (save for the basic requirements set out in the table above).

- The rules relating to anti-money laundering requirements, FATCA and the Common Reporting Standard apply equally to both Private Funds and Mutual Funds, as do the rules regarding data protection.

- CIMA's 'conduct of business' rules that apply to Private Funds and Mutual Funds, e.g. regarding the calculation of NAV and disclosure are, for practical purposes, similar (and aligned with market practice).

There are, however, some differences between the regulation of Private Funds and Mutual Funds, which need to be borne in mind in the structuring and launch process. These are as follows:

- *Disclosure.* Unlike Mutual Funds, Private Funds are not required to file an offering document with CIMA (a summary of terms is sufficient). However, where a Mutual Fund is not widely placed, there is scope for registering a Mutual Fund as a "Limited Investor Fund", which removes the requirement to file an offering document with CIMA. For a Mutual Fund to register as a Limited Investor Fund with CIMA, the AIF must be held by not more than 15 investors, the majority of whom are capable of appointing or removing the operator, i.e. the trustee, general partner, directors or managers (depending on the structure of the relevant vehicle) of the AIF.

- *Minimum Investment Threshold*. There is no minimum investment amount for a Private Fund or a Limited Investor Fund. However, the minimum initial equity interest purchasable by a prospective investor in a typical Mutual Fund is US$100,000 or equivalent.

- *Operator Registration with CIMA.* Operators of Mutual Funds (including Limited Investor Funds) that are companies, i.e. directors of exempted companies and SPCs, and managers of LLCs, must be appropriately registered with CIMA and in 'good standing' in accordance with the Directors Registration and Licensing Act. This requirement does not currently apply to operators of Mutual Funds that are not companies or to operators of Private Funds.

- *Timing of Registration with CIMA*. Both Private Funds and Mutual Funds (including Limited Investor Funds) are not permitted to carry on, or attempt to carry on, private or mutual fund business, respectively, unless an application has been submitted for registration with CIMA. A Mutual Fund must submit such application by the date it carries on, or attempts to carry on, mutual fund business, and a Private Fund must submit its application within 21 days of accepting capital commitments, and by the date capital contributions are received, from investors for the purposes of investments.

Conclusion

There are a range of vehicles available in the Cayman Islands that are able to accommodate most types of institutional, sophisticated and professional investors (depending on their specific requirements), strategies and broader structuring considerations. Once the appropriate form of AIF vehicle has been determined, the liquidity rights of the AIF will define the appropriate path to registering with CIMA either as a Private Fund (if the AIF is closed-ended) or as a Mutual Fund (if the AIF is open-ended). However, there are certain exceptions to the general rule that such AIFs are required to register with CIMA, which may be relevant to the structuring of the AIF.

In the event the AIF is required to register with CIMA, it is of note that the regulatory regimes in the Cayman Islands applicable to closed-ended and open-ended structures are now largely aligned. Some differences may, however, need to be borne in mind in the structuring and launch process.

The Modern Compliance Officer

Dale Emery
Vice President
Laven

Dale Emery has been a Compliance Officer and Head of Compliance at a number of well respected Authorised firms and is now a Vice President within Laven's Compliance Department. In this piece, he writes on what he sees to be the major challenges within the Compliance Industry and outlines a few tools in the arsenal that a Compliance Officer can utilise.

The role of a firm's Compliance Officer has steadily expanded over the last decade. In more recent years, a deluge of new regulations, coupled with an ever-increasing focus on personal liability and threat of enforcement has placed more pressure on the role.

Since the enormous burden imposed by the implementation of MiFID II and subsequent legislation such as SM&CR, Compliance Officers have routinely had to spread their time obligations more thinly across more duties. Further challenges have been presented by the COVID-19 pandemic. The sudden lack of proximity between staff and the move to an entirely electronic system of communication has thrown up its own set of hurdles, as well as heightening the threat of cyberattacks and further difficulties in ensuring that firms' data is kept secure. The situation will only be compounded by a busy schedule of new regulations being imposed on firms in the coming years.

Upcoming Regulatory Calendar

9th December 2020 - Reopening of temporary permissions regime (The FCA must be notified by 9th December in order to be included)

12th October 2020 - SFTR (securities financing) - came into effect

29th December 2020 - CRDV and BRRDII requirements come into force 29 Dec 2020

31st December 2020 – End of Brexit EU Withdrawal Transition Period

31st March 2021 – Senior Managers and Certification Regime (SM&CR) becomes enforceable.

26th June 2021 - Investment Firms Prudential Regime

28th June 2021 - CRDV & CRRII

Other regulation in 2021: - Review of AIFM, Financial Services Bill coming (including changes to insider dealing and prudential regime).

Upcoming regulation in 2022: (ESG Disclosure Regs: for UK asset managers/investment managers with > £50bn. For other managers this will be implemented in 2023)

The nature of the Compliance Officer role means that much of their day-to-day is taken up by dealing with all manner of ad-hoc tasks, preparing for deadlines, regular committee meetings, dealing with internal matters as well as dedicating a large amount of time to longer-term projects.

Finding any more time to keep up to date with regulatory updates and other developments can therefore prove to be difficult.

Many firms have turned to recruiting new compliance staff to manage the increasing workload. A shortage of highly skilled compliance practitioners means that this is often an expensive and difficult pursuit, however.

Regulators have in recent years frequently cited poor expertise and experience among compliance staff when making enforcement decisions and even with a well-resourced compliance department, the fast-moving regulatory landscape can make it difficult to adapt to new regulatory developments.

It is often hard for Compliance Officers and Managers to look beyond the daunting regulatory calendar as obligations and requirements mount up. However, at Laven, we've been exploring what Compliance Professionals can do to enhance their workflow and turn the role from just a "value protector" to also being a "value creator" within the business. One of the first obstacles to overcome in this regard is regulatory reporting which can still be paper-based or, even when outsourced to an external consultant, conducted over email and non-specialised software such as Microsoft Word or Excel.

The aim of turning Compliance Officers into "value creators" is to give them the freedom to take on a proactive approach to their work, rather than being bogged down in ongoing processes and spending much of their time 'firefighting' recurring administrative matters.

Regulatory Technology

Streamlining an entire compliance workflow may seem like a daunting task. However, the Modern Compliance Officer has a couple of relatively new tools in their arsenal that can aid them in this mission.

The most effective solution to this problem lies in using technology to organise the varied internal processes faced by the Compliance Officer.

