AIMA Journal Edition 110

Includes articles about:

- Brexit
- MiFID II
- Responsible Investing
- Outsourcing
-...and more

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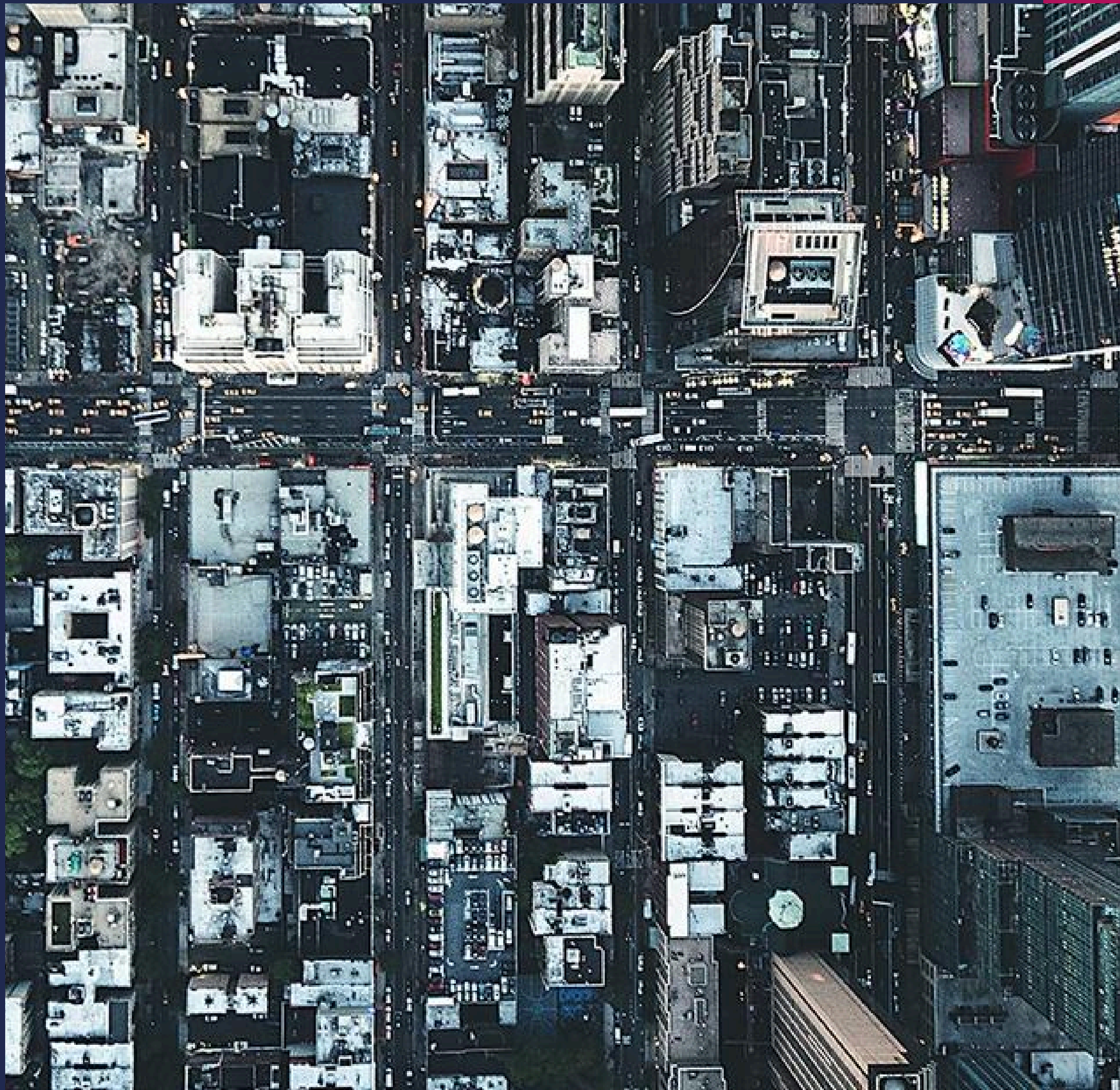
Update about the Alternative Credit Council

By Jack Inglis, CEO, AIMA



Jack Inglis

After the financial crisis, many alternative investment firms moved into the private credit and direct lending space, helping to create jobs and economic growth. But with some policymakers describing the activity as "shadow banking", we stepped up our advocacy efforts globally and, in particular, in Europe where the financial markets have been dominated by bank lending.

In 2014, to formalise our work in this arena, we set up what we believe to be the only advocacy structure for the private credit sector, which we called the Alternative Credit Council or "ACC". We have hosted the ACC under the wider AIMA umbrella and have given the group its own unique identity, reflecting the distinctive characteristics of the space.

Today, the ACC has its own board (overseen by the AIMA Council) and its own logo, tagline ("lending for growth"), and web address (www.lendingforgrowth.org - which directs the user to an ACC section of the AIMA website).

The ACC is funded by its members, who comprise hedge fund firms, private equity firms with credit funds as well as traditional long only and pure direct lending asset managers.

More than 80 of our manager members are now active in this space, managing private credit assets worth about $300bn, or roughly 50% of the global sector.

Our engagement has helped to reframe the debate around private credit. Our large research reports and the case studies within them, under the banner of "Financing the Economy" (2015 and 2016), have helped to enhance understanding about private credit with politicians, regulators and the media.

Today, it is more common to hear the term "market-based finance" than "shadow banking" in policy discussions and there is widespread support for initiatives such as loan funds and the EU's capital markets union.

If members have any questions about the work of the ACC and its place within AIMA or would like to become more active in ACC activities, please contact us at info@aima.org. All AIMA members can become ACC members free of charge.

ALTERNATIVE CREDIT COUNCIL
LENDING FOR GROWTH

AIMA

Alternative beta is not beta

By Simon Savage, Director of Alternative Beta at Man Group

Simon Savage

Introduction

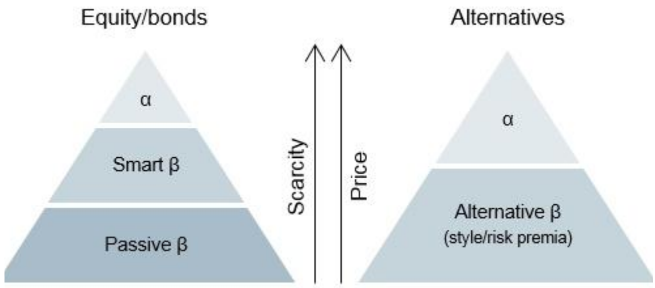
Finance is an industry where the importance of words has often been marginalised. On a trivial level, this has led to a cottage industry in confusing, and often absurd-sounding jargon. In some areas, however, the lack of clear language is not only annoying, but potentially dangerous, and Alternative Beta is a pressing example. For many investors we speak to, products associated with the term 'beta' imply returns that are clustered around a clearly identifiable core asset or benchmark. This is generally applicable for long-only mandates. As per the schematic in figure 1, passive beta will replicate a pre-defined benchmark index (e.g. iShares MSCI World) and smart beta will express a particular factor tilt within that universe (e.g. iShares Edge MSCI World Value) leaveing alpha as the scarce skill of generating truly idiosyncratic returns.

This product schematic breaks down when we try to adapt this long-only model to fit alternative return strategies.

One of the primary differences between long-only strategies and alternatives is that alternatives are significantly less constrained meaning they can more freely seek to exploit the investment opportunities created by market inefficiencies. These opportunities can be divided into two broad categories: alpha strategies and 'style' or 'risk premia' strategies. Alpha strategies are those that require deep investment skill, can access difficult to trade markets, are capacity constrained or require specialist structuring insight. Style or risk premia are strategies that are more generic in nature and have high capacity and liquidity. As is indicated in figure 1, it is tempting to group these strategies under the collective name of 'Alternative Beta' to mirror the established classification model applied to traditional assets. In this article we argue that this would be a mistake. While we believe it is appropriate to associate Alternative Beta with larger capacity, higher liquidity and lower fees, it is not, however, 'beta' in the sense that the performance of these strategies can be considered explained by specific market environments.

The first section contrasts the return dispersion observed in traditional and Alternative Betas. Next we suggest some explanations for the differences seen, before finally offering an idea for how we believe investors could better understand these products.

Figure 1. Alt Beta's place in the investing universe



Traditional vs Alternative Beta

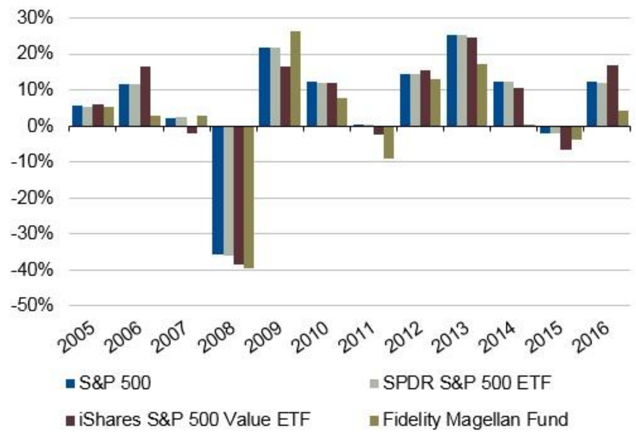
The case for traditional asset beta is well established, easy to demonstrate and therefore readily applied to investing. Figure 2 shows the annual performance of three different US portfolios against a benchmark S&P 500 index in blue. The SPDR S&P 500 ETF represents passive beta, or the base of the left hand triangle discussed in figure 1. As can be seen this experiences returns which are almost identical to the index, but for adjustments such as fees and construction costs.

This beta persists as we go up the triangle. The iShares S&P 500 Value ETF is an example of what we consider a smart beta portfolio – it owns the same universe of stocks as the SPDR fund, but according to certain pre-determined rules, tilting to buy more of the stocks with cheaper valuations. This alteration in construction causes some slight deviation in annual returns but the market remains the dominant explanatory factor of performance. Finally, even the USD13bn Fidelity Magellan fund, one of the most recognised names in active management, shows performance that is also significantly influenced by the market.

There is no surprise here to us, as we would anticipate the historical returns of these funds to be largely explained by the prevailing environment, being positive in a bull market and negative in a bear market. We believe this simple observable fact has been driving the unrelenting rise in allocation to passive funds as offering the most efficient method of achieving the core asset class return objectives.

It would be ideal if we could find similarly cost efficient strategies to produce the core returns for the universe of non-traditional assets, so called 'alternatives'. So it is understandable for investors to turn to products labelled 'Alternative Beta' for the solution, but is that wholly appropriate?

Figure 2. Illustration of traditional beta using annual performance of three funds versus S&P 500 index



Risk factor	Definition
Momentum	Tendency for an asset's recent price performance to continue in the near future
Carry	Tendency for higher yielding assets to outperform lower yielding assets
Value	Tendency for relatively cheap assets to outperform more expensive assets
Defensive	Tendency for higher quality, lower risk assets to generate higher risk adjusted returns.

However when we examine the performance of seemingly similar strategies that have a common risk factor label we observe returns that are distinctly different. This is illustrated in figure 4, which shows the performance of market neutral value strategies investing in a universe of European stocks. All three are essentially trying to achieve the same objective; that is to devise a set of rules that create a portfolio which buys undervalued stocks whilst selling short expensive ones in order to systematically capture the convergence between the two.

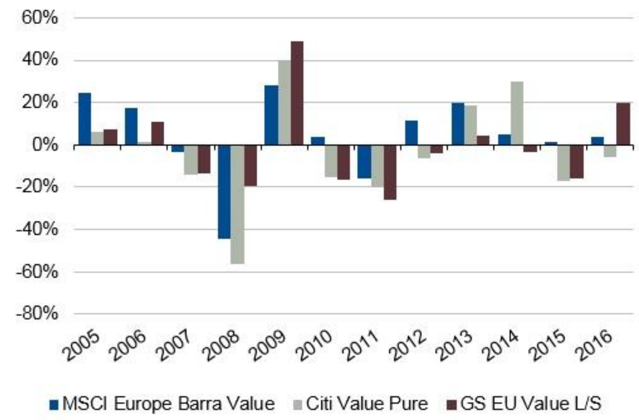
The returns have been normalised for volatility to make them more comparable and it is immediately apparent that despite the common naming convention the outcomes are far from normalised. Indeed they look more like a group of 'active' strategies investing in unique styles rather than offering the desired clustering properties of a core 'beta' for the Value risk factor in Europe.In the universe of alternative strategies a framework of categorising investment styles has emerged that is summarised in figure 3.

Figure 3. Alternative risk factors

As we examine the returns of more strategies grouped by their risk factor style, the more we see a similar broad spectrum of realised returns making the classification system of Alternative Beta seem imprecise. So what can explain these observations and can we hope to make a case for such products having understandable beta sensitivities to agreed benchmark definitions at all?

To investigate the feasibility of defining a benchmark for alternative factor strategies, let us consider the choices that we are confronted by in their construction. I have split them into three types – parameters, conditioning and execution.

Figure 4. Annual Performance of Value risk premia1



1. PARAMETERS

The principles by which a strategy will trade can be defined in a set of parameters. Here is an outline of some of the basic choices:

The investment universe – setting out the list of instruments by asset type, geography, sector, size and liquidity where the particular risk premium is most applicable.

The metric that represents the risk factor – there are many different ways in which investors think about valuation of stocks, for example. At time of writing, if you were to assess the S&P 500 by P/E, P/B and P/FCF2, for example, you would get three different answers as to which stock is the most undervalued (Arconic, Transocean and Prudential respectively3).

Lookback periods for time series factors – for a momentum strategy, for instance, are we more interested in a trend over a month (a 'faster' signal) or a year (a 'slower' signal).

The potential impact on returns associated with these parameter choices is highlighted in figure 5. Here we again examine the European value strategy but compare the results from using two different valuation metrics: book to price and earnings yield. One can see that even changing one parameter can lead to a substantially different return path, but another more alarming observation is also shown. If you had run this analysis in late 2009 you might have thought that there was not much difference between the two definitions of value. Fast forward and you would have been a dissatisfied investor had you chosen B/P as your preferred metric.

Figure 5. Two interpretations of European Value – simulated performance since 2005

2. Conditioning

We believe the second set of choices in designing a successful strategy revolves around conditioning. This relates to any rules built into the portfolio which nuance the principles applied by the parameters. Examples include risk management techniques such as volatility scaling and portfolio construction, different methods of weighting constituents based on their factor signals, or introducing secondary signals (e.g. augmenting value signals with a price momentum element).

The varied impact of conditioning can be seen in figure 6. This shows two methods seeking to capture the size risk premium – that is the premium paid for taking the risk of owning small cap stocks, relative to the wider market.

The Simple Size model ranks a global stock universe by their market capitalisation and buys equal weights of the smallest 20% of stocks, selling short the largest 20%. The minimalism of this method means that there will be all sorts of other biases affecting the performance such as sector and country tilts. The Factor Neutral Size model uses a ranked scoring method for size, but then determines the long and short stock exposures through a country, sector and factor neutralising portfolio construction technique, leaving the purest possible portfolio exposure to the size risk premium.

CFA textbooks, Fama/French and the pantheon of mainstream financial academics will tell you that there is a premium for investing in smaller market capitalisation stocks. Interestingly, however,
figure 6 shows us that a naive method of portfolio construction may be deficient in delivering the expected returns.

But here arises a further complication: advanced financial and statistical knowledge is required to implement the necessary conditioning and this knowledge can easily spill over into hubris. In other words, with so many available conditioning tools, there is a temptation to get too clever, to fiddle with more and more buttons on the control panel. Degrees of freedom are a double-edged sword: on the one hand they allow for precise exposures to be expressed, but on the other, their increase leads to data mining, over-fitting and poor out of sample performance. A balance must be found.

Figure 6. Simulated portfolios capturing Size risk premium with varied conditioning

3. Execution

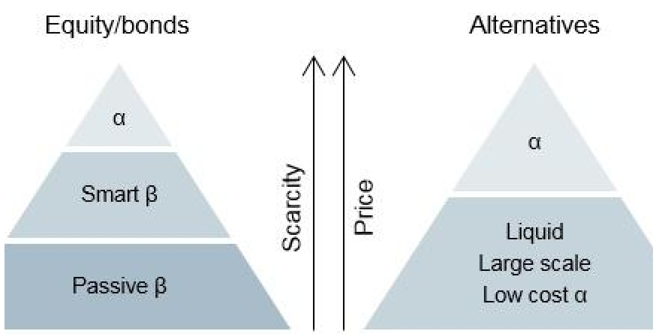
Finally, constructing an investible portfolio strategy requires decisions around execution. On an explicit basis this requires striking the balance between purity of signal and the cost of turnover. Market moves can happen very quickly. The parameters and conditioning of the portfolio may be well tuned, but this can quickly degrade if the regularity of rebalancing is too sporadic. On the other hand, if turnover is too frequent this will result in spiralling transaction costs which can itself interfere with the realised returns.

Conclusion

Imprecision of definition makes benchmarking difficult. It is easy to define the S&P 500 as the 500 largest stocks by market capitalisation and create both a benchmark return and a portfolio to match that performance. Given the range of choices outlined above, the analogous challenge for risk factor strategies is clearly much more complex making any benchmark for Alternative Beta nebulous at best. In short, Alternative Beta products cannot be considered in the same way as Traditional Beta. Finding a path through the myriad of choices to create an investable alternative factor strategy requires a degree of skill that is often associated with alpha generation.

However, we believe there are some investment product properties that the word ‘beta’ should automatically bring to mind. It should imply higher liquidity, larger capacity and operational efficiency which in turn should also imply a lower fee than a fully-fledged alpha seeking product. All these properties are achieveable in practice for alternative strategies, so we would propose to amend the schematic shown in figure 1, to that illustrated below in figure 7. What some see as Alternative Beta, we view as a cheaper, larger scale, more liquid, alternative alpha.

Figure 7. Alternative Beta is Liquid Alternative Alpha



Footnotes

1. Source: MSCI, Citi and Goldman Sachs.
2. Price to earning, price to book and price to free cash flow respectively.
3. Source: Bloomberg, as at February 2017.

Important Information

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All investments involve risks including the potential for loss of principal. Alternative strategies involve magnified risks, are speculative, are not suitable for all clients, and intended for experienced and sophisticated investors who are willing to bear the high economic risks of the investment. Past performance of an investment strategy does not guarantee similar future results.

Manager-In-Charge regime: What licensed corporations need to do

By Scott Carnachan, Consultant and Isabella Wong, Senior Associate at Deacons

Scott Carnachan

Isabella Wong

On 16 December 2016, the Hong Kong Securities and Futures Commission (SFC) introduced its new Manager-In-Charge of Core Functions (MIC) regime, with details set out in its Circular Regarding Measures for Augmenting the Accountability of Senior Management (Circular) and a related series of 40 Frequently Asked Questions (FAQs).

The MIC regime is a substantial change to the way in which the SFC seeks to exercise regulatory oversight of licensed corporations. The MIC regime will impose new reporting obligations on all licensed corporations and will require ongoing reporting of information about people in middle office and back office roles who may not be licensed with the SFC. For licensed corporations that are part of a wider group, the MIC regime may also require licensed corporations to identify and report information about individuals from other group companies (within or outside Hong Kong) that are not regulated by the SFC.