'RegTech' or Regulatory Technology is software used to supplement or facilitate the compliance workflow. RegTech software is designed to reduce human error and create both time and cost efficiencies to help ensure compliance with regulatory and best-practice standards.

RegTech achieves this through centralising the management and compliance workflow in one single location installing more of a process into the compliance workflow.

These unique and innovative systems reduce human error and create both time and cost efficiencies to ensure compliance with regulatory and best-practice standards. It is worth saying that the majority of these RegTech software's do not seek to replace the Compliance Officer or undermine the importance of their expertise and experience, but rather support and supplements the role.

There are plenty of options to choose from depending on your business needs and internally we've witnessed that users will save up to 40% of the time usually spent managing their regulatory compliance workflow to ensure efficient use of their internal resources. The aim is to provide you with a highly functional environment populated with the core information that will allow point and clicks workflows.

Online Compliance Training

Another tool that the majority of Compliance Officers already utilise is Online Training programmes. Whilst it's important to state that Online Training will rarely entirely satisfy firms Regulatory requirements for training, it can certainly serve as the primary source of compliance education within a firm.

Since the start of the COVID-19 Pandemic and the shift to a predominantly work-from-home workforce, we have seen platforms improve their offerings to ensure connectivity and the sharing of knowledge amongst teams.

The Regulatory Scope of Staff Training has also increased in recent times. Whereas 10 years ago, the main obligations for FCA and PRA Authorised firms were Anti-Money Laundering ("AML") and Market Abuse Regulation ("MAR") which still carry legal obligations for firms within the Financial Services industry.

Regulators now recommend a much larger list of topics to be covered. Whether this is SM&CR and Conduct Rules Training, which is due to come into force end of March 2021 or the increased need for Data Privacy and Cybersecurity Training as Financial Services turn even more digital.

Whilst setting your staff tonnes of Online Training might satisfy the regulator, it is unlikely to go down well with your staff. Indeed, the new working-from-home norm has resulted in reported cases of "e-learning fatigue" amongst staff. To mitigate this, at Laven we have utilised different formats such as interactive text, video and audio to switch up how participants receive the information.

We have also recommended compliance staff take advantage of customisation options. We've seen that adding names, pictures and examples that are specific to the firm have seen a decrease in the number of times employees need to take the assessment before passing signalling hire engagement.

Artificial Intelligence (AI) to automate processes and manage Data Flows

While it is not yet possible to fully rely on AI to automate all of a firm's compliance processes, AI is already a feature of many firm's administrative procedures such as for monitoring and surveillance purposes.

'Machine Learning' processes are applied to detect complex patterns which highlight potential evidence of market abuse and other financial crime. With the aid of human analysis, these systems continually self-calibrate to enhance their processes.

This can greatly reduce the amount of false-positive search results and save time and therefore expense. The technology is increasingly being applied to both front and back-office procedures to improve efficiencies and accuracy.

Last year, the FCA announced the launch of the Financial Services AI Public Private Forum ("AIPPF") in conjunction with the Bank of England. Its stated aim is "to facilitate dialogue between the public and private sectors to better understand the use and impact of AI in financial services, which will help further the Bank's objective of promoting the safe adoption of this technology."

This affirms the regulator's stance that it is open to the proliferation of AI as a tool to be used by firms for implementing compliance procedures while ensuring that their use remains appropriate.

Webinars

Traditionally keeping up to date with the latest industry news and practices would involve the Compliance Officer attending regular seminars and conferences in person. This would often be a time-consuming process sometimes, taking up an entire morning or afternoon.

A switch to online webinars, facilitated largely due to the arrangements made necessary by the pandemic, has meant that their attendance now requires much less time and expense.
Various associations and regulators such as the FCA have seen their output of Webinars increase during the pandemic, a trend that will undoubtedly continue going forwards.

Bolster your Arsenal

The role of the Modern Compliance Officer is not an easy one, especially given the vast swathe of new regulatory obligations firms are having to undertake as laid out in the table earlier. There are, however, several tools at their disposal that can serve to turn their job form primarily value protection, to a value creator and a key contributor to the wider success of the firm.

A regulator changed course on data collection. Why?

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HOW WE GOT HERE

After the 2008 global financial crisis, a broad range of investment managers faced a tsunami of regulatory reporting requirements across multiple jurisdictions. Filers not only need to aggregate data from multiple sources, normalise and enrich it to make it usable, but also frequently submit different data fields (and use different calculation methodologies) for reporting in different jurisdictions. It's no wonder that to many, this continues to feel like an insurmountable task.

Compliance costs increased. New technology emerged and existing systems were rejigged to help in the process. It was, and continues to be, a challenging experience for all involved, but one deemed necessary by the regulators to aid in identifying trends and monitoring for systemic risk.

The CFTC

In the United States, a massive piece of financial reform legislation, the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] mandated that the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC) begin collecting information from investment advisers about the private funds they manage. Reporting on the resulting form, Form PF, began in 2012.

Although not required to do so, the CFTC went beyond Form PF and produced its own reporting requirement, Form CPO-PQR.[2] CPO-PQR would capture more Commodity Pool Operators (CPOs) than those caught under Form PF.

It required detailed information about commodity pools, including borrowings, trading and clearing mechanisms, value of aggregated derivative positions, geographical breakdown of pool investments, turnover rates, and liquidity and counterparty credit exposure.

The CFTC reasoned that it needed the additional information for several broad purposes, including: (1) increasing the CFTC's understanding of its registrant population; (2) assessing the market risk associated with pooled investment vehicles under its jurisdiction; and (3) monitoring for systemic risk. [3]

Many of the questions were challenging to calculate and required numerous underlying assumptions that would vary from filer to filer. Further, CPOs maintained information in different ways. The CFTC took this into account and allowed filers a substantial amount of flexibility in the assumptions applied as well as calculation methodologies.

In addition to this, because the Form required a large volume of complex data, the CFTC did not require that reporting be done in real-time.

1 Public Law 111-203, 124 Stat. 1376 (2010).

2 Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 FR 11252 (24 Feb. 2012) ("2012 Form CPO-PQR Final Rule"), https://www.govinfo.gov/app/details/FR-2012-02-24/2012-3390.

3 2012 Form CPO-PQR Final Rule at 11253-54.

Instead, the information could be reported on a delayed basis, with firms keeping track of their size to determine whether to report quarterly or annually.

THAT WAS THEN, THIS IS NOW

Today, the CFTC is effectively walking away from that requirement. On 10 November 2020, the CFTC adopted amendments to Form CPO-PQR, [4] omitting most of the pool-specific details. Gone is the asset liquidity and concentration of positions requirement. So are clearing relationships, risk metrics, financing, as well as investor composition.

It also transitioned to a more standard "one size fits all" filing, with the same reduced form to be submitted by all CPOs on a quarterly basis, regardless of AUM size.

WHY THE CHANGE?

The CFTC made the about-face for three main reasons:

1. Information was not being used

Some of the more detailed information for commodity pools was removed because the CFTC was not able to make full use of the information, as originally expected. [5]

The CFTC believed that the detailed pool-specific information would help it identify trends over time, including a pool's exposure to asset classes, the composition and liquidity of a pool's portfolio, and a pool's susceptibility to failure in times of stress.

But, as CFTC Chairman Heath P. Tarbert pointed out in his supporting statement to the final rule, the "'garbage-in, garbage-out' predicament—that is, the concept that flawed, or nonsense, input data produces nonsense output or 'garbage'" applies to much of the CPO-PQR. [6]

As it turns out, somewhat unsurprisingly to some industry pundits, you cannot apply an apples-to-apples comparison across an industry when the data comes from firms applying different assumptions and utilising different calculation methodologies. Add to that the infrequent and delayed reporting of the data and you have information that is unusable for spotting trends and monitoring for systemic risk.

2. Information could be found elsewhere

Some of the data could be found elsewhere, in a trusted, consistent format and on a timelier basis. In revising the form, the CFTC mentioned that it had devoted substantial resources to developing other data streams and regulatory initiatives. [7]

The CFTC found that these other data streams (which include information related to trading, reporting, and clearing of swaps), were often more useful, more robust and obtained in a more timely fashion than the information provided via the CPO-PQR filing.

The CFTC explained that most of the transaction and position information that is used for surveillance is available elsewhere and on a more frequent basis. [8] The added benefit of getting data in a more consistent format and on a timelier basis is that it makes it easier to combine the data into a holistic surveillance program. [9]

4 Compliance Requirements for Commodity Pool Operators on Form CPO-PQR, 85 Fed. Reg. 71772 (10 Nov. 10 2020), https://www.federalregister.gov/d/2020-22874 (the "Adopting Release").

5 Amendments to Compliance Requirements for Commodity Pool Operators on Form CPO-PQR, 85 Fed. Reg. 26378 (4 May 2020), https://www.federalregister.gov/d/2020-08496 ("the Proposing Release"), at 26380.

6 The Adopting Release at Appendix 2 (Supporting Statement of Chairman Heath P. Tarbert).

7 Ibid. at 71811.

8 Ibid. at 71811.

9 Ibid. at 71775.

3. Regulatory priorities have evolved

When it first proposed the revisions, the CFTC stated that it was reassessing the Form's scope and alignment with the regulator's current regulatory priorities.[10]

While looking after the best interests of the investor as well as the sustainability of the market as a whole, regulators must balance competing demands with limited resources. In explaining its decision to revise the Form, the CFTC stated that "challenges with the data collected...combined with the resource constraints of broader [CFTC] priorities, have frustrated the [CFTC's] ability to fully realise its vision for this data collection."[11]

The CFTC determined that it could still monitor CPOs and their pools via other data streams. In the end, the CFTC opted to prioritise its limited resources to pursue other key regulatory initiatives.

TAKE-AWAYS

Reducing reporting burdens takes intention

The CFTC could have left the CPO-PQR reporting requirement alone and simply not used the data. It also could have published guidance to rein in the flexibility it initially provided filers. Both could have frustrated filers and possibly still failed to provide the regulator what it needed.

But instead of doing these things, it acknowledged that it could not use some of the data for its intended purpose, and that it could get other data elsewhere that was just as good (if not better) for it to reach its new priorities. So it stopped collecting the data.

This is just one example of the CFTC's ongoing efforts to review the regulatory use cases for reported data, as well as identify where other data channels can be accessed to achieve its ultimate objectives.

Regulatory priorities evolve - so should regulatory data practices

Regulatory priorities shift with evolving financial markets, changes in government, and new unforeseen stress events. This does not necessarily need to mean more regulation. Instead, such changes could simply mean different approaches to data analytics. Progressive regulatory bodies are open to shifting regulatory reporting practices as markets evolve with the times.

Regulations are not static; firms cannot rest

Adjusting to the new regulatory world after the global financial crisis was quite a heavy lift. But there is no rest for the weary. Just as the reporting requirements became "business as usual" for firms, regulators altered reporting schemas, guidance, and reporting mechanisms. As they become more sophisticated and learn more over time, regulators will continue to shift on what data they want and how such data will be used.

Asset management firms must have an agile process, utilising services and state-of-the-art technology, to accurately complete required regulatory filings. A change in schema or guidance should not overload in-house technology teams or disrupt the overarching business of the firm.

Even when the regulatory change seemingly makes reporting easier, there is still a process firms must go through to accurately capture the evolving requirements and subsequently enact the changes. This process is made easier for those who have built partnerships with key service providers and subject matter experts.

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10 The Proposing Release at 26380.

11 The Adopting Release at 71775.


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UK Regulatory Enforcement Outlook for 2021: An appetite for improvement

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Introduction

Amid the uncertainty brought about by the end of the Brexit transition period and the ongoing Covid-19 pandemic, asset managers should be aware that the UK Financial Conduct Authority ("FCA") will retain an active approach to financial crime and regulatory enforcement in 2021. in the FCA's areas of focus in the asset management industry are likely to be:

- Ensuring firms are continuing to operate effective systems and controls despite the disruptions caused by the ongoing pandemic. Indeed, a recent FCA Market Watch newsletter[1] reminded firms of the importance of effective controls for monitoring and recording communications and the role those controls play in deterring and detecting market abuse.

- Overseeing firms' progress in addressing the areas of concern set out in last year's "Dear CEO" letters to the asset management industry, including prioritising effective governance through the application of the Senior Managers and Certification Regime (SM&CR). [2]

Potential areas of enforcement focus in 2021

The FCA's open cases as at 31 March 2020 highlight the emphasis placed by the FCA on financial crime (71 open cases) and insider dealing and market manipulation (117 open cases). While Covid-19 may have impacted the FCA's enforcement capacity, we anticipate a continued emphasis on both of these areas, with firms needing to adapt to the evolving risks presented by new working environments. The areas we consider are likely to be a focus for the FCA over the next 12 months in its pre-enforcement and enforcement activity are set out below.