Overview of the MIC regime

In the Circular, the SFC sets out its view that the senior management of a licensed corporation includes MICs, in addition to directors and responsible officers (ROs). An MIC is an individual appointed by a licensed corporation to be principally responsible, either alone or with others, for managing any of the "Core Functions" of the licensed corporation. There are eight Core Functions, (i) Overall Management Oversight, (ii) Key Business Line, (iii) Operational Control and Review, (iv) Risk Management, (v) Finance and Accounting, (vi) Information Technology, (vii) Compliance and (viii) Anti-Money Laundering and Counter-Terrorist Financing. Licensed corporations will need to designate an individual as the MIC for each Core Function and will need to report information about its MICs, and any changes in this information, to the SFC.

The Circular identifies several reasons for the SFC to introduce the MIC regime. The MIC regime is intended to ensure that persons who are MICs for the Overall Management Oversight and Key Business Line functions of a licensed corporation become ROs of the licensed corporation, if they are not already ROs. The MIC regime is also intended to promote awareness of the responsibilities of the individuals identified as MICs. Although not expressed in the Circular, over time the MIC regime is also likely to increase the localisation of Core Functions in Hong Kong for licensed corporations that are part of a wider international group.

The key dates for implementation of the MIC regime are:

18 April 2017: The SFC will start to accept MIC information and management organisational charts from all licensed corporations and new corporate licence applicants

17 July 2017: Deadline for licensed corporations to submit MIC information and management organisational charts

16 October 2017: Deadline to submit applications to the SFC for MICs who need to be approved as ROs

A more detailed timeline is attached at the end of this client alert.

Summary of actions required

The actions each licensed corporation needs to take include:

<u>Now</u>

- Read the Circular and the FAQs
- Inform the board of directors about the MIC regime
- Sign up to attend an SFC workshop on MIC filing procedures

<u>By 17 July 2017</u>

- Identify the individuals who are or will be MICs, brief them on the MIC regime and their obligations and get their acknowledgement of their appointment as an MIC
- Prepare descriptions of the roles of each MIC and a structure chart for the licensed corporation, including each MIC's reporting lines
- Prepare a formal board paper (a management structure paper) setting out the management structure of the licensed corporation, the roles, responsibilities, accountability and reporting lines of its senior management personnel
- Prepare relevant SFC forms
- Have the board of directors approve the management structure paper, the appointment of the MICs, the roles of each MIC, the structure chart and reporting lines, and the submission of information about the MICs to the SFC
- Submit information about the MICs to the SFC, including the structure chart and completed SFC forms
- Put in place a compliance process to monitor changes relating to MICs and to report such changes to the SFC

<u>By 16 October 2017</u>

If the MIC responsible for Overall Management Oversight or a Key Business Line is not currently an RO, prepare and submit an application to the SFC for that person to become an RO

More on the MIC regime

1. Identifying MICs

The scope of the Core Functions is described in the Circular. A licensed corporation must identify and appoint an individual (either alone or with others) to take up principal responsibility for managing each Core Function. One person can be an MIC for more than one Core Function. An MIC may be located in or outside Hong Kong. An MIC may also be an RO and/or a director of the licensed corporation or an employee of a group company. The SFC also anticipates that in some circumstances two or more people may be appointed on a joint basis as MICs for a single Core Function.

The SFC expects an MIC to have authority (apparent or actual) over the Core Function(s) for which the MIC is responsible. The SFC expects an individual who is appointed as an MIC to have:

- a position in the licensed corporation which is of sufficient authority to enable the individual to exert a significant influence of the conduct of the Core Function;
- authority to make decisions (e.g. assume business risk within pre-set parameters or limits) for that Core Function;
- authority to allocate resources or incur expenditures in connection with the particular department, division or functional unit carrying on the Core Function; and
- authority to represent a particular department, division or functional unit carrying on that Core Function, e.g. at senior management meetings or in meetings with outside parties.

The SFC has also indicated that it expects licensed corporations to be satisfied that MICs are "fit and proper" to act as MICs for the relevant Core Functions. In practice, that is likely to mean the individual has sufficient knowledge, skill and expertise to assume the authority and responsibility of a senior manager in respect of the relevant Core Function and has not been subject to a disciplinary, regulatory or other sanction that adversely affects his or her ability to perform the relevant Core Function.

Once an individual has been identified, the licensed corporation will need to obtain acknowledgement from the individual of his or her appointment as an MIC.

If an individual will be appointed as the MIC responsible for either the Overall Management Oversight or a Key Business Line function then the licensed corporation will need to apply for approval of the individual as an RO, if he or she is not currently an RO. For this purpose, the FAQs indicate that the SFC will take into account industry experience in operations, compliance and other back office roles, in addition to direct experience in regulated activities such as asset management or dealing in or advising on securities.

2. Personal liability of MICs

The MIC regime does not create any additional liabilities or give the SFC any additional enforcement powers. What the MIC regime does is ensure that the SFC has additional information about licensed corporations and the individuals who are responsible for each of the Core Functions. It also imposes an obligation on licensed corporations to keep this information up to date.

The SFC does not approve or license MICs. However, an individual appointed as the MIC responsible for either the Overall Management Oversight or a Key Business Line function is expected to be licensed as an RO of the licensed corporation.

3. Reviewing organisational structure, reporting lines

The MIC regime will require licensed corporations to review their organisational structure to ensure it reflects the Core Functions and the SFC's expectations of reporting lines of the MICs. Whilst the SFC does not mandate any particular structure, it generally expects that an MIC should:

- report directly to either the board of directors of the licensed corporation or to the MIC who assumes the Overall Management Oversight function; and
- be accountable for the performance or achievement of business objectives set by the board of directors of the licensed corporation, or by the MIC who assumes the Overall Management Oversight function.

Licensed corporations will need to consider whether current job descriptions and reporting lines are consistent with the MIC regime, and may need to revise their organisational structure accordingly. That may mean, for example, revising current job descriptions to give individuals sufficient authority to act as an MIC and / or additional reporting lines to the board of directors of the licensed corporation or to the MIC who assumes the Overall Management Oversight function. For international groups, it may also mean adding employees in Hong Kong to act as an MIC.

When reviewing its organisational structure, a licensed corporation should also keep in mind the segregation requirements under the Management, Supervision and Internal Control Guidelines, which require licensed corporations to segregate front office functions from back-office functions.

There is no need to change the job titles of individuals to match the Core Functions.

4. Ensuring board approval of MICs

Once a licensed corporation has identified its MICs and has finalised its organisational chart, the Circular requires that the board of directors of the licensed corporation:

- approve the management structure paper;
- approve the organisational chart;
- approve the appointment of the MICs; and
- ensure each MIC has acknowledged his or her appointment as an MIC and the Core Function(s) for which he or she is principally responsible.

5. Preparing SFC notification/application documents

The documents that a licensed corporation needs to submit to the SFC by 17 July 2017 include:

- Information about each MIC, in the form of Supplement 8A. Currently, the SFC has published a draft Supplement 8A. The final version of Supplement 8A will be gazetted shortly and made available on the SFC website; and
- Organisational structure chart. The SFC has not mandated a specified form. It will vary depending on the circumstances of each licensed corporation.

If the individual identified as the MIC responsible for Overall Management Oversight or a Key Business Line is not currently an RO, the licensed corporation will need to prepare and submit an application to the SFC for that person to become an RO by 16 October 2017. The competency requirements for an RO are set out in the SFC's Guidelines on Competence.

The FAQs indicate that the SFC will take into account industry experience in operations, compliance and other back office roles, in addition to direct experience in regulated activities such as asset management or dealing in or advising on securities.

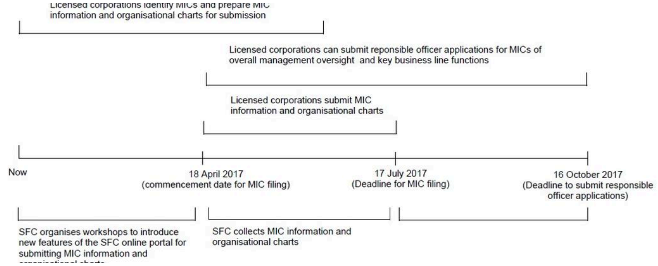
6. Reflecting MIC regime in internal documents and procedures

Licensed corporations will need to update their compliance manuals and policies to reflect the MIC regime.

Licensed corporations will also need to put in place a compliance process to monitor changes relating to MICs and to report such changes to the SFC.

Changes in the individuals who act as MIC for a Core Function and / or changes in organisational structure will also need to be approved by the board of directors of the licensed corporation.

Implementation timeline for MIC regime



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Will Brexit have an impact on offshore financial services?

By Fiona Chandler, support lawyer and Sean Scott, partner at Harneys

Fiona Chandler

Sean Scott

Now that the United Kingdom has served notice to leave the European Union under Article 50 of the Lisbon Treaty, managers of offshore funds have a clearer timetable for when Brexit will happen, with the UK scheduled to leave the EU on [ ] March 2019. The terms of the UK's exit will be the subject of intense negotiations over the next two years, which are expected to be closely followed by investment managers, together with the rest of the financial services industry. Although much has been uncertain since the result of the United Kingdom's referendum in June last year, it is clear that the effects of Brexit will be felt beyond the UK and Europe. This article looks at the impact that the UK's departure from the European Union (EU) may have on various of its Overseas Territories (such as the Cayman Islands, Bermuda and British Virgin Islands) and their financial services industries, during the next two years of Brexit negotiations and following Brexit in March 2019.

1. Will there be any impact on offshore jurisdictions during the Brexit negotiations?

UK Overseas Territories such as the Cayman Islands, Bermuda and the British Virgin Islands are not members of the EU and for now, nothing has changed for these jurisdictions. Each has their own separate legal system and EU law does not apply directly to them. Although their status as Overseas Countries and Territories of the EU will technically change when the UK leaves the EU in 2019, we do not expect there will be any direct impact on these jurisdictions' existing legislation or stability as a result of the United Kingdom serving its Article 50 notice, during the next two years of Brexit negotiations or on Brexit.

Although Overseas Territories may not be expecting extensive direct effects of Brexit, we are monitoring potential indirect effects on these jurisdictions and their financial services industries. These may result from the UK's loss of influence over EU financial services legislation and policy now that negotiations for the UK's exit have begun, in particular in the next two years in relation to the "EU tax blacklist" and the ongoing review of third countries for the extension of passporting rights under AIFMD[1].

The EU is currently in the process of creating its 'common EU list of problematic tax jurisdictions' which it is expected to complete by the end of 2017, in the middle of Brexit negotiations. The political element of this is very high and the lessened influence of the UK increases the likelihood that it could become an attack on low tax rates. This raises concerns for the Cayman Islands, BVI and Bermuda, notwithstanding their full compliance with the OECD's transparency requirements.

With the AIFMD passport, the European Securities and Markets Authority's (ESMA) advice in Summer 2016 noted that there are no significant obstacles regarding competition and market disruption impeding the application of the AIFMD passport to the Cayman Islands and Bermuda, with ESMA delaying its definitive advice on both countries as they were in the process of implementing new AIFMD-like regulatory regimes and other legislative changes. ESMA has since confirmed that it is continuing its assessment of Bermuda and Cayman with a view to reaching a definitive conclusion on whether to extend the passport to these countries. As the passport is not yet available to any third country, it remains to be seen if or when the passport becomes a reality, whether it becomes a lower priority for ESMA during the Brexit negotiations and post Brexit and whether the national private placement regimes are simply left in place for marketing alternative investment funds, including those from the Cayman Islands, Bermuda and BVI, into Europe. Some commentators have suggested that ESMA may now delay any extension of the passport to third countries until the UK's status post Brexit has been settled, including whether it will enjoy any passporting rights under AIFMD and other financial services legislation.

One area where Brexit may have a direct impact, however, is on foreign policy, including economic and financial sanctions and restrictive measures. Although EU regulations are not usually implemented in Overseas Territories as they are outside the EU, currently the UK directly applies EU-origin sanctions to its Overseas Territories. Following Brexit, UK foreign policy can be expected over time to start to differ from the EU's policy, including in the way it deals with countries currently subject to sanctions. How it will differ and any impact it may have on these jurisdictions remains speculation at this stage however.

2. Will offshore jurisdictions have any input into Brexit negotiations?

The UK has made it clear that it will be negotiating its exit terms from the EU and, although it is actively engaging with its Overseas Territories to understand their priorities and concerns, those offshore jurisdictions will not be directly involved in the Brexit negotiations. Since the referendum in June last year, the Overseas Territories have been meeting regularly to discuss their priorities on Brexit, and also meeting with the UK government to make their priorities and concerns known and taken into account. The UK government's recent White Paper noted that the unique relationships between the Overseas Territories and the EU will change and also that the UK government will continue to involve these jurisdictions fully in their work, respecting their interests and engaging with them as the UK enters negotiations. Many of the Overseas Territories have also been running public consultations in their jurisdictions to understand the key concerns raised by Brexit, including for their financial services sectors given the importance of those industries in various of these jurisdictions.

3. What impact will there be on offshore financial services sectors post-Brexit?

As the final terms of the UK's exit deal from the EU will not be known until the end of the negotiations in 2019, the impact on financial services in the UK and any indirect impact on the financial services industries in specific Overseas Territories, also cannot be known at this stage. We expect that the relationship between the UK and its Overseas Territories and Crown Dependencies (such as Jersey and Guernsey) will not change, and that the relationship between those Overseas Territories with strong financial services sectors will remain strong following Brexit. The BVI's Premier, Dr Orlando Smith, recently reiterated the Overseas Territories' commitment to working with the UK to help achieve its goal of a "Global Britain" post-Brexit.

4. What post-Brexit plans are managers of offshore funds making?

Since the referendum there has been a lot of discussion about how UK based investment managers will operate post Brexit, although up until now many managers have been starting to review their options, while holding off putting any firm plans in place. This approach was due to the uncertainties over timing, the terms of the final exit deal and how it will actually affect financial services firms operating in and from the UK in practice. As with other business sectors, many managers are considering plans for a hard Brexit, with the UK outside the EU Single Market and EU passporting rights to operate around the EU from London no longer available, so that if a bespoke deal for financial services is negotiated by the UK government this will be a bonus.
Now that Article 50 notice has been served, we expect that the two year deadline ending in March 2019 will bring contingency planning by London based managers of offshore funds into more focus. A continued wait and see approach and flexibility are still likely to be needed however, given that the final exit terms will only be known later in the negotiation process, including whether they will include transitional arrangements to ease changes in gradually. There also remains a strong sentiment that managers will find solutions that will avoid having to move operations and staff out of London.

Although we do not expect Brexit to have much direct impact on the financial services industries in the Cayman Islands, the BVI and Bermuda, we are continuing to monitor developments closely and advise clients on how they may be affected.

Footnotes:

[1] Alternative Investment Fund Managers Directive

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Beyond passporting: Brexit's impact on MiFID II

By Luke Nelson, Senior Manager at PwC

Luke Nelson

Since the outcome of the EU referendum was announced in June 2016, MiFID II has been one of the most widely discussed areas of EU regulation. So far the debate has centred on the issues of passporting and regulatory equivalence, which pose a potential licensing gap for UK firms. But a closer examination of MiFID II and MiFIR reveals a myriad of additional issues and complexities that Brexit will give rise to, which we believe policymakers and firms need to consider. Brexit is likely to open up a Pandora's Box of technical complications due to the way EU and UK regulation has been constructed.

In the case of MiFID II, it's quite possible that these unintended consequences will require rewriting some of the rules to make them fit for purpose both in the EU and the UK. The MiFID II rules, like all other EU regulations, were written on the basis that the UK is part of the EU. In many cases it is not clear what the appropriate way forward is, given we're in an unprecedented situation. But policymakers will need to find a way forward on these issues – as well as similar complexities for other pieces of financial services legislation – and quickly.

Avoiding a licensing gap

The media and industry have given lots of attention to the existing MiFID passport, which along with the CRD IV passport, is one of the two most commonly used passports for banks and investment firms. CRD IV doesn't provide a passport for third country firms, so UK firms without another existing EU banking licence will have to set up and obtain a licence for a subsidiary in another EU country to access passporting under CRD IV.

In the immediate aftermath of the vote, many commentators pointed to the equivalence mechanism in MiFID II that can allow firms from outside the EEA, 'third country firms', to do business in the single market without the need for authorisation in individual Member States. At first glance this was seen by some as a panacea for continued access to the single market.

MiFID firms are concerned there will be a significant licensing gap brought about by a lack of agreement, transitional arrangement or equivalence decision. The current MiFID directive doesn't provide for third country passporting - a third country passport will be available when MiFID II comes into effect on 3 January 2018. But the UK will not be a third country until it formally exits the EU. A third country passport wouldn't be available to UK firms until post-exit, which is likely to be in spring 2019. In reality the equivalence mechanism under MiFID II is untested. It is likely to be highly political in the aftermath of the Brexit negotiations, and in any case only applies to business carried out with eligible counterparties and professional clients. So it's no use to firms wanting to do business with retail clients in the EU.

Only after the UK's formal exit, would the EC be in a position to make a determination about whether or not the UK has an equivalent supervisory and enforcement regime. If and when the EC reached an equivalence determination, ESMA would then begin accepting individual firms' passport applications. It has to approve each individual firm's application for a third country passport. Together, those two processes could take a number of months. So absent grandfathering of existing passports or transitional provisions being agreed as part of the Brexit negotiations, UK firms would experience a licensing gap, i.e. they could not carry on MiFID business in EU countries until ESMA approved their third country passport application. Waiting out a licensing gap won't be a viable option for most firms – they will be forced to set up a new MiFID firm in another EU country to keep doing business in the EU (if they don't already have one).

Calculating thresholds for pre-trade transparency

Many of the obligations in MiFID II rely on quantitative thresholds that will be skewed if UK data is not included in the calculation. Perhaps the clearest example of this issue is the systematic internaliser determination. Under MiFID II, a firm that executes client orders against its proprietary capital, rather than matching the order with another client or executing on a venue, is considered a systematic internaliser if the volume of this activity that it carries out exceeds a certain quantitative threshold. This situation poses an important strategic issue for firms because systematic internalisers have to comply with additional transparency requirements – they have to show their pre-trade prices to the market. In some instances and for some financial instruments, firms are likely to be reluctant to do this.

The calculation for determining whether or not a firm is a systematic internaliser is complex and varies according to the type of financial instrument and whether there is a liquid market for that particular instrument. But a common component across all financial instruments is that firms should compare the amount of client orders they are internalising against the total trading activity of that financial instrument in the EU.

It's no secret that a significant proportion of EU trading activity in all financial instruments takes place in the UK, and the thresholds were set taking that activity into account. If the UK data is removed from the total EU activity, the absolute threshold lowers. This reduction is likely to bring far more firms across the EU into the systematic internaliser regime and could inappropriately extend the pre-trade transparency regime to less-liquid parts of the EU market. If the UK data is removed and the UK is forced to continue to use the existing systematic internaliser thresholds to achieve equivalence then it's likely that lots more UK-based firms would be brought into the regime too. Even if the UK ends up joining the EEA, an outcome that looks increasingly unlikely, this problem will persist; the calculation specifically references total EU trading data rather than total EEA trading data.