Market abuse

In last year's Dear CEO letter, the FCA observed that there was "***significant scope for improvement,***" in alternative investment firms' market abuse controls.[3] These risks have been heightened by the pandemic and, even prior to the pandemic, market abuse was a significant focus for the FCA. In an October 2020 speech, the FCA made it clear that "going forward, office and working from home arrangements should be equivalent – this is not a market for information that we wish to see be arbitraged."[4] The FCA's expectations in this area will require asset management firms to:

- Continuously update market abuse risk assessments and policies to ensure they remain fit for purpose amid changing working environments.

1 https://www.fca.org.uk/publications/newsletters/market-watch-66

2 FCA Business Plan, 2020/21.

3 https://www.fca.org.uk/publication/correspondence/portfolio-letter-alternatives.pdf

4 https://www.fca.org.uk/news/speeches/market-abuse-coronavirus

- Ensure that where encrypted messaging apps or video conferencing facilities are used for in-scope activities – including managing investments – they are "recorded and auditable".
- Regularly review insider lists, those who have access to them and consider the changing nature of what constitutes inside information – for example, knowledge of whether a company has utilised the furlough scheme.
- Implement rigorous oversight processes reflecting the new working environment.

Cum ex issues

Firms involved in lending equities around dividend dates should review their practices for potential exposure to the world's largest tax evasion investigation into dividend-stripping schemes, known as the "**Cum Ex**" investigation, with the FCA currently in the process of determining whether to take regulatory action against participants.

Short selling strategies

The FCA's enforcement activity in 2020 included its first fine under the EU Short Selling Regulation in connection with a firm's failure to make appropriate notifications and disclosures of a net short position. Short selling has recently been (indirectly) under scrutiny and firms employing short selling strategies should be particularly conscious of their reporting obligations.

AML systems and controls

AML systems and controls will remain high on the FCA's agenda with a particular focus on governance by senior managers and the prominence afforded to AML within firms' governance models. Recent enforcement activity demonstrates that firms and senior managers must ensure a comprehensive documented process for exiting customer relationships, a process for refreshing KYC checks, and effective transaction monitoring systems.

Alternative investment funds dealing with cryptoassets must also be alert to the heightened money laundering risks. We anticipate that further regulation and enforcement with respect to cryptoassets is inevitable, with HM Treasury launching a consultation and call for evidence in January 2021 on the UK regulatory approach to cryptoassets.[5]

AML issues are not just a focus in the UK. The US FBI identified concerns last year over the use of the private placement of funds, including investments offered by hedge funds, to launder money and evade sanctions, and has cited a lack of adequate controls as a risk area.

Sanctions systems and controls

The FCA is alert to sanctions systems and controls failures and some of the largest ever fines issued by the FCA have touched on weaknesses in sanctions-related controls. The UK sanctions regime has also changed as a result of Brexit. Firms must ensure that their sanctions screening systems take into account both the new UK sanctions regime and any nuances in the way that existing sanctions legislation has been updated post-Brexit.

Individual accountability – SM&CR

The FCA flagged in their Dear CEO letter last year to asset managers that "***Overall standards of governance… generally fall below our expectations***"[6] and have reiterated in a recent Market Watch newsletter that Senior Managers have an important part to play in embedding the right culture and governance within firms. Senior managers should ensure their governance processes place sufficient emphasis on the implementation of SM&CR and should expect the FCA to take particular interest in any failings. Senior managers should feel confident that:

- **They understand** the regulatory environment of their business.
- They have the **right compliance tools** and management information to enable them to effectively carry out their roles.

5 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/950206/HM_Treasury_Cryptoasset_and_Stablecoin_consultation.pdf

6 https://www.fca.org.uk/publication/correspondence/asset-management-portfolio-letter.pdf

- **Policies and procedures** are **appropriately tailored** to their business model and are comprehensive and robust enough to discharge responsibilities under the Market Abuse Regulation (MAR).

Cybersecurity

The damage from the recent Solar Winds hack in the US has been substantial and, in light of widely reported increases in cybercrime (along with the FCA's focus in its Dear CEO letters to asset managers on managing technological and cyber risks), firms would be well advised to ensure that their cybersecurity systems and controls are sufficiently robust.

Client Assets

The FCA has recently taken action for failures in the adequate protection of client assets, even in circumstances where no actual client assets or money were lost. Client asset arrangements are a perennial focus for the FCA; in its 30 September 2020 'Dear CEO' letter, the FCA set out that it is imperative to maintain adequate arrangements to safeguard client assets amid the uncertainty caused by Covid-19.[7]

Conflicts of interest

The FCA requires firms to manage conflicts of interest fairly, as conflicts may arise between the interests of the fund and investors, and also between affiliates such as AFMs and delegated investment managers. The FCA is currently investigating 11 fund firms as part of its review into Authorised Corporate Directors (ACDs). This relates to potential conflicts of interest around external ACDs' governance and oversight of retail investment funds. The FCA has also taken action when institutional clients have been treated differently to retail clients.

Firms and senior managers need to ensure that they have controls in place to identify conflicts at all levels and structures, both vertical and horizontal, to enable appropriate disclosures to be made when necessary.

Environmental, Social and Governance (ESG) for the regulated sector

Asset managers are subject to increasing regulatory disclosure requirements in relation to sustainability risk and ESG issues. One example is the EU Sustainable Finance Disclosure Regulation[8] which applies to asset managers established in the EU and those marketing to EU-based investors via National Private Placement Regimes. The UK has also produced a 'regulatory roadmap' that will ultimately require managers to disclose against the Task Force for Climate-related Financial Disclosures.

Where asset managers are required to disclose their approach to sustainability risk and ESG, regulators may be increasingly focused on the suitability and accuracy of those disclosures and it may also present risks of litigation from investors.

Regulatory permissions

The FCA has also taken action where firms have had incorrect permissions for the activities they are carrying on. On the other hand, the FCA recently announced in response to a high-profile independent investigation into a collapsed investment fund that it will "undertake a 'use it or lose it' exercise, with firms that have not used their regulatory permissions to earn any regulated income for the last 12 months at risk of having their Authorisation revoked, to reduce the risk of firms using a permission to carry out regulated activity purely to add credibility to their unregulated activities." [9]

These recent events are reminders for firms to ensure they have the appropriate regulatory permissions and that they cancel any permissions that they no longer require.

7 https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-general-issues.pdf

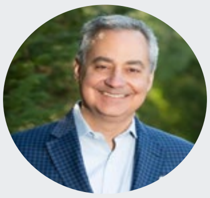
8 https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32019R2088&from=EN

9 https://www.fca.org.uk/publication/corporate/lcf-independent-investigation-response.pdf. Dechert's London office supported the Independent Investigator in connection with the investigation into the FCA's regulation of London Capital & Finance plc (https://www.dechert.com/knowledge/news/2021/2/dechert-supports-dame-elizabeth-gloster-in-her-independent-inves.html)

What can firms do?

It is clear from FCA statements that the regulator is not substantially relaxing its expectations of firms because of the challenges of different working practices arising from the pandemic. Firms, and particularly asset managers, must assess the adequacy of their systems and controls in the areas highlighted here and in the FCA's previous Dear CEO letters, and take risk mitigation steps to remedy weaknesses.

Pandemic progress, not compromise: How investor relations found a way forward under lockdown



Ron Biscardi
CEO
iConnections

For many, the pandemic has been a story of compromise and make do. As the world shifted to remote working overnight, the lack of face-to-face interaction made day-to-day activities in some industries difficult. Reliant on networks and meetings, early on, fund allocation seemed an area likely to fall victim to Covid-19.

The reality, however, has been different.

Despite challenging conditions, in many ways, the industry has expanded. In spite of lockdown, connections between managers and allocators have continued to flourish with thousands of hours of meetings being held in new work-from-home environments.

With physical meetings and conferences being put on hold, the industry has had to find new ways to reignite activity and match allocator capital with investment strategies. The key to success has been combining human investor relations expertise with the tools and data already at our fingertips.

By harnessing technology to enhance rather than replace the human touch, investor relations teams around the world have been able to use information to help managers and allocators understand how to connect with the right partners.

The world of capital introductions is not a simple self-service model like price comparison websites: while data and algorithms are vital in the initial identification and intelligent matching of manager and allocator preferences, the human touch is key to leveraging information to ensure that clients receive the best results.

With the end of lockdown in sight, the prospect of a transition back to a more familiar way of working will inevitably start appearing in managers' and allocators' diaries, and face-to-face meetings and physical conferences will become a real prospect.

While the knowledge that we will soon reclaim a more normal working life is exciting, 'the great work from home experiment' has been invaluable in teaching us important lessons in how to work more effectively and drive results. We have seen significant benefits to capital introductions under lockdown which we think will endure once the pandemic subsides:

- With complex requirements and significant amounts of capital at stake, trust in a platform and the assurance of a team are invaluable. Holding informal meetings such as virtual 'coffee chats' for managers and allocators after matching on paper is an effective and informal means to build relationships and discuss how to work together. These meetings recreate a familiar and comfortable work setting that do not require significant travel or time investment, yet the data and expertise that underpins the meetings more often than not generate a positive outcome.

- For smaller managers, the shift to virtual working has had its benefits. Where before, some may have felt they were fighting for attention in a crowded room, the pandemic has afforded high-potential emerging managers an audience with previously difficult-to-access allocators. A more equal and less-biased approach has emerged where managers are selected based on strong figures and track records, rather than relying on existing networks and ideas.

- Enriching managers' sales funnels with data and analytics has also proved vitally important. Seeing which pieces of content caught the eye of allocators or how firms are interacting with their profile helps users to adapt their strategies, allowing managers to generate the best results and streamline their sales processes.

It is more likely than not that the outcome of the return to work in the alternative funds industry will be a hybrid model in capital allocation. While there will be physical meetings as we had pre-pandemic, the industry will be more reliant on intelligence derived from platforms to match need and requirements to enhance the due diligence process.

The industry will also use insights taken from content marketing to understand the ideas that are gaining interest and how to increase engagement with prospective clients. While some meetings will no doubt return to taking place physically, in many cases, it will make sense to continue meeting virtually, armed with vital data and insights, to save time and costs in a format that the industry has quickly grown comfortable with.

These benefits have longevity and will extend far beyond the pandemic. Many of the working practices developed over lockdown have been to the benefit not the detriment of investor relations and have afforded managers and allocators more flexibility, greater efficiency, and the means to expand their immediate networks. We foresee that at the centre of this hybrid model will be human curators: investor relations teams who manage these large data sets, derive insights and advise managers and allocators to deliver the best outcomes.

Humans will be instrumental in maintaining and building these relationships in the virtual and physical realm. With so much information at our disposal, human guides who not only understand the data but also managers' and allocators' individual businesses will be essential to match requirements and free-up their clients' time to allow them to do what they do best.

While we have moved to a virtual working world, humans are more important than ever and working with a centralised community with unprecedented access to data and insights will be critical to delivering alpha.

The investment limited partnership: A new dawn for Irish private funds

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With consistently low and in some cases negative interest rates and high valuations in public equities, the hunt for yield has enticed more investors to consider allocating to illiquid asset classes in long-term, closed-ended products.

Private equity (**PE**) and venture capital (**VC**) has experienced an average growth rate of 9.9% over the past decade, with assets under management recently exceeded a record $4.74tn.[1] Limited partnerships have been and continue to be the structure of choice for PE and VC investors and sponsors.

Against this backdrop, the Irish government has worked in collaboration with the Irish funds industry and the Central Bank of Ireland (**Central Bank**) to modernise and enhance the existing Irish investment limited partnership (**ILP**) legislation. The outcome of this collaboration is a modern, efficient, regulated yet flexible partnership vehicle.

What is the ILP?

The ILP is a regulated, AIFMD-compliant common law partnership structure, tailored specifically for Irish investment funds. The ILP is established on receiving authorisation by the Central Bank and, as with its international counterparts, is formed by a limited partnership agreement (**LPA**) entered into by one or more general partner(s) (**GPs**), who manage the business of the partnership on the one hand, and any number of limited partners (**LPs**) on the other hand.

Since the ILP has no legal personality, it acts through its GP, who is ultimately liable for the debts and obligations of the ILP. The GP can be a standalone entity who appoints an external alternative investment fund manager (**AIFM**) or it can be an Irish or EEA AIFM.

There are no restrictions on the number of LPs that can be admitted to an ILP. As they are passive investors, their liability is limited to the value of their investment, except where they become involved in the management of the partnership. The ILP legislation includes a non-exhaustive list of safe harbour activities that can be carried out by LPs without being deemed involved in the management.

All of the assets, liabilities and profits of the partnership belong to the partners in accordance with the partnership agreement.