Finding a solution

So what might the solution be? It seems unlikely that the EU would rewrite its MiFID II rules to include all EU trading data plus that of the UK, given the UK would be just another third country post-Brexit. Perhaps the UK data could be included in the calculation temporarily as part of a transitional arrangement on MiFID II, but it's difficult to see the UK being included in the calculation in the long term as this would probably not sit well constitutionally with EU institutions and some Member States.

An alternative approach would be to recalibrate the calculation in MiFID II so that the absolute threshold is more in line with what it would be with UK data included. This alternative would perhaps be the best solution for EU firms but it would require amendments to the MiFID II legislation and potentially create further delays. The date the rules apply has already been pushed back by a year to January 2018, so there is likely to be little patience from the EP and EC for additional postponement.

Should the EU recalibrate the threshold, this change would leave the question of what the UK should do, or will be required to do if it wants to achieve equivalence with MiFID II. It seems unlikely that it would be acceptable for UK firms, some of the largest in the EU with significant trade flow, to simply use the recalibrated thresholds, because that would create an unlevel playing field. UK firms would effectively be given a lower bar than their EU competitors and would be less likely to fall within the systematic internaliser regime. So perhaps the UK would be required to come up with its own thresholds for domestic activity with the aim of producing a similar result to the original calibration. Such a calibration would most likely take some time as it would require significant quantitative analysis of the UK market – and it's precisely this type of technical issue that has the potential to undermine a swift MiFID II equivalence determination for the UK overall.

The systematic internaliser regime is just one example of a quantitative threshold in MiFID II. There are others where the principle is the same, creating similar problems for regulators. Commodity derivative position limits use the concept of total deliverable supply referencing EU data. The transparency regime for non-equity products relies on liquidity thresholds that have been developed using total EU data that includes a significant portion of activity in the UK. It's likely that ESMA will have to spend significant time working out the solutions to these very technical issues that threaten the workability of many parts of the MiFID II package, not just for UK firms but across the EU. Whether it has the resources and time to do this before MiFID II has to be implemented is questionable.

Achieving equity trading equivalence

As well as the thorny issues around quantitative thresholds, other fiddly aspects of MiFID II will be affected by the UK not being a part of the EU. The equity and derivative trading obligations require firms to execute certain types of instrument on an EU venue or third country venue which is equivalent. The mechanism for determining equivalence of trading venues is different to the mechanism for determining MiFID II country equivalence for the purpose of allowing third countries to do business in the single market. In fact, there are even different mechanisms for establishing whether a venue is equivalent for the equity trading obligation (this relies on the Prospectus Directive) and whether a venue is equivalent for the derivative trading obligation (a brand new mechanism in MiFIR).

It's likely that UK venues will be acceptable for execution for some time to come, but it is not out of the question that they could fall victim to a politicised equivalence determination. The net effect is additional complexity and uncertainty for firms.

Complicating transaction reporting

Another area where Brexit could cause operational complexity for firms is transaction reporting. Under MiFIR, firms must report transactions in instruments traded on a trading venue, or where the underlying is an instrument traded on a trading venue (which in this context refers to EEA trading venues). When the UK leaves the EU (and as seems likely the EEA), its trading venues will no longer be EEA trading venues. So in theory, the MiFID II transaction reporting requirement will no longer apply to instruments exclusively admitted to trading on UK venues – but in reality this is not likely to be the case. At the very least, the FCA is extremely likely to still expect UK firms to report transactions in instruments traded on UK venues, despite the potential loss of the explicit MiFID II requirement, for its own supervisory purposes and to achieve equivalence with the MiFID II rules. The FCA required transactions to be reported to it long before MiFID required it.

But the picture is perhaps less clear for EU firms (other than those operating in the UK): will they have to report transactions in instruments admitted to trading on UK venues? Any change in reporting obligations is likely to bring additional operational complexity to an area firms have historically struggled with.

The challenge ahead

All of these issues will need to be addressed ahead of the UK leaving the EU – there are no provisions explaining 'in case of Brexit do this' in MiFID II. Even establishing transitional provisions that are fit for purpose and provide clear direction for firms is likely to be extremely challenging in time for the UK leaving the EU, which now seems likely to happen in Q1 2019. The mind boggles when you consider that a similar exercise will have to be undertaken across all areas of EU law and regulation where its construction means that Brexit immediately creates practical and technical complications for regulators and firms.

As part of their Brexit planning, firms need to try to identify the full range of unintended consequences of the UK's exit from the EU for MiFID II - and for all other laws and regulations they operate under. Firms should also consider working with both regulators and politicians (in the UK and the EU) to ensure policymakers understand all the technical nuances of the impact of Brexit on financial services regulation. While big-ticket issues such as passporting rights have understandably taken centre stage until now, it's essential that firms and policymakers also consider the more detailed and technical implications if they want to avoid regulatory turmoil when the UK exits the EU.

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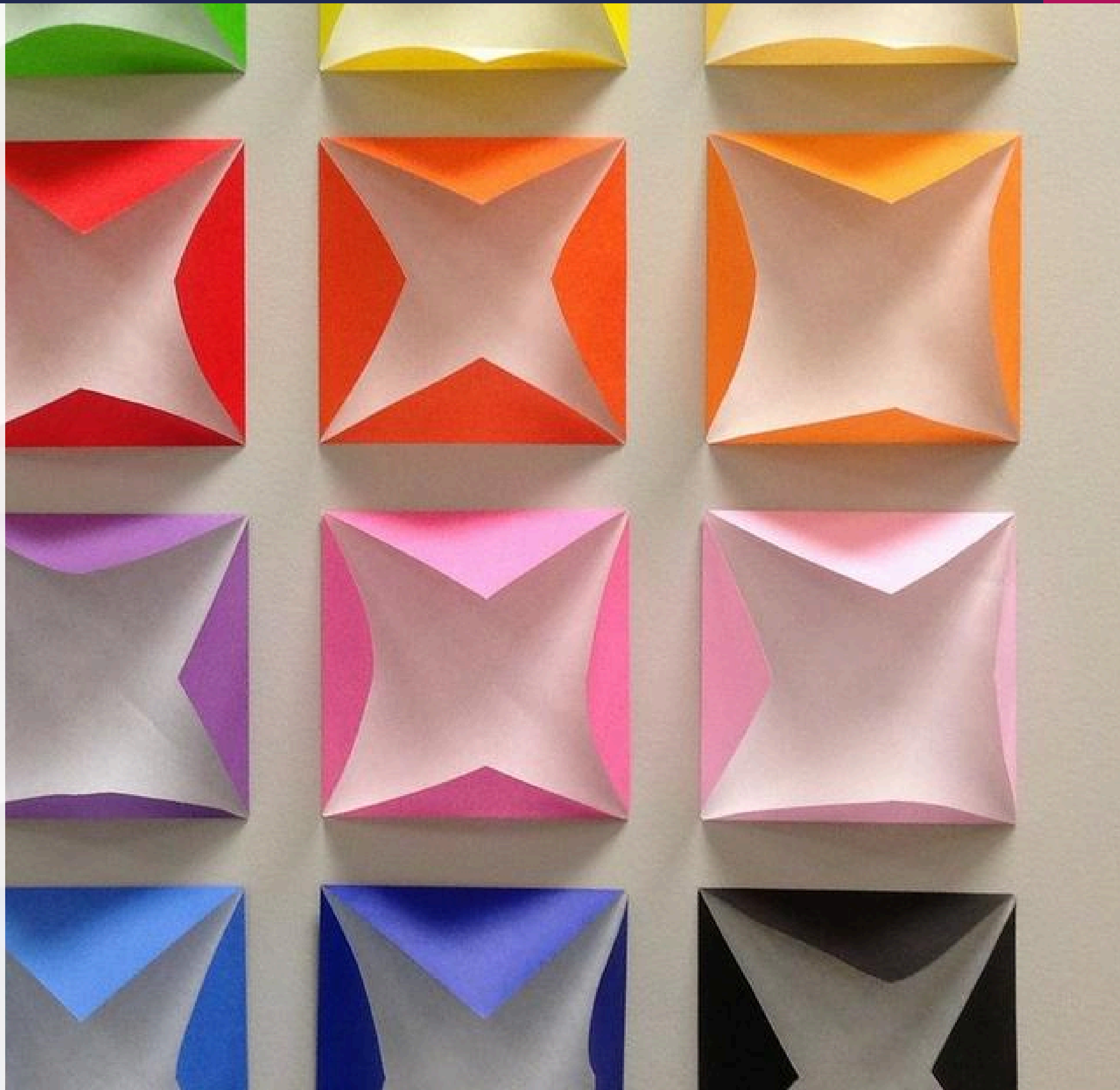


MiFID II and the paper conundrum

Lisa Roitman and Nadia Humphreys at Bloomberg's Entity Exchange

Lisa Roitman

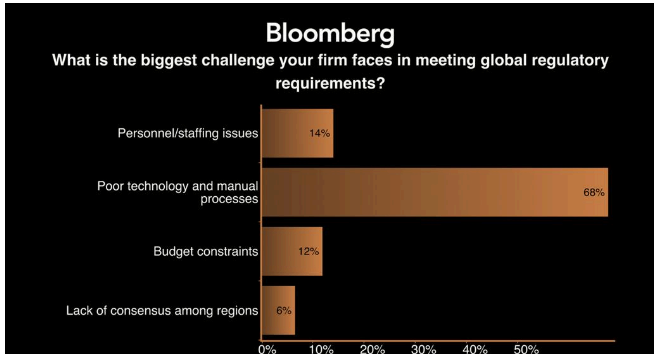
If you think MiFID II doesn't apply to you, think again. The new rules, which span topics as varied as best execution, transparency and trade reporting, research and record keeping, all have one thing in common… paper, and lots of it.

Firms who must comply with MIFID II will need to repaper their client agreements, whether these are covered by the regulation or not. The sell-side is mobilizing large operational teams to prepare for this expected increase in client outreach, and for the need to identify the information they are going to collect from clients. As for the buy-side, it will have to either accept or negotiate new terms of business with the sell-side, and may need to change fund disclosure material, internal policies and procedures, and investor subscriptions.

Exchanging and negotiating all this new documentation is going to take time, which is in short supply as the regulation comes into effect in January 2018.
According to a Bloomberg poll of ten top tier sell-side firms in London, an estimated 2.5 million documents will need to be exchanged in 2017 across their client base in order for them to become MiFID II compliant. This represents a significant burden on the buy-side, who rarely has the operational or legal resources available to receive and process these requests.

Perhaps even more important is determining exactly how firms will collect and respond to all this information. Traditional methods of exchanging contracts by email or post may fall short both in terms of operational strain and security. "Firms will need to think about how they can best leverage technology to assist with the challenges that this raises – manual processing is simply too time consuming," confirmed John Ahern, Partner at Jones Day.

Implementing technology to assist with the process can help with workflow management and provide audit trails of the exchanges. Using solutions to encrypt these communications, data and document exchanges provides security for sensitive client information. Seeking technology-driven ways to conduct client outreach, collect, organize and store information will be key to handling the repapering crush.



A live Poll conducted by Bloomberg in the "Bracing for Change in 2017" event posed the question.

What are the requirements?

While most see MiFID II implementation as a sell-side problem, there is no need for the buy-side to sit back and wait for the paper deluge. “Firms on the buy-side are sufficiently conversant with the MiFID II requirements and should consider taking the initiative to produce the relevant information for their sell-side counterparties with a view to speeding up the process and avoiding disruption post January 2018,” says John Ahern.

These are some of the key things that both sides will need to consider:

- Revising terms of business and updating execution policies
- Changes to research provisions
- Onboarding to new venues
- Obtaining and disclosing Legal Entity Identifiers (LEI)
- Delivery of Systematic Internaliser (SI) information to clients
- Due diligence in order to determine the correct Client Classification
- Due diligence regarding Algorithmic trading platforms
- Periodic report on suitability
- Changes to costs and charges
- Declaration of conflicts of interest and inducements

5 things buy-side firms should do right now to prepare for MiFID II

- Obtain a Legal Entity Identifier (LEI) across their universe of entities
- Determine the appropriate registration process for their business and notify their counterparts and third-party distributors
- Determine and be prepared to communicate their classification under MiFID II
- Plan for how their firm will handle and/or negotiate the document types to be delivered under MiFID II
- Look at technology solutions to ease the operational burden and increase the security of their communication

Fundamentally, there are many ways to engineer a solution to the paper conundrum, but firms shouldn’t wait. Do the analysis now, identify technology that can provide efficient solutions to the repapering exercise and take the pain out of MiFID II compliance.

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Currency hedging survives ESMA UCITS share class cull

By Mark Browne, Partner; Stuart Martin, Partner; and Declan O'Sullivan, Partner at Dechert

Mark Browne

Stuart Martin

Declan O'Sullivan

For the past two years, the European Securities and Markets Authority (“ESMA”), Europe’s main securities regulator, has had UCITS share classes in their sights. It has issued two discussion papers on the topic and has now finalised its work with the issue of its final opinion on - "Share classes of UCITS" issued on 30 January 2017 (the “Opinion”).

The Opinion is available to read here.

ESMA's Views on the Key Elements of Share Classes

The Opinion sets out the high-level principles which ESMA considers should be followed when setting up different share classes

1. Common investment objective: share classes of the same fund should have a common investment objective which is realised through investment in a common pool of assets;

2. Non-contagion: UCITS management companies should implement procedures to minimise the risk that features specific to one share class could adversely impact other share classes in the same fund;

3. Pre-determination: all features of the share class should be pre-determined before the share class is established;

4. Transparency: differences between share classes of the same fund should be disclosed to investors when they have a choice between two or more classes; and

5. Anti- circumvention: share classes should never be set up to circumvent the rules of the UCITS Directive particularly those on diversification, derivatives eligibility and liquidity.

focuses on.

Duration Hedging and Volatilty Hedging - Early Fallers!

The Opinion acknowledges that there are currently a number of types of UCITS share classes available in the EU which provide investors with different features in relation to their investment. One category of share classes (which ESMA categorise as “technical share classes”) differentiate between groups of investors (e.g. retail vs. institutional investors) or means of investment (e.g. variations relating to management fees, minimum investment amounts, voting rights and currency). ESMA consider that these technical share classes satisfy the principle of a common investment objective.

Other categories of share class (which ESMA categorise as “overlay share classes”) utilise derivative based hedging arrangements aimed at mitigating one or more of the risk factors attributable to the common pool of assets in which all share classes in a fund invest. It is this category of share class which the Opinion focuses on.

The discussion papers signalled that duration hedged and volatility hedged share classes may not be compatible with the high-level principles that are set out in the Opinion. The Opinion states that in ESMA’s view hedging arrangements at share class level are not compatible with the requirement for a fund to have a common investment objective. ESMA express the view that UCITS classes which aim at protecting the investor from certain types of risk should be set up as separate funds. The only type of hedged share classes which are considered by ESMA to satisfy the principle of a common investment objective are currency hedged classes.

It is clear from the Opinion that duration hedged share classes will be the big loser. According to Morningstar data quoted by Ignites (Ignites Europe, 31 January 2017) there are as many as 222 duration hedged classes with $10bn in assets managed by managers. The European Fund and Asset Management Association (“EFAMA”) has come out strongly against the Opinion and has been quoted in Ignites (Ignites Europe 6 February 2017) as saying that it believes that the Opinion is a “step too far” and is urging reconsideration on the basis that investors in these classes will be required to redeem and invest in new funds. Its essential argument is that culling share classes will lead to more funds and smaller funds.

Currency Hedging Clears the Final Hurdle

ESMA consider that currency risk hedging is compatible with a common investment objective on the basis that it enables investors from EU member states with differing currencies to “participate to the maximum extent possible in the same performance of the common pool of assets as other investors”, provided that the hedges meet certain conditions aimed at reducing contagion risk.

In Ireland, currency hedged share classes are the norm of most UCITS and the Central Bank of Ireland (the “Central Bank”) has well established guidelines on share class hedging. In addition to currency hedging, the

Central Bank has specifically permitted interest rate hedging share class level. It has also additionally been open to proposals for the use of derivatives at class level to provide for differing levels of participation in the underlying portfolio or differing levels of capital protection. These types of hedging, however are less prevalent in the Irish market than currency hedging.

Hedged share classes are also common in Luxembourg with a greater prevalence of duration hedged classes. The Commission de Surveillance du Secteur Financier has not, to date, imposed formal requirements regarding these share classes.

The conditionality that ESMA is proposing to apply to the use of currency hedged classes with a view to achieving its principles of non-contagion, pre-determination and transparency are remarkably similar to the rules that have been in place in Ireland and Luxembourg for many years. In Ireland the only additional requirements imposed to ensure that under-hedged positions do not fall short of 95% of the proportion of net asset of the share class, which is to be hedged against currency risk a requirement that many managers voluntarily adhere to in practice and to ensure that counterparty exposure is calculated at share class level. This latter requirement will need to be considered against the UCITS Directive which requires counterparty exposure to be calculated at fund level.

Going forward, for UCITS at least, class currency hedging will be the only permitted form of overlay.

Getting in Line - the Transitional Provisions

It is expected that the Opinion will have immediate effect and that the establishment of hedged share classes apart from currency hedged classes will no longer be permitted. However, it should also be noted that many managers provide that they “may but are not obliged to” undertake class currency hedging. This is in contrary to the principle of pre-determination; as detailed in the Opinion which gives rise to a number of questions such as whether the current optionality will continue to be permitted e.g in circumstances where the terms of the hedge may be disadvantageous. Managers may no longer have discretion on whether to hedge or not and may be required to undertake uneconomic hedges.

Fund documents, risk managements processes and hedging agreements will need to be reviewed to ensure compliance with the provisions of the Opinion, particularly the principles relating to non-contagion.

For those non-compliant classes that are currently in existence, notably the large cohort of duration-hedged share classes, ESMA will not require immediate closure or redemption from such classes, but it will require that they be closed to new investors from 30 June 2017 (being six months from the date of the Opinion) and closed to additional investment by existing investors from 30 June 2018 (being 18 months from the date of the Opinion). We will also have to wait and see how regulators will apply the new requirements to existing currency hedge share classes.

Managers impacted by the change will need to consider how they give clients the benefit of hedging going forward. The establishment of parallel funds or feeder funds are the more obvious solutions. However, this could also lead to the consideration of alternative options outside of the UCITS regime through the establishment of alternative investment fund structures within and outside the EU. In Ireland and Luxembourg, such structures include the Irish Qualifying Investor Alternative Investment Funds structures, the Luxembourg Specialised Investment Funds or Reserved Alternative Investment Funds. In the UK and other European jurisdictions, non UCITS structures are also available.

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The role of UK lending funds is increasing in the post-Brexit world

By Craig Reeves, Founder, Prestige Asset Management

Craig Reeves

The investment management industry has become even more critical in the UK's non-bank finance market

Interest in the UK as a market for investment does not seem to have dissipated in the wake of the Brexit vote. Foreign investors see an opportunity from the weaker British pound to increase their exposure and there is also considerable interest in the long-term prospects for the UK economy and the yields to be earned from effectively managed lending strategies.