The ILP is tax transparent for Irish tax purposes and is not subject to Irish tax on its investment income and gains. For Irish tax purposes, the income and gains of the ILP are treated as arising to each LP in accordance with the apportionment under the LPA as if the income or gains had arisen to the relevant partner without passing through the hands of the ILP.

A regulated yet flexible partnership structure

As a regulated structure, the ILP can be set up as a qualifying investor AIF (**QIAIF**) or a retail investor AIF. Historically, managers have been most interested in the QIAIF category, which is designed for sophisticated investors and is very flexible. In order to invest in a QIAIF, investors must meet the "qualifying investor" criteria and

1 2021 Prequin Global Private Equity & Venture Capital Report.

commit at least €100,000. ILP QIAIFs can be structured to suit all major investment strategies and can avail of a full suite of liquidity options making it suitable for PE, real estate, venture capital, infrastructure, sustainable finance, credit, lending vehicles, managed accounts, hybrid funds and hedge funds. ILP QIAIFs are not subject to legal risk spreading obligations, making them extremely useful for single asset funds and/or funds with very concentrated positions.

Importantly in the real asset investment space, ILP QIAIFs can avail of streamlined capital drawdown structures and provide for robust enforcement provisions in the case of defaulting LPs.

Furthermore, there are no restrictions on the use of financing by the ILP, its subsidiaries or its alternative investment vehicles with full security packages available to lenders over all assets, including contractual call rights in any master/feeder structure. There is also flexibility for an ILP to utilise subscription financing, margin lending, NAV and other types of facilities including total return swaps and other derivative arrangements.

One of the key selling points of the ILP QIAIF is its speed to market. Provided that all service providers (AIFM, investment manager, depositary, administrator) are approved by the Central Bank in advance, the ILP can avail of the Central Bank's 24-hour authorisation process.

Enhancements to the ILP

The enhanced ILP legislation (the Act) came into effect on 1 February 2021 and introduced a series of best practice features, some of which are set out below.

Clarification of rights and obligations of LPs	LPs can be divided into sub-categories for example for regulatory reasons, fee treatment, rights and voting. The concept of a "majority of limited partners" provides flexibility to specify a majority by number, value, class or a majority that is higher than a simple majority. Expansion of the non-exhaustive list of safe harbor activities, which can be performed without affecting limited liability status, including participation on LP investment committees.
Simplification of the administration of changes in GPs	Provision for the statutory novation of assets and liabilities on substitution of a GP without further formality. Express confirmation of the ability to transfer a GP's interest and provision for the liability of incoming and outgoing GPs.
Changes designed to make ILPs run smoother	It is no longer necessary for all partners to consent to changes to the LPA and the Act allows for approval by a majority of partners or without partner approval where the depositary certifies that the change is non-prejudicial.
Umbrella funds	The Act allows ILPs to be set up as an umbrella fund with segregated liability between sub-funds. This is unique among common law partnerships and allows ILPs to be set up with multiple sub-funds.
Migration of partnerships	The Act allows for the migration of partnerships into and out of Ireland on a statutory basis, removing uncertainty associated with the legal migration of a partnership.
Alternative foreign name	An ILP can now register an "alternative foreign name", with official recognition.

Central Bank Guidance

In parallel with enhancement introduced by the Act, the Central Bank has published helpful Guidance on share class features of closed ended QIAIFs. This clarifies the ability to facilitate key features of PE funds.

The Guidance specifically provides for:

- the issue of interests at a price other than NAV, without prior Central Bank approval;
- application of excuse and exclude;
- stage investing; and
- management participation through establishment of management or "carry" classes.

As well as providing for these helpful features, the Central Bank clarified that it no longer requires a GP who appoints an external AIFM to be separately authorised. Instead it relies on the directors of the GP being subject to the Central Bank's fitness and probity requirements.

Sustainable Investments

Any discussion of the enhanced ILP would not be complete without further focus on sustainable investments.

The European Commission's Action Plan: Financing Sustainable Growth (Action Plan) sets out the EU Strategy to integrate ESG considerations into its financial policy framework and mobilise finance for sustainable growth. A key objective of the Action Plan is to create an environment to raise the estimated €175 and €290 billion per year of private capital needed to finance a sustainable infrastructure and related investment.

The European Commission also presented its Green Deal in December 2019. This hugely ambitious project sets out a growth strategy aiming to make Europe the first climate neutral continent by 2050. As part of the Green Deal, a European Green Deal Investment Plan (the Plan) was presented in January 2020 seeking to mobilise at least €1 trillion of sustainable investments over the next decade.

The Plan envisages a framework to facilitate the public and private funding needed for a transition to a climate-neutral, green, competitive and inclusive European economy.

Owing to the flexibility on investment restrictions, borrowing and related features as well as the speed-to-market, the ILP QIAIF is likely to be among one of the more popular regulatory categories for ESG funds. AIFMs have already taken full advantage of the flexibility provided by QIAIFs to invest in sustainable asset classes as varied as forestry funds, wind and solar power plants and this trend is likely to intensify with the recent enhancement of the ILP.

Conclusion

The enhanced ILP and helpful Central Bank Guidance come at an opportune time where there have been increasing allocations to private funds from pension plans, insurance companies and other institutional investors, many of whom prefer or are required to invest through more regulated products. It also comes at a time where sustainable finance is a dominant theme in the European investment industry.

The modern and efficient ILP now strikes the right balance between regulation and flexibility and it is uniquely placed to meet the requirements of investors who require a regulated structure. Its flexibility and speed to market also position the ILP to play a significant role in raising private capital to meet sustainable investment targets set by the European Commission.

Hedge funds start integrating ESG

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While 2020 was a disruptive year for many financial institutions, it was a positive one for asset managers running ESG (environment, social, governance) strategies. This is because COVID-19 prompted investors to think more carefully about sustainability, a by-product of which was that ESG funds attracted increased net inflows - totalling $71.1 billion between April and June 2020 - thrusting their global AuM (assets under Management) past $1 trillion. [1]

In the US, sustainable funds amassed a record $21.4 billion during the whole of 2019, but last year's fundraising efforts had already exceeded that amount by September – after accumulating $30.7 billion. [2] Hedge funds are also becoming more active around sustainability issues, although they have been slower than traditional asset managers to integrate ESG into their investment processes.