The UK has always been regarded as one of the top prospects for foreign direct investment. Lending funds, which have been expanding their share of the alternative assets market as government bond yields have hit negative territory, represent both an uncorrelated source of returns and, in the case of the rural sector, bring the additional attraction of loans often secured against prime UK farmland.

The latest economic numbers seem to be pointing to a much more benevolent environment for the UK than previously forecast. But with all this good news, Brexit will also mean a re-think for some business sectors as they seek to address systemic problems that the withdrawal from the EU could exacerbate.

The UK remains dependent on food imports: the weaker pound is putting pressure on the margins of many companies. The UK currently imports approximately 30% of its food and, with a weaker currency, food security will inevitably creep onto the agenda.

Food wastage could become a major issue as the country seeks to detach itself from Europe. Britain wastes more food per week than any country in Europe, with the average household throwing away 13lbs of food per week. British households have been found to squander over £12 billion in avoidable waste every year, which works out at £480 per household. [1]

This brings with it environmental implications. Meat production, for example, consumes many resources in the first place. Even a small amount of waste meat already has major implications in terms of lost resources. According to a study produced by the European Commission's Joint Research Centre, over-zealous sell-by dates and over-ordering by middle class households must shoulder much of the blame, not just in the UK, but across Western Europe.

Food waste will need to be addressed. With higher taxes being levied on traditional forms of waste disposal, businesses in the food industry have to embrace new technologies. The UK is lucky to be on the cutting-edge of many aspects of R&D in the agriculture sector, including the development of anaerobic digestion plants.

These tackle not only the management of waste but also have the useful by-product of bio-gas, which can be employed by farms as a source of alternative energy or turned into biomethane for use in the national gas supply network.

We are already actively involved in the financing of anaerobic digestion plants in the UK. These are digesting organic waste – e.g. from food wastage – while generating an ultra-low carbon fuel which can replace more expensive fossil fuels as well as providing a local and cheaper alternative source of natural fertiliser from the digestate.

Biogas is just one source of alternative power lending funds can help to develop – there are many others, and their development is essential if the UK economy is not to be undermined by a potentially more critical threat than Brexit, namely a power shortage.

Not enough power

The UK's issues with electricity did not go away with the Brexit vote. The country is still struggling to cope with the integration of green energy into its power mix – alternative energy sources currently constitute approximately 20% of power generating capacity.

Within the rural economy, higher electricity prices will not be helpful: one senior executive at the UK Government regulator Office of Gas and Electricity Markets (Ofgem) has already warned that households may be forced to pay extra to keep their lights on, but let's not forget the impact on small businesses, including companies responsible for food production. The closure of coal fired power stations will mean that the distribution of power across the UK may be irregular. This has implications for farmers, who are turning to alternative and localised power sources to ensure they can continue to operate.

Even the Chancellor has admitted that the country will need to invest "eye-wateringly large sums of money" to keep the lights on. Many farmers have traditionally turned to banks for loans to help them invest in such projects on their properties, but sadly this energy crisis comes at a time when EU funding, and bank finance, often remain restricted.

The UK's smaller, rural communities have been subjected to a relentless drive by the major banks to cut costs by closing branches. Unlike many other countries, the UK does not have specialist agricultural or farmers' banks that were founded to lend specifically to rural businesses. The loss of lending institutions in smaller communities could have significant implications for businesses in the farming and food processing industries.

What needs to be avoided is a situation where a combination of debt and falling earnings forces many farmers to simply sell their land and retire. Farmers are unable to make sufficient profit to be able to reinvest in their businesses, modernising them and making them more dynamic.

Indeed, with rising inflation farmers are also starting to invest more heavily in infrastructure that will help them cut costs, not only by generating green energy on-farm, but also through other innovations like raw milk vending machines and higher margin organic related produce; while in some cases supermarket groups are starting to pivot back to UK suppliers as a result of a weaker pound.

The ongoing financing of the farming sector in the UK remains shrouded in uncertainty in the run-up to an eventual Brexit, although three things seem certain. Everyone will still need to eat, prices will continue to rise and small businesses will still need to borrow money in order to invest in productivity. There is increasing emphasis being placed on secured lending from alternative sources to banks, and lending funds are well-placed to play an important role.

According to the Financial Stability Board, in 2015-16, by far the biggest category of non-bank lending globally was being carried out by investment funds. It estimated that in 2016 alone 60% of global non-bank credit intermediation was formed by investment funds.

Interest in lending finance from institutional investors is increasing steadily: research from Willis Towers Watson indicated[2] that investor appetite for illiquid credit was burgeoning to compensate for lower yields in public markets. This has been further borne out by McKinsey[3] and Preqin. Fifty-seven per cent of investors said they planned to increase exposure to private debt strategies in 2017, more even than private equity[4]. With the European specialist illiquid credit manager market now approaching the size of its US counterpart, investors also have a wider range of strategies to choose from and given that the UK has one of the largest finance industries in the world, the pool of talent from the commercial banking world is significant.

Footnotes:

[1] Daily Telegraph Newspaper
Barclays, Office for National Statistics

[2] Global Alternatives Survey, 2016

[3] McKinsey Global Private Markets Review, 2017

[4] Preqin Investor Outlook: Alternative Assets H1 2017

AIMA

Responsible investment for institutional investors in hedge funds - an event summary

By Justin Sloggett, Senior Manager, Investment Practices and Marisol Hernandez, Manager, Investment Practices at United Nations Principles of Responsible Investing

On 3 November a group of institutional investors, hedge fund managers and consultants, with the support of the Principles for Responsible Investment (PRI), APG Asset Management, the Alternative Investment Management Association (AIMA), Ropes & Gray and the Chartered Alternative Investment Analyst Association (CAIA), met together in a conference in New York.

The aim of the conference was to dispel some of the misconceptions about the incorporation of responsible investment (RI) in hedge funds, its application in the due diligence process, and the main challenges faced by the industry. The key takeaways are detailed below.

What is RI in hedge funds?

Investors are beginning to incorporate responsible investing criteria in their hedge fund allocations. Forward-thinking hedge fund managers already apply RI practices and some have done so for years.

There is a common misperception that RI is incongruous with hedge fund investing, but this is due to misconceptions surrounding both RI and hedge funds. Investors with limited knowledge of RI practices often refer to it as 'socially responsible investing' or 'ethical investing' and many believe that RI is purely screening and/or active ownership. They are often not aware of other RI practices, including ESG integration, which the PRI defines as "the systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions".

Institutional investors who assess hedge fund managers on their RI practices believe that RI investing has two components, which can be easily applied to hedge funds:

- incorporating ESG data into the investment process and stock valuation (i.e. ESG integration, screening and thematic investing); and
- active ownership and governance strategies.

They also believe that RI investing can mitigate portfolio risk and enhance portfolio returns.

How are RI practices incorporated into the due diligence process?

Institutional investors invest a great deal of time studying their managers' investment processes. Increasingly, RI questions are being included in the hedge fund due diligence process. The key questions institutional investors ask include:

- Does the investment manager have a formal RI policy or other governance mechanism for oversight?
- Does the investment manager have dedicated employees or other resources in place to facilitate RI incorporation?
- How does the investment manager integrate ESG factors in its investment decision-making process? Have investment decisions changed as a result of ESG considerations?

- What transparency and reporting is the investment manager prepared to make available?

- After the allocation is made, investors then monitor their underlying investment managers to ensure continued adhere to these policies.

Investors' expectations

> "The amount of time spent on considering ESG issues should be correlated with the amount of time spent considering other investment issues".
>
> – Panellist

Investors with a RI mandate are looking for investment managers that systematically integrate ESG issues into their investment process, valuation calculations, and active ownership practices, and those who continually assess the impact of ESG issues on their portfolio's risk and return.

These investors want their managers to have a policy in place and be able to demonstrate that this policy is being put into action. Investors agreed there is nothing worse than managers that have a policy and procedures in place which they do not follow.

Investors found that the most successful approach for achieving the incorporation of RI policies and procedures by managers is through having a two-way dialogue with the managers. Whilst managers must be able to demonstrate that they are taking RI seriously and constantly assess and report on their progress, investors should work with the manager to ensure their expectations are clear. This two-way dialogue ensures a productive relationship between investors and hedge fund managers.

Will investors be attracted to funds that are applying ESG considerations?

There is increasing demand from pension funds (private and public), endowments and foundations to have a fully sustainable approach to their investment processes that incorporates RI practices. These investors are attracted to managers that comply with their RI demands and that consider all material factors, including ESG factors, to create better and resilient portfolios. However, it is also critically important that they are not sacrificing returns in the name of RI. According to data[1] presented at the event, 3/4 of investors around the world are incorporating ESG when allocating to alternative investors, and 2/3 are thinking about ESG when they are making hedge fund investments.
However, advanced RI practitioners believe it is extremely short-sighted to incorporate ESG factors into the investment process purely for reputational purposes. Ultimately, investors value managers who consider ESG issues to improve the risk-return trade-off of their portfolio and so help attract clients – not those who treat it as a marketing tool.

What are the challenges faced by the hedge fund industry?

The main challenges faced by investors and managers alike are poor RI data, unclear guidelines and the absence of an independent third party verification.

Hedge fund managers pursue a wide range of diverse investment strategies, some of which are better suited to a formal RI policy. Panellists made clear that no strategy is inherently incompatible with RI, just that some have a greater degree of relevance and as a result, they have a nuanced approach to due diligence. When trading equities, it is very straightforward to think about how ESG factors can be incorporated into an investment process. However, it is much more challenging to incorporate ESG issues into fixed income arbitrage or global macro and CTA strategies. This is particularly true in emerging markets because of price fluctuation and volatility, which can affect the cost of capital, including the cost of food or other agricultural products.

Concluding comments

The hedge fund industry is beginning to take steps to adopt RI policies and report on ESG issues. This is expected to grow as investors step up their demand for RI-compliant hedge fund investments and better data and reporting guidelines become available.

In order for institutional investors to identify managers that can generate enhanced risk-adjusted returns through RI investing, they must dedicate resources to it, ensure investment staff are trained, and incorporate a governance framework to guarantee RI is a real part of the investment process and not just marketing spin.

For their part, investment managers should ensure that RI is an organic part of their investment strategies and approach ESG factors as they approach any other signal – rather than something bolted on in response to an investor request. In this way, they can achieve the enhanced risk-adjusted returns available through RI investing.

The panellists ably demonstrated that RI is not incompatible with hedge fund investing, but we are indeed in the early stages. In the end, it’s the investors and fund managers’ responsibility to close the gap between where the hedge fund industry is now in terms of RI and where it will be in 5 years’ time.

[1] Source: Survey “Global insights on ESG in alternative investing”, March 2015, Mercer and LGT Capital Partners.

The ICAV in Ireland: The story so far

By Ian Dillon, Partner and David Naughton, Associate of William Fry

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Introduction

The Irish Collective Asset-management Vehicles Act 2015 (the "ICAV Act") came into operation on 11 March 2015, thereby introducing a new type of corporate legal vehicle, the Irish Collective Asset-management Vehicle ("ICAV"), which may be used to establish either a UCITS investment fund or an AIFMD compliant alternative investment fund ("AIF"); typically a qualifying investor alternative investment fund ("QIAIF").

The ICAV adds to a number of existing legal vehicles that may be used to establish investment funds in Ireland, namely; the public limited company ("PLC"), the unit trust, the investment limited partnership and the common contractual fund. ICAVs are first registered as a corporate legal vehicle and then authorised by the Central Bank of Ireland ("CBI") as the chosen investment fund, and the ICAV that was registered was authorised by the CBI on 30 March 2015 as a QIAIF.

On the two year anniversary of its introduction, this article makes some observations on the use of the ICAV so far.

Some observations on the ICAV so far

The creation of the ICAV, and its registration with the CBI, is straightforward and efficient:

- An ICAV is constituted by way of the preparation of its instrument of incorporation ("Instrument"). The Instrument is in large part similar to the constitution of a PLC and does require careful drafting in order to address the nuances of the ICAV Act. Once the Instrument is drafted, we move to the registration process.
- Unlike the PLC, where the Companies Registration Office in Dublin acts as registrar of this legal vehicle under the Companies Act 2014, and the CBI authorises the investment fund as either a UCITS or an AIF, in the case of an ICAV the CBI has assumed the role of registrar of the ICAV, in addition to authorising the ICAV as either a UCITS or an AIF.

- Registration of an ICAV involves completion of a straightforward form and its submission, along with the draft Instrument, to the CBI, which allows two weeks from the date of receipt of a completed application to issue a registration order for a new ICAV. In our experience to date, the CBI generally processes ICAV registration applications more quickly than the allotted 10 business days.

Investors recognise the UCITS or QIAIF brand so familiarity with the ICAV is not a major issue:

From the perspective of brand familiarity, in speaking to investment managers, there is limited concern that the ICAV is currently a relatively new corporate legal vehicle without strong investor familiarity. This lack of concern is due to the familiarity that global investors have with the regulated investment fund structures that may be authorised using an ICAV - the UCITS or the QIAIF.

Conversion to an ICAV or migration into Ireland to become an ICAV is being utilised:

- The ICAV Act permits an existing corporate investment fund authorised in Ireland as a UCITS or QIAIF to convert to an ICAV by way of continuation, using a straightforward registration process. In order to convert a filing is made with the CBI, which subsequently issues a certificate of registration of the corporate investment fund as an ICAV. Importantly, the investment performance track record of the corporate investment fund is not lost as a result of its conversion to an ICAV.
- The ICAV is also available to corporate investment funds from other designated jurisdictions who wish to migrate to Ireland. These investment funds can also register and continue in Ireland as an ICAV without losing their investment performance track record.
- The CBI has confirmed that where a corporate investment fund is migrating to Ireland as an ICAV, the ICAV registration details will need to be submitted 10 business days in advance of the proposed QIAIF or UCITS authorisation day. Provided there are no issues with the registration and authorisation applications, the registration order will issue from the CBI on the authorisation day together with the letter of authorisation of the ICAV as a UCITS or a QIAIF.

Are we witnessing the decline of the use of the PLC as a corporate legal vehicle to establish an authorised investment fund in Ireland?

Between 11 March 2015 and 31 January 2017, the establishment figures for these legal vehicles were: 280 ICAVs as opposed to 40 PLCs (of that number, only 6 PLCs were established in 2016). Whilst it is difficult to be definitive, this trend towards preferring the ICAV may be due to some of the following reasons:

- **No risk spreading requirement.** ICAVs authorised as QIAIFs have no risk spreading requirement, unlike in the case of PLCs authorised as QIAIFs, making them extremely useful for single asset investment funds, investment funds with very concentrated positions and investment funds which have pro-longed "ramp-up" periods.

- **Falls outside of the Companies Act, 2014 in Ireland.** ICAVs are outside the scope of the Companies Act, 2014 in Ireland. This

1. removes Irish corporate law formalities which were not appropriate for investment funds but mandated for PLCs;
2. "future proofs" ICAVs against changes to the Companies Act for the purposes of addressing company law reform;

- **New ability to make non-material changes to constitutional rules in an efficient manner.** No alteration of the Instrument may be made without investor approval unless the depositary certifies that the changes to the Instrument do not prejudice the interests of investors. This protects investors but also simplifies the process to facilitate standard/non-material changes to the Instrument. This contrasts with the current process for PLCs whereby any change to its constitution requires investor approval.
- **New ability to dispense with the requirement to hold an annual general meeting.** Unlike a PLC, the directors of an ICAV are permitted to elect to dispense with the holding of an annual general meeting ("AGM") by giving written notice to all of the ICAVs shareholders. There is an investor safeguard in that shareholders holding 10% or more of shares can demand an AGM. This option can be extremely beneficial for investment funds with discretionary investor mandates or where there is a large number of nominee investors who may not return proxy forms or where the investors have indicated a preference to dispense with AGM formalities.
- **New ability to prepare separate accounts at sub-fund level.** The ICAV Act allows for the preparation of separate sub-fund accounts for an ICAV umbrella investment fund. In contrast, an umbrella investment fund structured as a PLC has to produce one consolidated set of accounts for the entire umbrella structure, which mandates a single year-end date and allows investors in one sub-fund to receive financial details for other sub-funds in the same umbrella.
- **New ability to "check-the-box" for U.S. tax purposes.** A PLC cannot elect to be treated as a partnership for US tax purposes. If an Irish investment fund wished to attract US investors, until now it would generally be structured in the form of a unit trust. The ICAV has the ability to "check-the-box" to be treated as a "partnership" (if it has more than one investor) or a "disregarded entity" (if it has only one investor) for US tax purposes.
- **Ability to revise the ICAV Act.** Primary legislation, such as the ICAV Act, may be amended by the parliament of Ireland as the nature of the investment fund industry evolves in the European Union.

A final word

For the investment manager, an ICAV provides a delivery channel to different investor bases, depending on whether the ICAV is authorised as a UCITS or a QIAIF. Irrespective of the investment fund authorisation sought, the benefits of using the ICAV remain, in large part, constant; for example:

- the ability to alter the Instrument without investor approval provided the depositary certifies that the changes to the Instrument do not prejudice the interests of investors;
- the ability to make an election under US 'check-the-box' tax rules, allowing the ICAV to be treated as a partnership or a disregarded entity for US tax purposes; and
- the ability to prepare separate accounts for individual sub-funds of an umbrella ICAV.

It seems that the use of the ICAV will continue to be widespread and its place on the list of potential legal vehicles that may be used by an investment manager for the authorisation of its investment funds domiciled in Ireland is assured.

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To outsource or not to outsource: The key issues you need to consider

By William Hedges, Senior Solicitor and Alex Green, Senior Solicitor at Macfarlanes

Alexandra Green

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Introduction

Outsourcing is a business model that has become increasingly common in the asset management industry. Specialist outsourced service providers operating in the sector offer opportunities for a variety of efficiencies, both in terms of cost savings and service improvements.

However, while appreciating the scope of those opportunities, it is important to acknowledge that the decision to outsource also presents a variety of corresponding risks. Unless properly considered and managed as part of due diligence and in the outsourcing contract itself, these can leave asset managers with significant legal, regulatory and reputational exposure.

Five key issues

The following represent what we consider to be five of the most important considerations in this context. Each outsourcing deal will of course present its own challenges, but in our experience asset managers will often encounter issues similar to those highlighted when outsourcing one or more of their functions.

Issue 1 - ensuring regulatory compliance

In the context of outsourcing in the asset management industry, the single most important consideration when taking the decision to outsource will be how to ensure that the asset manager's regulatory compliance is not jeopardised.

At the most basic level this will require the asset manager to comply with its obligations under SYSC 8 to conduct proper due diligence on the proposed outsourced service provider. Is it competent to undertake the functions that the asset manager wishes to outsource? Does it have a strong track record of compliance; or have there been instances of service failure or, worse, of being subject to regulatory censure?

Beyond that though, many outsourcings will involve, specifically, a transfer of aspects of an asset manager's regulated functions (albeit that ultimate regulatory responsibility for the services cannot be delegated). FCA rules explain that the asset manager must retain the necessary expertise to supervise the outsourced functions effectively and to manage the risks associated with the outsourcing, and must supervise those functions and manage those risks.

The question therefore becomes how to ensure the outsourced service provider ensures that the services that it provides are – and will allow the asset manager to remain – fully compliant on an ongoing basis even though the service provider is not ultimately responsible for the service to the end client from a regulatory point of view.

That the outsourced service provider should commit to providing fully compliant services would at first sight seem a very basic proposition. But in fact there is usually significant reluctance by outsourced service providers to accept that their obligations extend beyond providing the services as listed and defined in the contract. Outsourced service providers will agree to meet any regulatory obligations to which they are directly subject by virtue of the services they provide, if any, but take the position that it is not for them to second guess the asset manager's regulatory duties. Asset managers are therefore left to identify and "plug" the regulatory gaps. In many suppliers' minds, regulatory compliance and dealing with ongoing regulatory change is fundamentally a customer issue (and indeed, a line of business for the service provider who will often expect to impose additional fees for updating the services over time – on which see issue 4 below).

The asset manager may also not be clear in practice regarding the extent to which it is required to police the outsourced service provider's services or "step in" if it has concerns. If the service provider is not itself regulated but puts the asset manager into regulatory breach, the need to act promptly will typically be apparent. However, if the service provider is itself subject to, and in breach of, FCA rules and the asset manager knows the service provider is in discussions with the FCA, the extent to which the asset manager needs to intervene may be rather less clear-cut.

Given the rapidly changing regulatory environment (not least MiFID II, and with the lack of clarity surrounding Brexit), if anything we have seen outsourced service providers becoming more reluctant to take on any more than the minimum responsibility for their own regulatory compliance. Yet experience shows that the regulator has high expectations of firms who choose to delegate, and will typically expect them to "ensure" the compliance of the delegated services, especially if they carry key regulatory risks, as is the case for custody and client money services. With that in mind, the importance of agreeing in the outsourcing contract a clear and unambiguous apportionment of duties and appropriate escalation and monitoring/intervention measures for regulatory issues cannot be overstated.

Issue 2 - driving supplier performance

A crucial requirement in any services agreement is the inclusion of mechanisms that will properly incentivise the service provider to perform the services to an acceptable standard. At the most fundamental level, nobody (least of all end clients) will want service standards to deteriorate when an asset manager moves to an outsourced model, or for the transition process to be anything other than seamless. However, it is not uncommon for such issues to arise unless the contract allows the outsourced service provider to be held to task over its level of performance.

With that in mind, asset managers taking the decision to outsource should incorporate some or all of the following mechanisms into the outsourcing contract:

A requirement for the outsourced service provider to pay liquidated damages to the asset manager in the event of delays against the agreed timeline for transition to, and commencement of, the outsourced services.

A requirement for the outsourced service provider to pay specific service 'credits' to the asset manager if key aspects of the services fail to meet a contractually agreed standard.

At a minimum, an ability for the asset manager to conduct an audit of the outsourced service provider's operations. If possible, the asset manager should have the additional right to step in and perform a more substantial oversight and management role where deficiencies are discovered.

A right for the asset manager to terminate the contract if service standards are particularly poor and move to a replacement outsourced service provider.

Critical or important outsourcing contracts will have to address the requirements in SYSC 8.1.8R, in any event, and the mechanisms above will often help the firm to meet those obligations.

We find that the mechanisms above, which seek to drive the outsourced service provider towards good service, are often most effective when combined with performance incentives where the outsourced service provider has performed at or beyond the contractually agreed levels.

Issue 3 - allocating liability

Connected with issue 2, a consideration of particular importance for an asset manager entering into an outsourcing contract will be ensuring that the outsourced service provider has an appropriate level of investment in the project. By this we mean ensuring that the service provider is on the hook for a sufficiently large quantum of damages in the event of any breach of the terms of the outsourcing contract to compensate the asset manager fully for losses it may expect to suffer. Without this, in the event of a breach of contract the asset manager may find itself with no remedy against the outsourced service provider (which evidently offers little incentive for the service provider to keep to the mark in the first place).

The task of allocating liability sensibly between the asset manager and outsourced service provider may seem a simple one in theory. However in practice this will involve the asset manager avoiding the traps of broad liability limitations commonly seen in the market under which outsourced service providers' liability is either excluded totally or, if not excluded, is capped at a low level. Where such limitations have been agreed, from a contractual liability perspective the outsourced service provider can operate with near impunity.

Assuming such broad liability limitations can be avoided, a further consideration in this context is how certain specific categories of loss should be allocated in the contract as between the asset manager and the outsourced service provider. Having regard to the categories of loss that are most likely to befall if things go wrong in outsourcings in this sector (which in extreme cases may include fines imposed by regulators, data losses or potentially even losses of client assets) will be of material benefit should the situation arise.

Issue 4 - providing for future change

Most asset managers entering into an outsourcing with an outsourced service provider will expect the relationship to continue for a number of years at least. In the context of such a long-term relationship, it will be important for the asset manager to take steps to ensure the outsourced services will continue over time to represent good value for money and, as a priority, to develop in line with best market and regulatory practice.

This issue will need to be considered and dealt with in the outsourcing contract at the outset. The contract should both impose an obligation on the outsourced service provider to keep the services current, and explain which party must pay the costs incurred in making such service improvements over time. Otherwise, if the asset manager wishes for changes to be made to the services, the only way of achieving this will be to request an amendment to the contract. This may mean the outsourced service provider will have no obligation to agree to such an amendment and, even if it does agree, the asset manager will inevitably be required to pick up the cost.

Issue 5 - planning for exit

While most outsourcing contracts are intended at the outset to be long-term partnerships, this aspiration is unfortunately not always successful. For obvious reasons it can be difficult, or even awkward, to consider exit planning when entering into an outsourcing. The reality though is that at some stage the relationship will expire and the asset manager will need to transition to a new service provider.

Regulatory focus on this stage of the arrangement is particularly acute. For this reason asset managers do need both to consider and to properly describe in the outsourcing contract the full exit process that will be followed on termination of the outsourcing contract, and each party's respective responsibilities at that time. Of particular importance in this regard will be to what obligations the outsourced service provider agrees with respect to transferring client and financial data to the asset manager; as well as more general requirements with respect to providing information on the services such as may be needed to allow a smooth and efficient exit.

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Extension of the Senior Managers and Certification Regime: Lessons learnt from the banking regime

By Dorian Drew, Partner, Regulatory Enforcement; Alistair Woodland, Partner, Employment and Chinwe Odimba-Chapman, Senior Associate, Employment at Clifford Chance LLP

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The Senior Managers and Certification Regime (SMCR) was introduced to banks in the UK just over a year ago. The Bank of England and Financial Services Act 2016 (the Act) provides for the extension of the SMCR to all financial services firms, including asset managers. Approximately 60,000 additional firms will be brought within the scope of the extended SMCR regime.

Whilst the obligations imposed on senior managers are, on their face, very similar to the requirements of the Approved Persons regime, the emphasis and focus on the part of the Regulators on individual accountability and responsibility and the ability to more clearly identify who within firms is responsible for particular areas add a new dimension to the obligations.

It is possible for asset managers and others to draw some lessons from the implementation of the banking regime for asset managers, which will help them navigate the extension of the SMCR in 2018.

Summary of requirements under the SMCR

In summary, the following are the key components of the SMCR as applicable to banks in the UK:

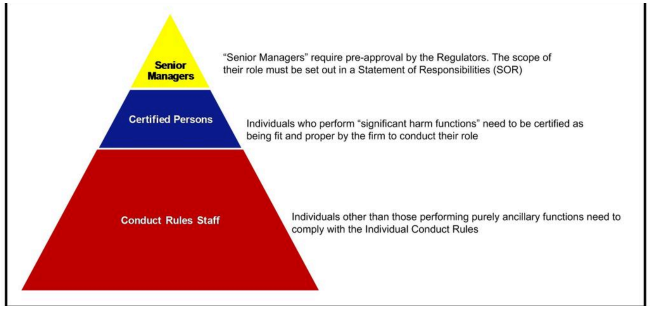
Senior Managers

Individuals fulfilling "senior manager functions" are required to be pre-approved by the Regulators. The extent to which an individual requires approval depends on whether they fulfil a role which requires it or whether they have overall responsibility for a business area, activity or function of the firm. The scope of each senior manager's role must then be clearly documented in a Statement of Responsibilities (SOR). This document is critical in delineating responsibilities across the firm and ensuring that there is coverage of responsibilities for all key activities conducted by the firm and certain other prescribed responsibilities.

The firm is also required to produce a management responsibilities map, which summarises its management and governance arrangements and allows the Regulators to identify quickly which individuals are responsible for which areas and activities of the firm.

In relation to obligations on senior managers, the SMCR imposes on senior managers a new, so-called "duty of responsibility". The duty of responsibility requires senior managers to take reasonable steps to avoid the occurrence or continuation of a contravention of a regulatory requirement on the part of the firm in the area for which they are responsible. This duty is in addition to Conduct Rules, some of which only apply to senior managers, and which largely replicate the Statements of Principle for Approved Persons. A notable addition to the Conduct Rules is an obligation on senior managers to take reasonable steps to ensure that any delegation of their responsibilities is to an appropriate person and that they oversee the discharge of the delegated responsibility effectively.

There are also new requirements regarding handovers for incoming and outgoing senior managers, which will require careful thought.



<u>Certification and Conduct Rules staff</u>

Individuals who do not fulfil senior management functions, but do fulfil certain specified "significant harm functions" within the firm, will need to be certified by the firm as fit and proper to conduct their role. The key difference here is that the firm is responsible for the fit and proper assessment, rather than the Regulators. This is a significant departure from the Approved Persons regime, and imposes potentially onerous obligations on firms to ensure that they have policies and procedures in place to make an appropriate determination of fitness and propriety. All other staff, apart from those performing purely ancillary functions, will also be required to adhere to individual Conduct Rules. The firm will need to ensure that Conduct Rules staff are appropriately trained and understand their obligations.

Lessons Learnt

The introduction of the SMCR prompted significant change, both from the perspective of the black letter requirements of the regime, but also from the steps many banks felt it prudent to take to ensure that employees, and senior management in particular, were prepared to take on their obligations under the SMCR. The scale and depth of the effort required to ensure compliance with the regime, even for smaller firms, should not be underestimated.

There are a number of key practical lessons learnt from the banking SMCR which asset managers (and other financial services firms) may wish to consider:

General

Lesson 1: Ensure you have identified the right legal entities: Each authorised firm will need to be included in the SMCR so it may be worth considering whether entities still require authorisations, or can be de-registered. Bear in mind that de-registration can take some time.

Lesson 2: Consider the impact of reporting along product and regional lines on the mapping of responsibilities. Reporting along geographic and product lines can make mapping responsibilities complicated, and it is important to leave sufficient time to work through any issues.

Lesson 3: Review governance and controls to improve standards and to ensure consistency across the firm. Taking the opportunity to ensure that formal governance frameworks are clear and effective, and that informal governance and control frameworks operate within guidance set on a firm-wide basis, will assist senior managers (and the firm) in being able to demonstrate appropriate controls aimed at the avoidance of regulatory contraventions.

Senior Managers

Lesson 4: Consider how the firm will describe the scope of each senior manager's responsibility. Whilst in theory this may sound straightforward, documenting the delineation between roles can be complicated, particularly where the Regulators ask firms to aim to do this in 300 words of less. One particular area of complexity may be the cross over between business areas and functions. Confirming the scope of responsibilities may also require discussion between senior managers, and so it is prudent to start this process early.

Lesson 5: Review reporting lines to ensure that there is clear delineation of roles and responsibilities. Often, reporting lines have developed organically over time, meaning that they can be unclear. Again, navigating this can be more complicated where firms are organised on geographic and/or product lines.

Lesson 6: Review delegation arrangements. A firm will want to ensure that there is a clear delegation of responsibilities from each senior manager to direct reports, and that the senior manager understands his or her obligations to effectively oversee delegations. Again, delegation arrangements are often informal and, whilst everyone thinks they understand the arrangements, there can be confusion or a lack of clarity when asked to document this.

Lesson 7: Review how management information is created and disseminated (both generally within the firm and on an individual senior manager basis). It will be key for firms to ensure that management information is serving the purpose for which it is intended.

Lesson 8: Ensure senior managers are engaged early so that they feel part of the process and understand in detail their responsibilities and the importance of any planned reviews. Different senior managers are also likely to have different concerns and areas of focus. Engaging early enables an effective dialogue about those concerns. This might for example include one to one meetings with senior managers to gain an understanding of any concerns, their area and their view on the scope of their responsibilities, and what "reasonable steps" might look like for them.

Lesson 9: Consider preparing a senior managers handbook. This will provide an ongoing resource for senior managers, including providing guidance on the duty of responsibility and practical ways in which they can demonstrate having taken reasonable steps.

Certification and Conduct Rules requirements

Lesson 11: Appreciate the definition of an "employee" used to identify individuals subject to the regimes is wider than its ordinary meaning. For example, it includes consultants, secondees and other workers. Identifying individuals who are classified as employees can be time consuming in itself.

Lesson 12: Appreciate the definition of "significant harm function" for Certification staff may also require some analysis. Although the rules applicable to other firms are likely to differ slightly from those applicable to banks, the rules for banks contain some complexities which, if replicated, will take some time for firms to work through.

Lesson 13: It is helpful to use a methodology document setting out how Certification and Conduct Rules staff have been identified. This is particularly useful where staff are not being identified centrally, to ensure a consistent approach, but in any event this will enable the firm to clearly show the approach it has taken.

Lesson 14: Maintain a live inventory of Certification and Conduct Rules staff. Considering early on how this will be maintained, and whether it will require changes to IT systems, will assist later when individuals start to be identified.

Lesson 15: Once the population of Certification staff has been identified, the firm will need to consider what changes are required to its onboarding, appraisal and exit processes to ensure compliance with the Certification regime at every stage. Again, this may require changes to IT systems and training for business areas and HR staff, and so it would be advisable to start the process early.

Lesson 16: Put in place a process for Certification Staff who cannot be certified as fit and proper. If an employee who is Certification staff cannot be certified as fit and proper, early thought should be given to how this will be managed and the process in place to assess fitness and propriety and deal with any issues that arise.

Lesson 17: Consider the impact on regulatory references. The rules also require some changes to the way references are given. In particular, it will be difficult for references for senior managers and Certification staff to be automated going forwards. Firms will therefore need to develop processes for ensuring compliance with the new requirements.

Conclusion

There is no doubt that the introduction of the SMCR has resulted in significant change for banks. Asset managers and other firms impacted by the extension of the SMCR can learn a number of practical lessons from the banking regime by looking beyond the formal requirements, and considering how the firm can ensure that the implementation brings about the desired organisational and cultural changes.

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Watch the yield curve for signs of recession risks

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

Judging from the intensity and polarization of America's political debates as well as developments in Europe, one might imagine that the financial markets would be roiled and in a state of high volatility with wide credit spreads and expensive options. Nothing could be further from the truth. Despite the various controversies taking place in Washington and the potential political upheaval in Europe, U.S. markets have been placid, with risky assets such as stocks, corporate credit and industrial metals, generally trending higher with relatively low volatility and options premiums, coming at the expense of flight-to-quality assets such as government bonds and gold which have seen their prices move lower (i.e., yields higher). And, the U.S. economic expansion appears quite healthy and robust.

Figure 1: US GDP Growth Periods.

US Real GDP Expansion Periods Since 1949

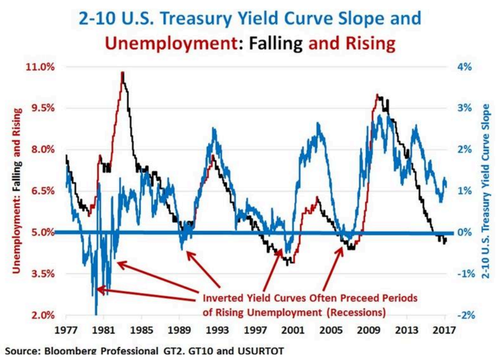
Start of Expansion	Real GDP Index Level	End of Expansion	Real GDP Index Level	Number of Quarters	Percent Change	Annual Average Growth Rate
Dec-1949	2004.7	Jun-1953	2593.5	14	29.37%	8.39%
Mar-1954	2528.0	Sep-1957	2875.9	14	13.76%	3.93%
Mar-1958	2772.7	Mar-1960	3123.2	8	12.64%	6.32%
Dec-1960	3081.3	Sep-1969	4736.1	35	53.70%	6.14%
Dec-1970	4708.3	Dec-1973	5462.4	12	16.02%	5.34%
Mar-1975	5292.4	Mar-1980	6524.9	20	23.29%	4.66%
Sep-1982	6486.8	Sep-1990	8983.9	32	38.50%	4.81%
Mar-1991	8865.6	Jun-2001	12710.3	41	43.37%	4.23%
Dec-2001	12705.3	Dec-2007	14991.8	24	18.00%	3.00%
Jun-2009	14355.6	Dec-2016	16804.1	30	17.06%	2.27%

Source: St. Louis Federal Reserve FRED Database (GDPC1)

We note that the current U.S. business expansion, which started in mid-2009 has been quite durable, albeit with only modest real GDP growth (Figure 1). If the expansion can make it through the end of 2018, it will be the second longest of 10 growth periods since WWII, at 38 quarters, just behind the 41 quarters of the 1990s expansion that managed to extend itself marginally into the 2000s, and ahead of the 35 quarters posted in the 1960s. Also, one may note that the annual real GDP growth is on a declining trend. This is due to much slower labor force growth, aging of the population, more sluggish labor productivity growth, and the constraining effects of much higher debt loads as a percent of GDP.

Just because an expansion period is getting a little long in the tooth, though, does not mean a recession is inevitable. With the benefit of hindsight though, it is obvious that all growth periods eventually come to an end. And, the expansion periods do tend to have many variations on the underlying cause of their demise. Nevertheless, and while not perfect, there is a common warning sign that recession risk is rising; namely the shape of the yield curve. When yield curves flatten and then become inverted, with short-term rates rising above longer-term bond yields, they can often signal a recession in the next 12 to 18 months (Figure 2). And, with the recession, there is usually a period of much higher equity volatility.

Figure 2: Inverted Yield Curves Preceded Each Employment Recession for at Least the Past 40 years.



Yield Curves as Warning Signs

At the moment, there are still 120 basis points (bps) of spread separating two and 10-year government bond yields—about 20 bps higher than the historical average for the past 40 years. This suggests that the U.S. economy is nowhere even close to a recession and that a downturn in 2017 is improbable, although not impossible. That said, each Federal Reserve (Fed) rate hike means short-term rates are on an upward path. The yield curve will start to flatten when bond yields no longer move upward as the Fed continues to raise rates.

Yield curves matter because, traditionally, banks and other financial institutions have depended, in part, on positively-sloped yield curves to boost earnings. To the extent financial institutions are willing to accept interest rate risk, they can fund themselves in the short-term from depositors or other lenders at a price close to the central banks' policy rate and then lend longer term at a higher rate for a profit. So long as the yield curve is positively sloped, their long-term loans earn a term premium over the cost of their short-term borrowings.

If the appetite for interest rate risk is low, financial institutions can still earn profits from using their borrowed funds to make loans at higher prices to entities with lower credit ratings, thereby earning a risk premium without explicit interest rate risk. Credit risk, however, typically comes with embedded interest rate risk. The borrowers are often highly leveraged or have very risky cash flows. The embedded interest rate risk shows up delinquency rates and bankruptcies. Also, as short-term rates approach zero, there can be a compression of interest rate spreads that negatively impact bank earnings.