A survey by BNP Paribas of 53 hedge funds running more than $500 billion in combined AuM found 40% of managers include ESG considerations in their investment processes, whereas the rest do not. However, the BNP Paribas study added that it anticipated most hedge funds will adopt ESG approaches by 2022.[3]

ESG funds put in a powerful performance

Countless columns have been devoted to hypothesising about whether ESG funds outperform non-ESG funds or not. Sceptics have repeatedly attested that there is insufficient historical data to evidence any outperformance by ESG managers, although recent analysis by Morningstar revealed that close to 60% of sustainable funds have delivered higher returns than their opposite conventional fund numbers over the last 10 years. [4] ESG hedge funds have also produced solid returns over the last 12 months in what should strengthen their appeal among global institutions.

1 Morningstar analytics
2 Morningstar analytics
3 BNP Paribas (October 28, 2020) Where are hedge funds on the ESG spectrum?
4 Financial Times (June 13, 2020) Majority of ESG funds outperform the wider market over 10 years

It is highly likely that there will be a significant jump in the number of hedge funds launching ESG strategies over the next 12 months, mainly because of rising institutional demand for sustainable investment products.

A study by PwC found 77% of European investors – including pension funds and insurance companies - intend to stop using non-ESG investment strategies by 2022.

Index Name	Nov 20	2020 YTD returns (%)
Eurekahedge ESG Hedge Fund Index	7.25	6.51
Eurekahedge North American Hedge Fund Index	5.71	10.36
Eurekahedge European Hedge Fund Index	4.25	1.83
Eurekahedge Japan Hedge Fund Index	2.82	-1.54
Eurekahedge Asia ex Japan Hedge Fund Index	4.44	16.73
Eurekahedge Arbitrage Hedge Fund Index	1.68	8.13
Eurekahedge CTA/Managed Futures Hedge Fund Index	2.20	4.21
Eurekahedge Distressed Debt Hedge Fund Index	0.67	-0.69
Eurekahedge Event Driven Hedge Fund Index	4.97	2.42
Eurekahedge Fixed Income Hedge Fund Index	2.77	3.66
Eurekahedge Long Short Equities Hedge Fund Index	6.40	11.75
Eurekahedge Macro Hedge Fund Index	2.92	6.82
Eurekahedge Multi-Strategy Hedge Fund Index	3.62	6.43
Eurekahedge Relative Value Hedge Fund Index	6.78	9.59
Eurekahedge Hedge Fund Index	4.33	8.05

Source: Eurekahedge

European investors are widely considered to be ahead of the curve when it comes to ESG, at least when benchmarked against US allocators. Whereas four in 10 European and Asian pension funds have pledged to meet net zero carbon emissions by 2050, only one in five US schemes has made a similar commitment. [5] However, attitudes towards ESG among US institutions seem to be slowly changing

A study undertaken by the Financial Planning Association in 2018 found 26% of financial professionals were either using or recommending ESG funds to clients. The same survey conducted in 2020 revealed this percentage had increased to 38%. Several high profile US institutions – including the likes of CALPERS and Wespath - have signed up to the UN-backed Net Zero Asset Owner Alliance, a consortium comprised of 30 of the world's largest investors – all of whom have committed to reduce carbon emissions linked to the companies they invest in by 29% within the next four years. [6]

In January 2021, two of the five pension funds in the New York City Retirement Systems confirmed they would divest $4 billion from securities linked to fossil fuels. A failure to transition towards net zero is a pertinent risk management issue, a point made by Larry Fink, CEO at BlackRock in a recent investor letter. In the letter, Fink warned that those companies failing to adapt or transition towards net zero would see their businesses and valuations suffer. It is clear that more global investors are now prioritising ESG, and it is something which hedge funds need to respond to.

5 AI CIO

6 Financial Times

Regulators make their case on ESG

Regulation of ESG is becoming increasingly ubiquitous across a number of global markets. Again, the leaders here are widely acknowledged to be the EU, which will introduce a Sustainable Finance Disclosure Regulation (SFDR) rule in March 2021, forcing asset managers and asset owners to publish on their websites information on how they integrate ESG into their investment activities. From next year, EU regulators will demand that managers specialising in ESG and sustainability file a very detailed template outlining their ESG practices.

The EU rules will also create a taxonomy as regulators look to facilitate greater consistency in terms of what can be classified as being a sustainable economic activity. The taxonomy comes amid investor and regulatory concerns about green-washing (e.g. a lack of clear sustainable investment definitions) at fund managers. This is evidenced in a Schroders study, which found that around 60% of investors identified green-washing as being one of the most significant obstacles impeding their sustainable investment intentions.

In contrast, US regulation on ESG investing has been fragmented. A number of states including California, Illinois, Connecticut, New Jersey, New York, Oregon and Washington are pushing through with requirements designed to encourage their public pension funds to invest more sustainably.

However, the Department of Labor (DOL) – under the previous US administration – introduced a rule in October 2020 demanding pension funds prioritise financial returns when making asset allocations - as opposed to ESG criteria. Despite this, the new US administration is putting an enormous emphasis on the environment, suggesting there will now be a much greater focus on ESG investing.

Data continues to be a barrier

However, there are concerns about the quality of ESG data being disclosed by managers to their investors. One of the primary problems is that there are no harmonised ESG data standards. Instead, there are many different ESG standards and protocols, all of which have their own characteristics. With different managers subscribing to different ESG standards, the reports they produce for clients are often inconsistent and even contradictory. Similarly, ratings agencies will often have their own bespoke methods of collecting data from companies they are scoring. For instance, some ratings agencies will solely rely on questionnaires while others will only use publicly available information. Without a common data collection methodology, the ratings agencies' scoring processes will be fragmented. It is vital hedge funds work together towards improving ESG data quality and standards.

ESG: The future of investing

Hedge funds are embracing ESG for several reasons. Many have now accepted that the performance benefits of investing in ESG securities and assets are worthwhile. With more institutional investors incorporating ESG criteria into their selection processes, firms will need to take note if they are to successfully attract mandates. At the same time, regulators – including those in the US – are expected to be more proactive on ESG - in what could help further accelerate flows into ESG funds.

BAI Alternative Investor Conference

Virtual Event

27-30 April 2021

BAI AIC – A Virtual Venture

Prof. Dr. Beatrice Weder di Mauro
Professor of International Economics, Graduate Institute of International and Development Studies / IHEID
Research Professor and Distinguished Fellow Emerging Markets Institute, INSEAD, with the speech **"The Post-Covid World" on April 27, 2021**

Dr. Jörg Kukies
State Secretary, Federal Ministry of Finance (BMF), with a speech **on the role of Germany as a fund location in the sustainable and digital transformation in the EU, on April 28, 2021**

Prof. Dr. Veronika Grimm
Chair of Economics, Friedrich-Alexander University Erlangen-Nuremberg
Member of the German Council of Economic Experts, with the speech **"Green Investments: Challenges and Opportunities" on April 29, 2021**

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Business2Schools

Business2Schools encourages firms that have furniture and tech they no longer need, to donate these things to state schools; so they can be re-homed and re-used in classrooms across the UK. Donating the office infrastructure that businesses have finished with, rather than recycling, are fantastic measures of ESG, sustainability, the circular economy and climate change.

School furniture is replaced over decades, with computers and laptops on a 10-year replenishment cycle. Giving the things businesses don't need to schools has a huge impact on learning.

Lockdown has meant that schools have been hit heavily by the digital divide, which is those children and students unable to access online learning. The Department for Education said its data showed that over 700,000 devices have been delivered to schools in England but with many more families being classed as disadvantaged, just by nature of the size of their family, so many more devices have been needed.

For some working families with two or three children, one device in the home is not enough. **Leila Coward Head, St Thomas More Bexleyheath** said. *"Parents are finding difficulty enough working from home and being their child's teacher, without having to schedule timetables for the only device in the household."*

The BBC Make A Difference Campaign has really put Business2Schools on the map and there are now over 4,000 schools signed up across the UK and Ireland.

"The sheer volume of schools requesting help shows that there is a need for devices across the country" said **Colette Doran-Hannon, Head of Schools, England & Ireland Business2Schools.**

The BBC appeal has seen businesses donate over 86,000 devices, but this falls very short of the 1.7 million children affected by the digital divide. When schools return in the spring devices loaned so far will be returned to classrooms. Those children already affected by digital poverty will go back to being unable to access online learning for their homework. Operation "*Catch Up*" and "*Education Recovery*" are key criteria that education needs to address. More laptops and computers will really speed this process up.

Post lockdown the people tasked with getting the nation back on its feet over the next decades will be the children in our schools. We need to give them the tools they need to have access to online learning both at home and at school for the duration of their learning.

"Businesses hold the key to closing the digital divide and giving fairer access to education for all children. Recycling should not be the first option for businesses, when we have now opened the door to a solution that finds new homes for unwanted office infrastructure. We are changing the landscape for learning and impacting the outcomes for every state school child in the UK. How could you not want to get involved when you see the incredible smiles our charity brings to children and their teachers?" **Lindsey Parslow, Chief Executive Business2Schools**

www.business2schools.com info@business2Schools.com Registered Charity: 1185674

AIMA Events

AIMA continues to deliver a varied programme of events for members through virtual platforms. Hosting over 270 complimentary events annually, there is a wide selection of educational and thought leadership content for peer-to-peer learning.

20 - 21 April
Alternative Credit Council Global Virtual Summit 2021

29 April
Acorns of APAC - Emerging Manager Outreach 2021

5 - 6 May
Alternative Investments Conference 2021

10 June
AIMA APAC Annual Forum 2021

15 September
AIMA Australia Annual Forum 2021

12 - 15 October
AIMA Global Investor Forum 2021

21 October
AIMA Singapore Annual Forum 2021

30 November
AIMA Japan Annual Forum 2021

9 December
AIMA China Live 2021

Visit our video library of event replays for continued learning here

View the full list of our upcoming events here

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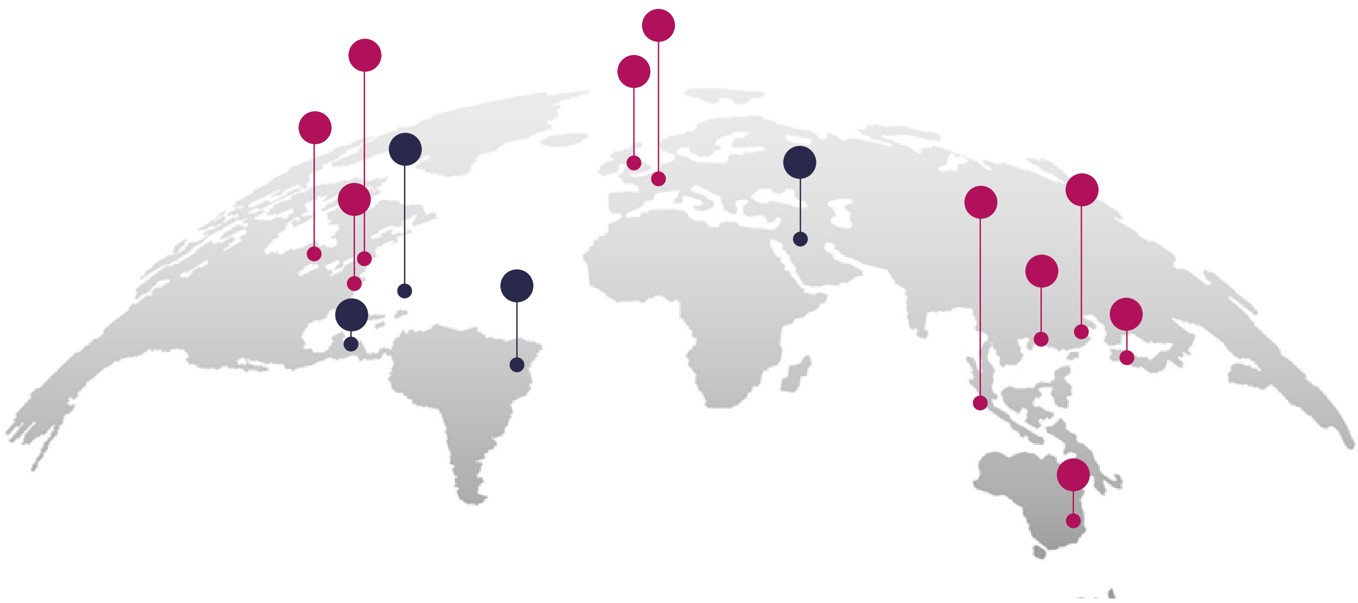

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Q2 Edition 126
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Publication 28th June

Q3 Edition 127
Deadline for submission 30th July
Publication 20th Sept

Q4 Edition 128
Deadline for submission 29th Oct
Publication 30th Nov

AIMA JOURNAL EDITORIAL GUIDELINES

Thank you for reading the edition 125 of the AIMA Journal.

If you would like to contribute to future AIMA Journals, please email **Caterina Giordo**

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