Finally, financial institutions can charge fees for their services to help boost profits. Fees can be interest rate sensitive, too. For example, mortgage servicing rights produce fee income, but that income can disappear if rates fall and the mortgages are refinanced earlier than expected.

The relationship of yield curve shapes to economic activity has appeared to shift over time. There are several possible reasons. However, we would like to focus on the rise of interest rate risk management sophistication and activity, tighter regulation of bank capital, as well as the trend toward ever-higher debt levels in the economy. These three factors all work differently in how they have affected the influence of the yield curve on the economy.

Back in the 1950s, 1960s, and 1970s, interest rate risk management was relatively unsophisticated. Lending institutions mainly emphasized maturity gap analysis, comparing the size of their bucket of short-term liabilities, often defined as maturities under one-year, to the size of their bucket of loans of one-year maturity or longer. This "bucket" approach to measuring interest rate risk gave the Fed considerable power to tame an economy they considered was overheating. When the Fed raised short-term rates and inverted the yield curve, bank profits declined rather quickly and precipitously, so they curtailed lending. Home mortgage lending, especially, was hit hard by an inverted yield curve, and recession were often characterized by a housing cycle related to interest rates and the yield curve.

The seeds of change in the appetite for interest rate risk and the way financial institutions managed those risks came in the 1970s. What had been missing in earlier decades were the tools for interest rate risk management. Under the guidance of CME Group Chairman Emeritus Leo Melamed, the exchange launched foreign exchange futures in the early 1970s once the Bretton Woods system of fixed exchanges rate broke down. Exchange-traded currency futures started the revolution in financial futures. Long-term bond futures contracts were introduced in the mid-1970s, followed by short-term Eurodollar deposit futures in the very early 1980s. At the same time as the exchange-traded interest rate futures markets were developing, over-the-counter markets developed for interest rate swaps to shift interest rate risk from one counterparty to another.

With the tools at hand, financial institutions gradually evolved in their interest rate risk management sophistication. The home mortgage market was particularly impacted, as risk management tools allowed for specialization in different aspects of the market, such as loan origination, loan servicing (i.e., collecting the payments), and taking the interest rate risk. The net impact on monetary policy was to reduce the effectiveness of interest rate policy as a tool to control inflation, as financial institutions simply evolved into less interest rate sensitive entities. Note that "less" interest rate sensitive, does not mean "zero" sensitivity, as interest rates remain very important for bank profits, just not in the same way as in the 1950s and 1960s.

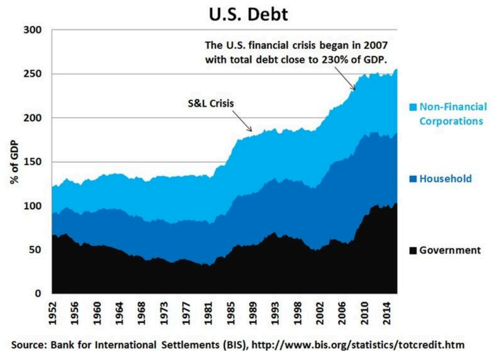
Regulating bank capital ratios has increasingly become the tool of choice by regulators to limit the exposure of the financial system to risks emanating from the financial system. This type of prudential regulation has probably worked to reduce systematic risk emanating from the financial sector, although not without unintended consequences. With tighter limits on bank capital ratios, monetary policy is now less able to provide stimulus to the economy. That is, the Fed can lower short-term rates, and even purchase US Treasury and mortgage-backed securities in size (i.e., Quantitative Easing or QE), and yet the impact on the economy is quite limited, even if the impact on asset prices is substantial. The issue is that once financial institutions are constrained by capital limitations, their lending will not automatically increase with lower short-term rates, and central bank asset purchases directly raise asset prices, such as equities and bonds (i.e., lower yields) without any knock-on impact to lending and economic activity.

Our conclusion is that while more sophisticated interest rate risk management and tighter capital ratios have worked to reduce (not eliminate) systematic risk from the financial sector, these two developments also have worked to diminish the potency of monetary policy. However, the shape of the yield curve remains a very useful indicator of a future recession. The reason is heightened debt loads in the economy.

The U.S. economy still has a mountain of debt, which continues to grow. In the wake of the 2008 financial crisis, there was never any net deleveraging for the whole economy. Private sector debt did fall as a percentage of GDP for a time but it was more than offset by a corresponding rise in public sector debt (Figure 3). In this regard, the U.S. is not alone or exceptional. Most of the developed world, including the Eurozone, Japan and the UK, are in a similar boat. Australia, Canada, China and South Korea are climbing aboard similar debt-laden boats, too.

A high burden of debt on an economy increases its sensitivity to interest rates and means the yield curve is likely to maintain significant predictive power related to the probability of future recessions. Interest expense rises with higher rates, and the more debt the economy has, the more vulnerable to higher rates. Heightened interest rate risk management does not reduce the overall level of interest rate risk in an economy, it merely moves it around to those with the appetite to take and get paid for taking interest rate risk and shifts the risks away from those that prefer to focus on other ways of earning returns. Similarly, tighter capital ratio regulation on financial institutions may work to reduce systematic risk coming from the financial sector. However, it will increase financial risk-taking in non-bank and differently regulated sectors. We think of this as the balloon theory of risk conservation. Due to underlying causes from economic risks, political risks, natural disasters, etc., there is a certain amount of risk in the overall economic system comparable to the total amount of air in the whole balloon. When regulators squeeze part of the balloon, the air (i.e., risk) goes to another sector.

Figure 3: Will Another Leveraging Cycle Boost Growth?



How Might the Yield Curve Move in the Future?

Knowing when the yield curve will flatten and possibly invert is key to determining the timing of the next recession, credit risk explosion and equity volatility spike. All of those phenomena tend to happen within about 12 to 24 months after the yield curve inverting.

By way of the obvious, there are two factors that determine the yield curve's shape: short-term, and long-term interest rates. Short-term rates are determined largely by the discretion of the central bank. The Fed, being data-dependent and skittish, is easily influenced by changes in economic data and in equity and bond market prices.

In 2015 and 2016, the Fed hiked its Federal Funds rate target range at the painfully slow pace of 0.25% per year. The Fed now appears on a much more rapid path to higher short-term rates. Even if they did four hikes this year, it probably would not flatten the yield curve, depending upon what happens to longer-term yields.

The other determinant of the shape of the yield curve, longer-term bond yields, are not so much influenced by Fed rate policy as inflation expectations and bond-equity trade-offs. Inflation has crept higher, moving above the Fed's 2% long-term target by several measures, if not yet by the Fed's favorite Personal Consumption Expenditure (PCE) price indicator. And, equity markets have rallied since the U.S. election on hopes of tax cuts, infrastructure spending, and lighter-touch regulatory policies, while bond yields have risen (i.e., prices have fallen). If inflation continues to creep higher and if the equity market sustains its rally, it is easy to imagine a parallel upward shift in the yield curve as the Fed raises its target range for the Federal Funds rate.

The current situation, with the Federal Funds rate below 1%, inflation rising above 2%, unemployment relatively low, and longer-term yields on the U.S. 10-year Treasury above 2.5%, there is a good case the yield curve will remain nicely positively-sloped in 2017. While Fed tightening has been a cause of an inverted yield curve and a subsequent recession many times in the past, at least for now, the very slow removal of monetary accommodation by the Fed simply does not suggest a shift to a flatter or inverted curve.

If the yield curve is going to flatten or become inverted, the likely cause may come from factors impacting longer-term bond yields. This means that the source of a bond market rally that works to flatten the yield curve and signal greater recession risk or higher equity market volatility is likely to come from an economic disappointment. We are not suggesting a bond rally and potential recession is likely any time soon; however, our radar has turned to monitoring potential sources of disappointment relative to expectations. In this regard, we are closely assessing fiscal policy. Our judgment is that equity markets have incorporated meaningful expectations of lower corporate and personal income taxes, as well as modestly improved economic performance. Therein lies the risks to the currently benign outlook.

What if it is a mistake to think that we will even see a fiscal boost at all. The Republican majority in Congress has decided to begin its term by tackling health care. If Republicans get it done, they will likely proceed with tax reform next. However, if the effort to reform health care is delayed or fails, it might damage the Republican Congress' ability to pass other legislation. We note that changing the Affordable Care Act is difficult and risky. Already there is push-back from all sorts of interest groups, not least of whom are the people who gained access to health insurance as a result of the law, not to mention hospitals, insurers and other groups. The next few months will probably determine the future of health care legislation.

Tax reform will be just as big of a challenge. While there is widespread agreement that the 35% tax rate on corporate income is aberrantly high, there is little consensus on what do to about it. Should the Congress simply cut the tax rate to 15% or 20%, as promised during the campaign, or should they cut the corporate income tax rate in exchange for adding a border tax adjustment which would make the package revenue neutral by no longer permitting the cost of imports as a deduction? Already, powerful opposing groups within the Republican Party are spending money lobbying for and against such an adjustment.

Reducing individual income tax rates either by closing loopholes, or not, poses similar dilemmas and will also be a challenge to get through Congress. The same can be said of infrastructure spending. Will it be achieved simply by having the Federal government borrow more money to finance the construction of roads, bridges, tunnels, airports and train lines or will it also involve privatization of public infrastructure? Will any of this pass through Congress? The Democrats are nearly united in opposition. This means that for legislation to move, there has to be near unanimity among the Republicans in both the House and the Senate as well as agreement from the Administration.

The answers to these questions matter for numerous reasons. Not least of these is that the more fiscal stimulus that gets enacted, the more the Fed is likely to raise rates. The more the Fed hikes rates, the more likely the yield curve eventually flattens and inverts to the probable detriment of those invested in high yield bonds and other risky assets as well as those who are short volatility. The sooner the yield curve gets to flat or inverted, the sooner the U.S. is likely to experience the next recession.

With so many moving parts, including fiscal policy and the psychology of investors, putting together a timeline for this is difficult. That said, it appears unlikely that 2017 will see a recession. We expect that growth will continue to muddle along in the 1.5%-2.5% range with some further decline in the unemployment rate and modest further upward pressure on wages and core inflation. That said, 2017 might see an increased likelihood of credit spread widening and volatility spikes (both implied and realized), especially if the Fed continues to hike rates at anything close to its new once-every-three-months pace.

The critical year is probably 2018. By 2018 we will know the extent of fiscal stimulus. Particularly, we will know if another round of federal debt finance is spiraling upward, taking the U.S. national debt toward 120% of GDP, or whether health care and tax reform have been handled in a revenue/expenditure neutral manner.

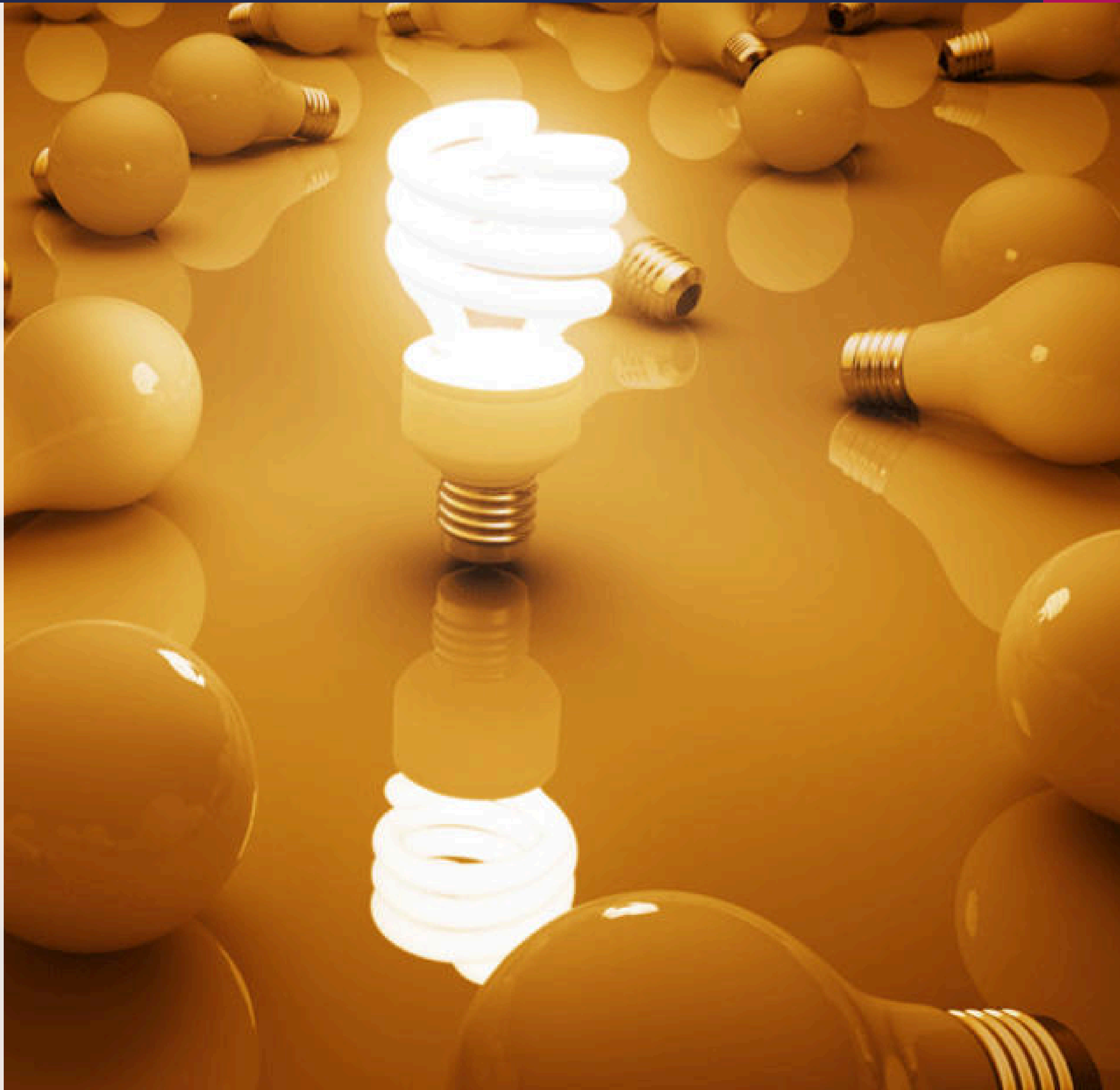
Fiscal stimulus with higher national debt raises the sensitivity of the economy to higher rates.

We expect a new Fed Chair and Vice-Chair in 2018, but given the Fed tightening cycle, fiscal policies increasing the national debt might raise the risk that the yield curve finally goes to flat or inverts, presaging a much more volatile period for investors towards the end of the decade and possibly the next recession.

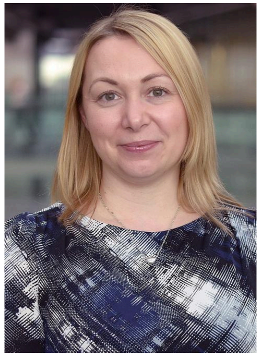
The other possibility, of more or less revenue/expenditure neutral policies from Congress, suggests the equity market may not get the fiscal stimulus it currently expects. And, if tax reform includes a border tax, there is the possibility of trade policy retaliation in the world. A disappointed equity market and lowered economic growth expectations could bring the type of flight-to-quality rally in bonds that flattens the yield curve and raises the probability of a future recession. Put another way, markets face considerable policy ambiguity, and depending on how the ambiguity is resolved, the current calm may give way to volatility. Time will tell. However, we know to watch the yield curve for storm warnings.

The R&D tax incentive that rewards innovation

By Dan Thomson and Emma Walsh at Ernst & Young LLP



Dan Thompson



Emma Walsh

The value of R&D to the UK economy

With Brexit on the horizon and global markets continuing to evolve, retaining and attracting organisations that undertake R&D activities is a crucial part of the UK Government's economic growth strategy.

R&D tax credits are a well-established, effective way of incentivising companies performing R&D. The UK boasts one of the more generous R&D regimes, seen as strategically vital to maintaining Britain's position at the cutting edge of science and technology. A recent announcement by Theresa May boosted the Government's commitment to transforming Britain into the 'global go-to place for scientists, innovators and tech investors', with the Prime Minister pledging a further £2bn of Government investment into R&D by the end of the current Parliament.

Awareness of the regime is growing in the financial services (FS) sector: in recently published HMRC statistics,[1] R&D tax claims made by FS organisations increased more than 10% over the previous year, a trend which looks set to continue. Significant potential benefits are available to alternative asset managers under the regime, although uptake in the sector is lower than other areas of the FS sector.

Some common misperceptions about R&D tax relief

Many alternative asset managers who look into HMRC's definition of 'R&D' conclude that they do not undertake activities which qualify for R&D tax relief. Interpreting qualification under the regime can often be confusing, given that the definition and guidelines run to more than 140 pages!

In practice, alternative asset managers need to extend continually their technological knowledge and capabilities to retain their competitive edge in pursuit of profitable returns. As this typically involves a broad range of technologically advanced activities, there is frequently significant scope for tax relief qualification. Some examples of potentially qualifying activities are as follows:

- Development or enhancement of core, unique IT platforms to support trading strategies, requiring a combination of a

multitude of technologies not achieved previously
- Research and modelling to inform signal generation, where undertaken as part of a project to extend technological capability
- Development and enhancement of data frameworks and distributed computing capabilities, enabling low-latency trade processing and risk calculation
- Creation of tools to scrape and collate market data from a variety of structured and unstructured data sources

Qualifying activities like these occur across the whole spectrum of management strategies, from fully discretionary to quantitative funds. Qualifying spend on R&D-eligible activities by both types of fund frequently runs into the millions, which can lead to significant and material tax benefits.

However, many firms are not yet claiming tax relief for activities which would qualify. One motive for this, which we have encountered a number of times, is that sensitive information critical to competitive advantage could be revealed. This is not the case. First, HMRC requires a narrative that they and their inspectors can understand to support a claim, and this does not include detailed confidential technical aspects. Second, if you choose to use an advisor to support your claim, their commitment to maintaining the confidentiality of your data should be paramount in their working approach.

After confidentiality concerns, another frequently asked question is: 'our competitors are all doing similar things: will we be eligible for tax relief?' Under the UK regime, where details of the technological advances competitors have achieved are not publicly available (which is almost always the case), work by a firm to develop its own solution can still qualify.

Projects do not need to develop completely new technology to qualify; materially extending technological knowledge (both within the firm and publicly) can also qualify for tax relief.

A final myth is that projects must be successful to qualify for R&D tax relief. Even the most experienced technologists take wrong turns when the path to the end result is unclear. HMRC recognises that experimentation is at the core of innovation and advance, and unsuccessful projects still receive tax relief if their activities qualify.

Where there is R&D, there is reward

An enhanced deduction of 230% on qualifying R&D expenditure is available to companies qualifying as Small and Medium Enterprises (SMEs) under HMRC rules. This translates to a 26% tax benefit where a company pays corporation tax at 20%, and can result in a cash refund for loss-making companies. Large companies can also claim, at a reduced (but still substantial) rate.

Companies can make a claim up to two years after the end of a corporation tax accounting period, meaning an R&D eligibility conversation can consider all recent activity and unlock more funding for further projects.

Fundamentals for claiming

The legal entity structure of your firm is a significant determinant of how much tax relief you can receive.

A partnership structure is often the primary choice for many alternative asset managers. Partnerships may not make direct R&D claims themselves but corporate members of partnerships may, in accordance with their profit share. Further, corporate members of partnerships that provide services to the partnership (or other group entities) under a services contract, and are paid a fee for those services, can make an independent claim on the basis of their own profits rather than their share of the partnership profit only.

Staff costs, including bonuses, are usually the most significant expense qualifying for the relief. Costs incurred for external staff, subcontracted work and software licences used on a project can also be taken into account, depending on exact circumstances.

An examination of organisational structure, and a survey of the major technological activities taking place, can enable experienced R&D advisors to give an indicative view of potential benefits, subject to more detailed review.

The right conversation gets the right result

IT professionals can quickly differentiate between those technological activities on projects which meet the R&D criteria, and those undertaken using available and existing knowledge. Developing a good understanding of the HMRC definition of R&D for tax purposes, and discussing its application to technological projects, is crucial to organisations making an informed assessment of R&D tax relief eligibility.

Making your claim

For alternative asset managers, turnaround time can be swift, and the time impact on important technologists minimal. For firms which have not yet claimed R&D tax relief, now is the time to look closely at the benefit it can provide.

Footnotes:

[1] Her Majesty's Revenue and Customs (2016) "Research and Development Tax Credit Statistics" https://www.gov.uk/government/uploads/sy...

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AIMA

How to stay one step ahead of MiFID: Three hard truths for buy-side firms

By Abide Financial

1. No-One Else Will Do It For You

> Under MiFID II, unlike under MiFID I, investment managers (IMs) can no longer place reliance on broker reports. Unlike under EMIR, there is no simple delegation route. Therefore, buy-side firms need to assume that they will be responsible for their own transaction reporting.

Investment Managers (IM) have enjoyed something akin to a free ride under previous reporting regimes. Under MiFID I, at least in the UK, reliance could be placed on the broker's report of having done a trade with the IM. In these circumstances, and assuming the trade was done by the IM under a discretionary mandate, no separate report was required of the IM. The majority of firms took advantage of this benefit, with the result that many buy-side firms have done little or no MiFID transaction reporting in the past. When EMIR came along the buy-side found that it could generally delegate its trade reporting obligation to its market counterparties. This was specifically allowed in the regulation and was facilitated by most major sell-side firms.

The regulators have given buy-side firms a straw to clutch at in the shape of the Receipt and Transmission of Orders (RTO) exemption, though anyone who has studied this option for more than five minutes has concluded that it does not help a great deal. The basic idea is that, provided a party acting as agent has sent all relevant order information to their upstream counterparty, this information can be incorporated into the counterparty's transaction report, allowing the agent not to submit a separate report.

However, under MiFID II there is no exemption from reporting, no matter who has reported a trade against you, and there is no easy route to delegation. For these reasons many IMs are now faced with developing their own reporting systems from the ground up.

Disadvantages for the buy-side firm include:

- The need to have a separate legal contract with each market counterparty, covering items such as format of data and timeframe for delivery
- The need to collect and send some of the most difficult to source and sensitive information related to a transaction, such as the national identifiers of the employees making investment and execution decisions
- The need to have a fall-back infrastructure for independent reporting in the case that the timeframes for order transmission cannot be achieved

Disadvantages to the sell-side firm that is offering to facilitate this structure include:

- The need to agree delivery timeslots and submission protocols under a legal contract with every agent who wishes to use RTO
- Taking responsibility for the safety of client's personal data

- Maintaining a dual infrastructure to cater for non-receipt of data by the agreed time, which triggers a very different reporting pattern

Not surprisingly, there has been limited enthusiasm for this option from either quarter, leading us back to the initial assertion – investment managers will need to prepare to do full transaction reporting under their own steam.

2. Reporting Volumes Will Be Higher Than You Expected

> A change in the reporting rules for your market counterparties makes it much more likely that they will report against you at fill level rather than order level, obliging you to report in the same manner. This may increase your reporting volumes 100-fold or more.

Investment managers are used to their brokers working orders in the market and booking out an average price transaction once the order is complete. Fill level information may be supplied intra-day for information purposes, but under MiFID I an agency broker is allowed to accommodate a client who prefers to receive a single contract note at an average price and to transaction report in the same way.

Transaction Reporting User Pack, Section 9.4

A firm may receive an order from a client that can only be filled by executing two or more transactions at different prices, but the client wants one or more contract notes showing an average price...

As there is only one client, where Firm X is acting in an agency capacity, Firm X can:

1. *report the two agency buy transactions from Firm Y (identified in the counterparty field) and include the identity of the client on each (in the customer/client identification field), even if the firm has issued a single contract note at the average price; or*
2. *report two market-side transactions with the word 'INTERNAL' in the customer/client identification field and one client-side average price report with 'INTERNAL' in the counterparty field and the client reference in the customer/client identification field.*

In other words, an agency broker could reflect the client's confirmation preferences in their transaction reporting structure, and the client could mirror this structure if making a separate report of their own. This concession disappears under MiFID II.

Level 3 guidance – Block 5.22 – One order for one client executed in multiple transactions (p82):

Even though the client wants an average price, the transaction reports have to reflect that every single market fill is immediately passed on to the client because the Investment Firm is dealing in a matched principal capacity.Investment Firm deals on 'any other capacity' basis.

The transaction reports of Investment Firm X dealing on an 'any other capacity' basis are exactly the same as the reports for matched principal above except that the trading capacity is reported as 'AOTC' rather than 'MTCH'.

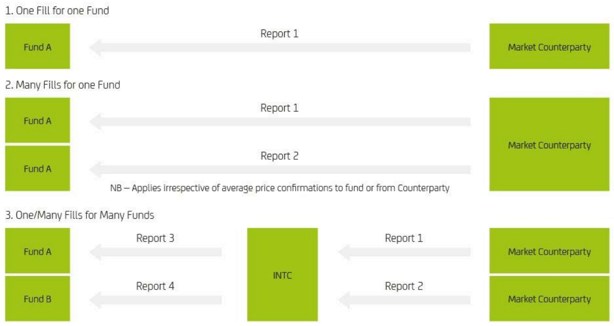
In other words, where market side brokers are acting in an AOTC (ie Agency) or MTCH (Matched Principal) capacity, they will have no option but to report against their clients at market fill level. Investment managers in turn will need to report from their perspective in a way that matches this level of granularity.

The other available trading capacity is DEAL (Principal). Principal brokers will still be able to take market fills onto their books intra-day and then book them out (and report them) at an average price once the order is complete. However, other sections of MiFID II militate against the use of Principal Brokers as a silver bullet for buy-side firms.

- Investment Managers may not be able to select brokers based solely on the convenience of the resulting reporting arrangements, given that they have fiduciary responsibilities towards their clients to obtain the best available prices (which may be offered by agency or matched principal firms)
- Principal brokers' aggregated bookings to their clients are likely to be seen as off-exchange transactions in venue-traded products, given that they differ in size, timing and price from the market fills. This could trigger post-trade transparency publication by the broker and over time a requirement to register as a systematic internaliser in each traded instrument. To avoid these outcomes, we expect even Principal brokers to move towards fill by fill allocation once the ramifications of the alternative arrangements become clear to them.

To summarise, we expect that most buy-side firms can anticipate a much higher volume of transaction reports to be required than would be indicated by the number of orders they are submitting.

One further complication for investment managers is that separate reporting patterns are required depending on whether an order is allocated to one underlying fund/client or to multiple accounts. If the allocation is to multiple accounts, then each fill can be reported as between the market counterparty and INTC (a dummy temporary holding area) and all allocations as between INTC and the relevant fund or client. However, if only one client is to receive an allocation then each fill related to the order must be reported as between the market counterparty and that managed account.



3. Trade Publication May Not Pass You By

> Post-trade transparency covers more instruments and more scenarios under MiFID II than MiFID I, giving rise to some edge cases where even Investment Managers operating in an AOTC capacity may need to publish just-traded prices to an Authorised Publication Arrangement (APA)

Trade publication, trade reporting and post-trade transparency are commonly-used terms for the same requirement – the need for the market to be informed promptly of the most recent prices at which venue-listed instruments have changed hands.

Are you trading instruments ON or OFF Venue?

In the case of trades which take place on-venue, the venue itself takes care of this publication. However, if the venue-listed product is traded off-exchange, for example via a bilaterally negotiated transaction, the regulator still wants the public to be informed of the price at which this happened, so as not to impair the transparency of the market as a whole. All trade publication other than by venues must be effected via an APA. The most frequent users of APAs will be Systematic Internalisers, who make a regular business of trading venue-listed instruments off-exchange. Note that no-one else needs to publish a trade report in this case. Unlike the case with T+1 transaction reporting, only one publication is required for every linked chain of trades, to avoid the market being misled as to the volume of trading taking place.

For equity share dealing it is most probable that there will be a venue or Systematic Internaliser (SI) involved in all equity trades given that a Trading Obligation will be in effect as soon as MiFID II reporting begins, and that obligation will demand that share dealing only take place via a venue or SI. In any case where neither a venue nor an SI is involved in a reportable trade, the onus falls on whichever MiFID Investment Firm (IF) sold the product, assuming that the trade took place between two IFs. It is at this point, somewhat at the margins of their business, that some

Investment managers will trigger a trade publication requirement. Let us take as an example a sale by the IM of a corporate bond. The bond market is not subject to the Trading Obligation, and bonds are not currently widely traded on-venue, which makes it highly feasible that an IM may sell the bond to an IF which has not registered as an SI. Under these circumstances the IM would be obliged to report the trade to an APA in order to allow publication within fifteen minutes of the trade taking place. In fact, diligent research at the Investment Association has highlighted a number of scenarios where the investment manager may need to make use of the APA services. Apart from the bond-trading scenario above, these include cases where the IM transacts with a non-EU entity or a non-MiFID firm within the EU, and where they undertake agency crosses between funds.

In all of these situations the IM is the only IF involved in an off-exchange trade. Where that trade involves an EU venue-traded instrument, the IM is the only party available to publish the trade.

Investment managers are not typically geared towards real-time extraction of data from trading platforms and quasi real-time reporting of that data. Even the presence of a tiny percentage of trades which require submission to an APA might call for wholesale architectural changes and development projects. IMs should not assume they are exempt from this requirement before putting all of their business flows and minority transactions under the microscope.

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How U.S. Private Fund Managers May Avoid Running Afoul of Proposed U.K. Legislation Criminalizing the Facilitation of Tax Evasion

By Will Smith, Partner at Sidley Austin LLP

In its latest effort to identify and punish those involved in tax evasion, the U.K. has proposed legislation making it a criminal offence for companies and partnerships to fail to prevent their agents from facilitating tax evasion. The proposed regulations – known as the "failure to prevent the facilitation of tax evasion" rules (UKFP rules) – are broad in nature and will affect a range of businesses, including private fund managers and other financial services firms.

This article, the second in a two-part series, provides an in-depth discussion of how the UKFP rules may apply to private fund managers, including U.S.-based investment managers that have a link to the U.K. The first article provided an overview of the UKFP rules and discussed the two new criminal offences prescribed therein.

How the UKFP Rules Apply to a Common Hedge Fund Structure

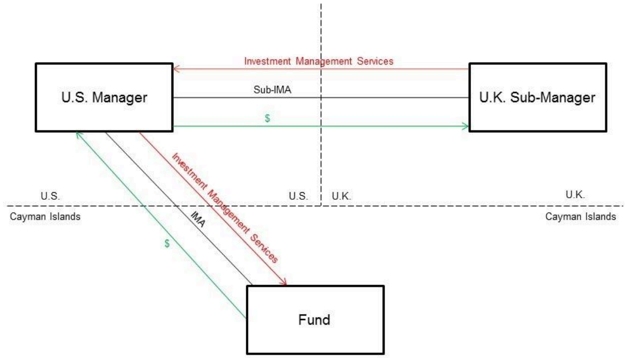
The proposed UKFP rules are broadly drafted and will have significant extra-territorial scope. Accordingly, the rules will need to be considered carefully by many enterprises with links to the U.K., including hedge fund managers and their related fund arrangements.

For purposes of this article, a standard hedge fund structure is considered to include the following:

1. a master fund vehicle, established as an exempted company incorporated and resident in the Cayman Islands (Fund);
2. an investment manager located in the U.S. (U.S. Manager), to which the management of the Fund has been delegated by way of an investment management agreement (IMA); and
3. an affiliate of the U.S. Manager located in the U.K. (U.K. Sub-Manager), to which certain aspects of the management services under the IMA have been sub-delegated by the U.S. Manager by way of a sub-investment management agreement (Sub-IMA).

The services provided to the Fund by the U.S. Manager and the U.K. Sub-Manager broadly consist of portfolio- and risk-management services; investment-advisory services; services relating to the arrangement of deals in investments and safeguarding or administering assets; dealing in investments as agent for the Fund; managing investments; making arrangements with a view to transactions in investments; marketing the Fund; and managing investor relations.

Below is a basic structure showing this arrangement.



Applying the UKFP Rules to the Fund, the U.S. Manager and the U.K. Sub-Manager

The UKFP rules provide for two new criminal offences:

1. The first offence applies to a company or partnership (Relevant Body) that fails to prevent the criminal facilitation of a tax evasion offence under U.K. domestic law (U.K. Offence).
2. The second offence applies to a Relevant Body that fails to prevent the criminal facilitation of a tax evasion offence under the laws of a jurisdiction outside the U.K. (Foreign Offence).

Provided that neither the Fund nor the U.S. Manager is incorporated in the U.K. or carrying on business in the U.K. through a permanent establishment, it would not have the requisite "U.K. nexus" to fall within the scope of the Foreign Offence under the first two elements of that rule. Accordingly, exposure in respect of the Foreign Offence would arise only to the extent that criminal tax facilitation activity takes place in the U.K. As a result, in practice, consideration of the application of the Foreign Offence may generally be more relevant to the activities of a person associated with the U.K. Sub-Manager.

Second, in the context of the Fund, the most likely person who could criminally evade tax (Tax Evader) is likely to be an investor in the Fund. However, given the fact that Cayman Islands funds are subject to the full range of automatic exchange of information regimes and should operate extensive "know your client" and "anti-money laundering" on-boarding processes, the risk that an investor would be approaching an investment in the Fund with the intention of criminally evading tax should be reduced. See "CIMA Enumerates Best Practices for Hedge Fund Manager AML Programs" (Mar. 17, 2016); and "Understanding the Intricacies for Private Funds of Becoming and Remaining FATCA-Compliant" (Sep. 12, 2013).

The Fund

The Fund will:

- likely have no employees;
- solicit and receive investments from a range of investors;
- retain the U.S. Manager under the IMA; and
- retain certain other third-party service providers, which may include an administrator, custodian, prime broker and, potentially, placement agent.

Accordingly, the principal risk areas for a Fund are likely to focus on the relationships with the U.S. Manager, the U.K. Sub-Manager and other third-party service providers. When it comes to appointing these entities, the terms upon which they will be retained are likely to be fairly prescriptive and will set out the specific roles and services which the Fund is expecting to receive. In many cases, these services will be operational and administrative in nature and are required by the Fund to conduct its business. For example, in the context of the U.S. Manager, the principal supply of services will likely be portfolio management. Portfolio management is, by its very nature, not a service that should be considered to give rise to a meaningful risk of criminal facilitation being undertaken.

On the other hand, however, services provided to the Fund by a placement agent could be seen as posing a higher risk. The Fund will have retained the placement agent to solicit investments from third parties. In providing this service, it is theoretically possible that the agent could criminally facilitate an investor in criminally avoiding tax.

The U.S. Manager and U.K. Sub-Manager

Both the U.S. Manager and U.K. Sub-Manager:

- are likely to employ or retain a range of investment professionals; and
- may directly retain a placement agent to assist with marketing the Fund.

Unlike the Fund, both the U.S. Manager and the U.K. Sub-Manager may have employees and may retain third-party service providers. As such, there is greater potential for risk under the UKFP rules. However, the same observations made with respect to the Fund should apply when considering functions such as portfolio management.

There is also one other circumstance that is important to note with respect to the operation of the U.S. Manager and U.K. Sub-Manager. Where the Fund is making international investments through the U.S. Manager or U.K. Sub-Manager, this raises the possibility of the Fund being the Tax Evader, with the relevant manager deemed the facilitator of the tax evasion (Facilitator) under the UKFP rules. Whilst, at first blush, this may appear somewhat unlikely, it is nonetheless important when the U.S. Manager and U.K. Sub-Manager are analysing their potential risk profiles under the UKFP rules.

Establishing a Defence: Creating Reasonable Prevention Procedures

No liability will arise to a Relevant Body under the UKFP rules where it can be shown that the Relevant Body has "reasonable" prevention procedures in place, designed to prevent the commission of an offence of facilitating tax evasion.

Reasonable procedures are those that are, broadly, proportionate to the risk faced by the Relevant Body of having persons associated with it committing tax evasion facilitation offences. U.K. Revenue guidance, in addition to the proposed legislation, states that, in some limited circumstances, it may be considered reasonable for the Relevant Body not to have any prevention measures in place (for example, where the Relevant Body has fully assessed the risks, and the costs involved in any implementation are disproportionate to the risks). U.K. Revenue does state, however, that "it will rarely be reasonable to have not even conducted a risk assessment."

It is important to note that having prevention procedures in place is not necessarily a guarantee that there will be no prosecution. It is always possible that the U.K. prosecuting authority may take a different view to the Relevant Body as to the reasonableness of the prevention procedures and decide to prosecute anyway. In such a case, the ability of the

Relevant Body to rely successfully on this defence would be determined by the courts.

For that reason (amongst others) it is important to pay attention to U.K. Revenue guidance in respect of prevention procedures. The guidance states that the prevention procedures should be formulated around six guiding principles:

1. **Risk Assessment:** The Relevant Body should assess the nature and extent of its exposure to the risk that those who act for it or on its behalf could engage in the facilitation of tax evasion offences. The guidance comments that the Relevant Body should "sit at the desk" of those providing services on its behalf and ask whether those service providers have the motive, opportunity and means to facilitate tax evasion offences;
2. **Proportionality of Risk-Based Prevention Procedure**s: Prevention procedures should be proportionate to the risk a Relevant Body faces of a Facilitator committing a tax facilitation offence. Excessively burdensome procedures tailored to every conceivable risk are not required; procedures need only be reasonable given the risks posed in the circumstances but must do more than pay lip service to prevention;
3. **Top-Level Management Commitment:** The guidance states that the most senior levels of the organisation are best placed to foster a culture where facilitation of tax evasion offences are considered unacceptable. Senior management are encouraged to be involved in the creation and implementation of preventative procedures and the assessment of risk;
4. **Due Diligence:** The organisation should apply due diligence procedures in respect of persons who perform services for or on behalf of the Relevant Body. The reasonableness of any prevention procedures should take account of the level of control and supervision the Relevant Body is able to exercise over a particular person acting on its behalf, as well as its proximity to that person. Increased scrutiny may be appropriate for persons working in higher risk areas;
5. **Communication (Including Training):** Prevention policies are to be "communicated, embedded and understood" throughout the organisation (not just at senior levels) through internal and external communication. This could potentially include tax evasion-specific training not just for employees but also for agents and other service providers; and
6. **Monitoring and Review:** There is an obligation to monitor the procedures and make improvements or other amendments from time to time as applicable.

The manner in which these six guiding principles are applied and operated by each of the Fund, the U.S. Manager and the U.K. Sub-Manager will, to an extent, depend on the functions being undertaken by or on behalf of each entity.

Practical Observations

The U.K. Revenue guidance makes it clear that prevention procedures should be tailored in a bespoke way to address the particular circumstances and risks of a Relevant Body. In the context of each of the Fund, the U.S. Manager and the U.K. Sub-Manager, it would seem prudent to undertake a risk assessment (see above). The conclusions reached in that risk assessment should be documented.

As a next step, consideration should be given to what (if any) prevention procedures are required. Set out below are a number of prevention procedures that could be implemented by the Fund, the U.S. Manager or the U.K. Sub-Manager (as the case may be) in the event that, based on the Relevant Body's risk assessment, it is determined that some prevention procedures should be implemented.

1. Each of the Fund, the U.S. Manager and the U.K. Sub-Manager could include appropriate contractual protections in their contracts with persons acting on their behalf that require the agent or service provider to: (1) represent that it will not be engaged in any activity that could give rise to the criminal facilitation of tax evasion; and (2) warrant and undertake that it has considered, has implemented, will keep under review and will amend (as applicable) from time to time reasonable preventative procedures in respect of its organisation.
2. Each of the Fund, the U.S. Manager and the U.K. Sub-Manager should perform due diligence on persons whom it directly or indirectly engages to act on its behalf.
3. The U.S. Manager and U.K. Sub-Manager should develop policies with the active involvement of senior management that outline appropriate conduct of the employees; explain how to report suspicious activities and what constitutes tax evasion; and summarize the penalties that could be imposed where a person facilitates tax evasion. Such policies should then be clearly communicated to their employees and agents (whether orally or in a document).

From an investor-relations perspective, it may also be helpful for the Fund to prepare a copy of its internal policy and procedures relating to the UKFP rules. This is in light of the growing interest investors are taking with funds' compliance procedures.

Conclusion

Whilst the application of the UKFP rules to particular fund structures will be determined by specific facts and circumstances, in general it should be possible for persons operating in the hedge fund industry to manage – and therefore mitigate – the risk of incurring liability under the new UKFP rules, provided that risk assessment is carried out and reasonable preventative procedures implemented.

It should also be noted that final legislation and official guidance on what constitutes reasonable prevention procedures has not been published as of the date of this article and may be subject to further amendment as the Criminal Finances Bill 2016 makes its way through the final stages of Parliament.

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Outsourcing Trading: a solution in a challenging environment

By Linear Outsourced Trading

Being an asset manager in today's market can be a bruising experience. Margins are shrinking, fees are under pressure, while operating costs have grown out of proportion. This is happening in tandem with unpredictable markets, making alpha creation for clients exceptionally difficult. Cost saving opportunities have to be identified wherever possible in a way that does not compromise the integrity and success of the business. Linear Outsourced Trading has sponsored this paper to look at some of the trends which are pushing asset managers towards outsourcing their trading desks to third parties.

The Cost Burden

It is no secret that active asset management returns have not been in line with investor expectations. In a forceful indictment, the UK Financial Conduct Authority's (FCA) Asset Management Market Study Interim Report stated that active asset managers routinely underperformed their benchmarks after fees. It also questioned why the industry's fees had not fallen as competition proliferated, something which has occurred in the passive fund sector, where there has been a race to the bottom on investor charges. All of this has contributed to the enormous growth in lower margin passive products, which, despite a fivefold increase in the UK since 2005, are still expected to gain market share.

The FCA's comments will naturally embolden investors to apply leverage on their active management fees. Such pressure will cause some firms to rethink their internal operational structures, and look for cost savings. The gravity of the situation facing asset managers is severe. According to a poll conducted by Financial News of leading asset management firms, 74% of Chief Investment Officers (CIOs) expected fees to fall in 2017. None expected fees to rise. In another study, Casey Quirk (part of Deloitte) forecasts that asset managers' median profit margins will fall nearly 18% from 34% to 28% by 2021.

The industry should be worried, as its very foundation is seemingly under threat from spiralling costs. So what major cost overheads can be scaled down? Traders do not come cheaply. The fully loaded cost of a typical trader with experience has been independently estimated at £300,000, meaning even the cost of a small team could be close to £1 million. This is an overhead many managers could do without. Outsourcing a trading desk to a trusted third party could save hundreds of thousands of pounds, allowing firms to invest elsewhere in their business.

The Race to Comply with Regulation

Regulation is a very significant cost for fund managers. Following the financial crisis, regulation has eaten into fund managers' margins, forcing them to make additional hires particularly around legal and compliance, and upgrade their technology and systems. The Markets in Financial Instruments Directive II (MiFID II) will be law in less than 12 months, and it is a deadline fund managers need to be working towards urgently. Non-compliance is not an option.

MiFID II covers a number of issue areas, but none are more important than its rules around unbundling. Research from sell-side brokers is typically paid for in equity commissions from managers, but this EU regulation will mean that the payment for research and execution services must be separate.

A study of more than 200 predominantly European asset managers by RSRCHX, a research firm, found a third of respondents had little idea of when they would be compliant with the rules, although half anticipated to be ready around summer.

50% of the firms in the survey are still uncertain about how to pay for research. The current environment and outlook means most buy-side firms are reluctant to incur the costs of research themselves but some are taking the moral high ground. RSRCHX said 19% of asset managers intended on paying for research from their own P&L, putting further pressure on margins, while 9% suggested they were in favour of passing on the cost to their clients - not an easy task when there is so much pressure on fees.

The consumption of research has been falling as firms have been forced to set monetary budgets and this reduction looks set to continue. RSRCHX analysis said 54% of the biggest firms expected their research spend to drop once the rules kick in. This is supported by a Financial News poll which found that 36% of CIOs from 23 firms managing more than £7 trillion will cut back on bank research. However, asset management firms are highly reliant on external research and there is likely to be a point where investment performance may suffer if the research spend is cut too severely. If asset managers decide to pay for research themselves - either externally or internally produced - they may have to assess whether having sufficient research or an in-house trading capability is more valuable.

Demonstrating to regulators that research and execution are divorced from each other is now a priority for asset managers particularly where individuals perform both functions. The associated reporting this will entail is also a huge cost for smaller managers. Some buy-side firms increasingly recognise that physically extricating trading desks and outsourcing such activities to a credible third party is a logical approach to take if they want to highlight to regulators that execution and research are unbundled.

Why are asset managers beginning to consider outsourcing trading?

In the past, portfolio managers have been reluctant to embrace outsourced trading primarily because sell-side research was interlinked with trade execution. Other concerns included potential information leakage and loss of control. So what has changed?

Beginning January 2018, research payments must be separate from trade execution commissions. Portfolio managers’ historical concerns that removing the trade execution from the research provider would affect the quality or quantity of research are becoming irrelevant. Client confidentiality and market abuse monitoring are regulatory obligations and any risk of information leakage is further reduced if there is no incentive to pass on information.

Trading desks are increasingly seen as a cost at a time when overheads are being closely scrutinised. Cost pressure on the sell-side initially encouraged the growth in electronic trading and the same pressures, together with changes in market structure, has encouraged the buy-side to follow a similar path.

As a result, trading has become highly commoditised and many trading desks are not adding the value they previously provided. It is understandable that managers like to be collocated with trading but it is a luxury that they can ill afford and one that can be replicated in a far more efficient structure.

Outsourced trading is likely to become common practice. Compliance was once seen as a function that had to be internalised by managers, but attitudes have changed. A similar mind-set towards dealing desks among investors and CFOs/COOs is clearly visible. Economic reality and not sentimentality about old trading methods is likely to drive strategy.

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Clock ticks down on latest tax evasion legislation

By Paul Hale, Managing Director, Global Head of Tax Affairs, AIMA

Within a couple of months the Criminal Finances Bill will be enacted. AIMA has been doing some work on the corporate criminal offence of failure to prevent the criminal facilitation of tax evasion which will be introduced. Businesses need to be careful not to fall foul of this new measure. It has similarities to other financial crime offences but businesses cannot rely solely on their existing internal procedures to address it. Even those not based in the UK need to be aware of it and take some actions in preparation.

The offence is committed by a company or partnership if someone such as an employee or contractor in the course of working for the business criminally facilitates a tax evasion criminal offence by another person and the business failed to prevent this happening. It is a strict liability offence punishable by an unlimited fine, but there is a statutory defence available that requires the business to show it had reasonable procedures in place to prevent the facilitation occurring (or that it was reasonable in the circumstances not to have such procedures).

The offence has extraterritorial effect in several ways. It applies where the tax evaded is UK tax, regardless of where the facilitation occurs; it applies where non-UK tax is evaded, if the facilitation occurs in the UK; and it applies to all taxes wherever the facilitation occurs if the business has a presence in the UK.

These two examples illustrate how this offence may arise:

- An employee of a fund management business learns that a UK resident investor wishes to conceal from HM Revenue & Customs (HMRC) the interest the investor is acquiring in a fund. The employee with the help of a contractor working for the fund's administrator arranges for false information about the investor's tax status to be recorded, which will result in an incorrect Common Reporting Standard report being made by the fund to its tax authorities. Wherever they are established, the fund management business, the administrator and possibly the fund can have committed the offence;
- A wealth management business in Utopia acts for an individual resident in Erewhon. At a meeting in a hotel suite, the client relationship manager helps the individual to evade tax in Erewhon. The offence can be committed if either the hotel is in the UK or the wealth management business has a branch or representative office in the UK (even though the employee and the client have no link to it).

Unless it is shown that reasonable procedures to prevent the facilitation of tax evasion are in place and are being properly operated with the support and involvement of senior management, no defence is available. The new offence is expected to apply from September 2017, but businesses should be starting to carry out risk assessments and putting procedures in place now, as HMRC expects them to be largely prepared by the commencement date.

While the name of the offence doesn't trip off the tongue, it should be on everybody's lips.

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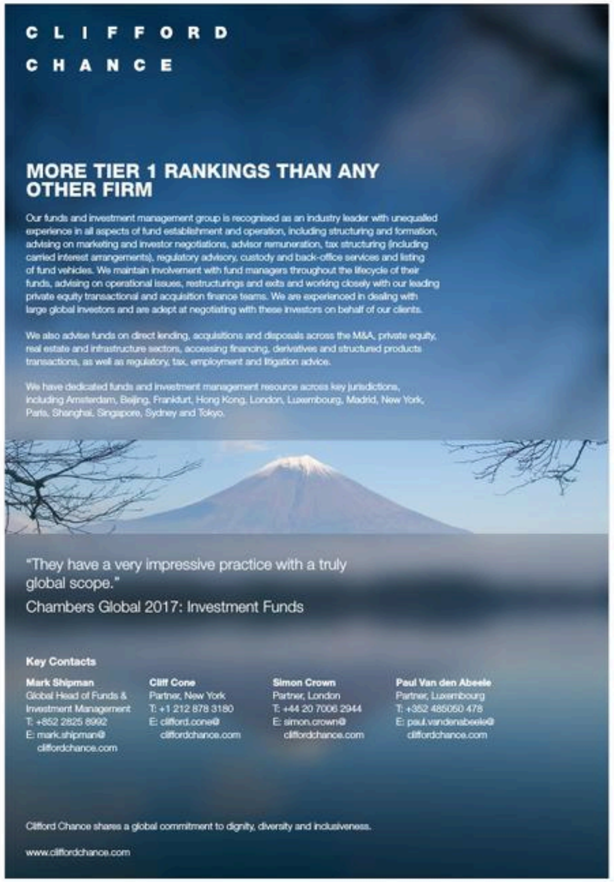

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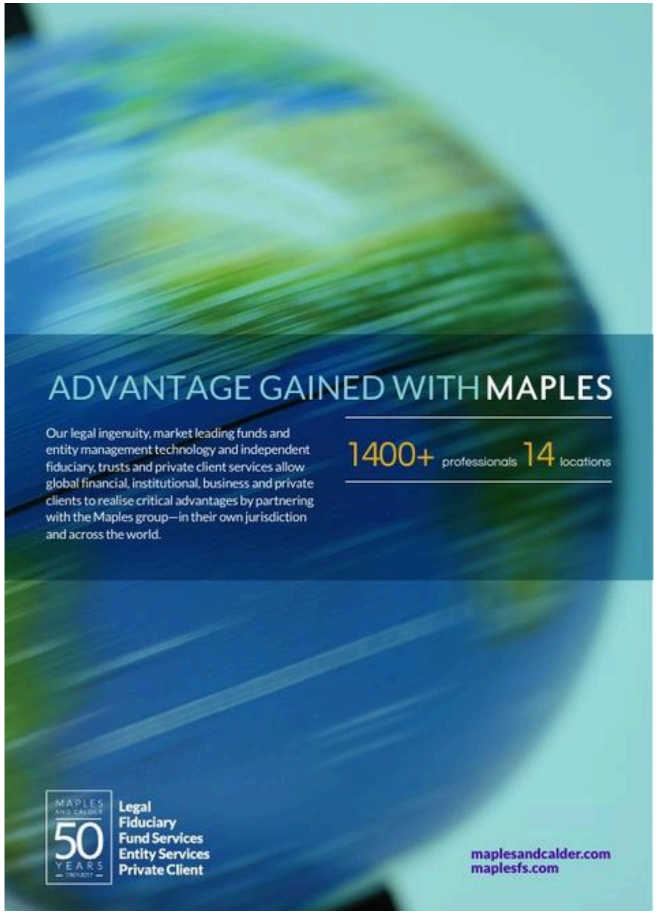

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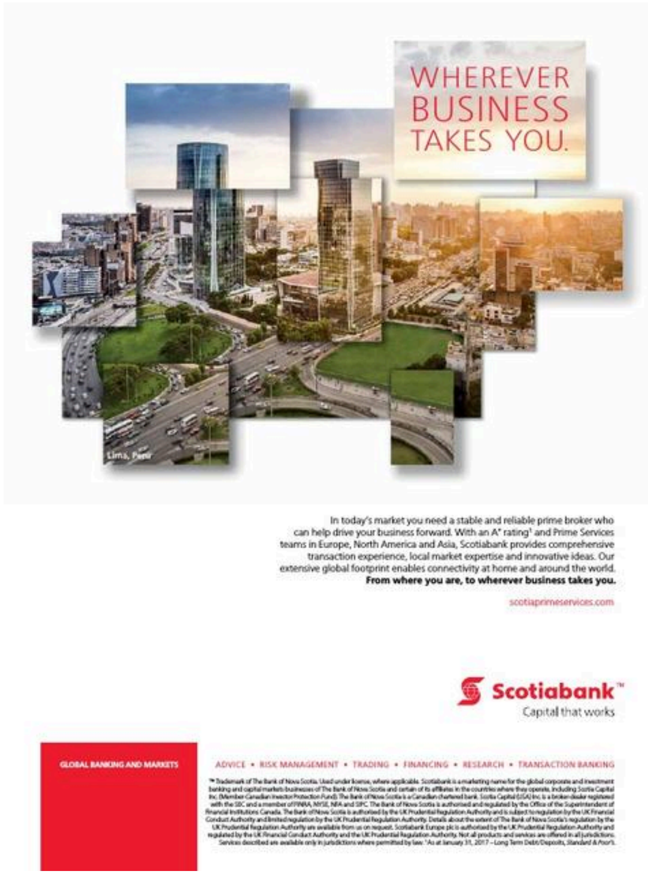

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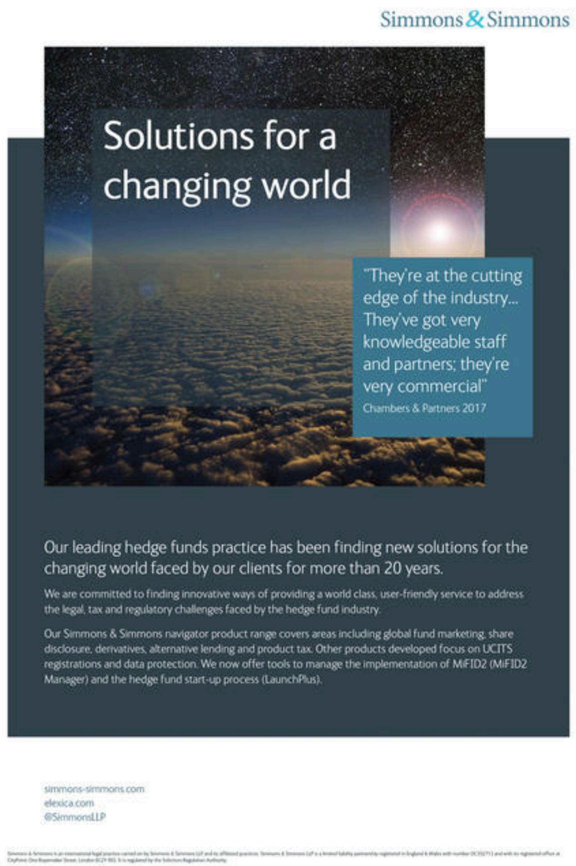

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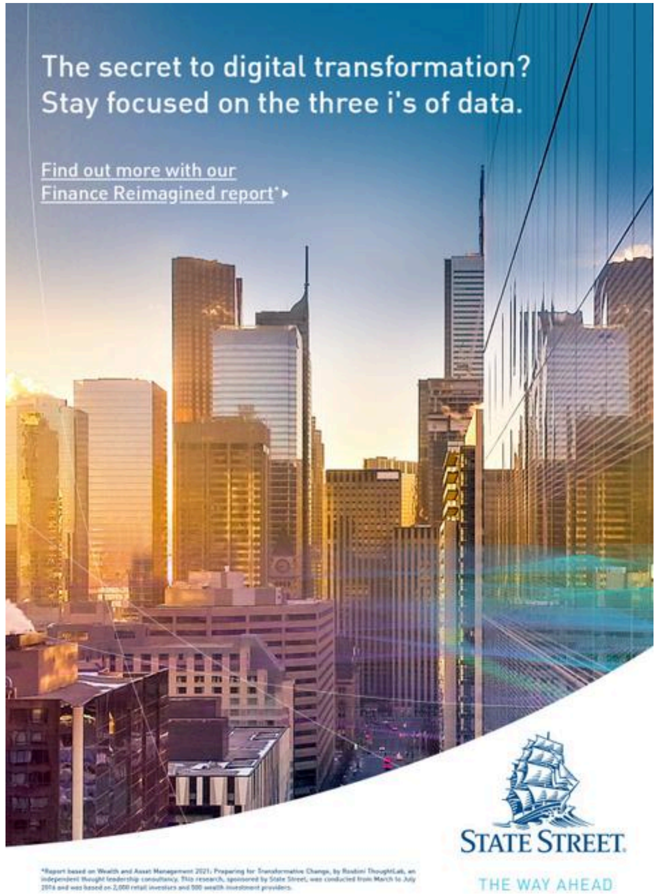

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