

# AIMA Journal

The Global Forum for the Alternative Asset Management Industry

Cover story:  
Opportunities in a  
volatile market **p30**

AIMA editorial: Why we  
need to understand what  
the public thinks about  
hedge funds **p4**

AIMA's quarterly Regulatory  
Update (members only) **p9**





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## AIMA updates

- 04**  
**The importance of improving public opinion about our industry**  
*By Jack Inglis, CEO, AIMA*
- 06**  
**Regulatory and tax submissions and papers in Q1**
- 09**  
**AIMA Regulatory update**
- 25**  
**Forthcoming AIMA events**
- 27**  
**AIMA news**
- 69**  
**AIMA's sponsoring partners**
- 70**  
**New members of AIMA**
- 79**  
**Contact AIMA internationally**

## From our members

- 30**  
**COVER STORY**  
**Opportunities in a volatile market**  
*By Neil Mason, Senior Managing Director, Man GLG*
- 34**  
**Not digital, not emotional, not aligned - why long-only funds are eating your lunch**  
*By David Masters, Director and Partner, Lansons*
- 37**  
**Implementation considerations within discretionary global macro**  
*By Josh Palmer, Senior Investment Analyst, Willis Towers Watson*

- 40**  
**MiFID II and paying for research: To bundle or unbundle? That is no longer the question**  
*By Sean Steinmetz, Global Head of Managed Brokerage Services, Bloomberg Tradebook, and Andrew Ezekiel, EMEA Commission Management Specialist, Bloomberg Tradebook*
- 43**  
**Implementing SFTR - what is required for hedge fund managers?**  
*By Owen Lysak, Senior Associate, Clifford Chance, and Jacqueline Jones, Senior Professional Support Lawyer, Clifford Chance*
- 47**  
**The changing landscape of major shareholding reporting in Europe**  
*By Claire Farley, Head of Regulatory Products, Allen & Overy LLP (aosphere)*
- 51**  
**People and confidential information: Dealing with key employment risks**  
*By Hayley Robinson, Partner, Macfarlanes and Matthew Ramsey, Professional Support Lawyer, Macfarlanes*
- 54**  
**ESMA Q&A on the application of the UCITS V Directive: Some breathing space to address compliance with the new rules?**  
*By Nicole Suignard, Senior Associate, Sidley Austin LLP*
- 57**  
**Section 871(m) - New US Withholding Tax on Dividend Equivalent Payments**  
*By Dan Farrell, Partner, Ernst & Young LLP, and Amanda Murphy, Director, Ernst & Young Ireland*
- 59**  
**Reflections on the private debt market in 2015**  
*By Alistair Hill, Partner, Simmons & Simmons*
- 63**  
**Rum punch and taxes - Puerto Rico may serve as an island escape**  
*By Adam J. Tejada, Tax Partner, K&L Gates and Frank W. Dworak, Tax Partner, K&L Gates*

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# The importance of improving public opinion about our industry

By Jack Inglis, CEO, AIMA



Since the global financial crisis, politicians, journalists and the general public have questioned the social utility of financial services in general and hedge funds in particular. This public discourse has impacted government decisions, influenced the nature of the post-crisis regulation of our industry and even swayed the investment decisions of pension funds and other investors.

Given what has been at stake, it has been necessary for AIMA to demonstrate, on behalf of the industry, the benefits that alternative asset managers and funds offer to the “real economy” and society. We have carried out research into the employment the industry generates, the taxes it pays, the investments it makes in small businesses, and the impact of its overall activity on economic growth. (‘The Case for Hedge Funds’, which can be downloaded from the AIMA website, pulls together many of the key facts and arguments.)

We have also stepped up our engagement with mainstream media (as an example, you may have seen [this interview](#) I gave recently to *The Independent* newspaper in London) and have increased our activity on Twitter and other social media channels. In addition, we have evolved the way we communicate externally

by investing in digital media, including a new website for AIMA to be launched in the next few months that will include additional educational material about alternative asset managers and funds.

I believe that we have made significant headway already. But this is an uphill battle - and there is a long way to go. To help us to understand the scale of the challenge, we commissioned research last year into public perceptions of hedge funds. The research project, which concluded recently, has enabled us to benchmark levels of favourability and test with the public whether our arguments about hedge funds truly resonate with them.

What we have found (not surprisingly) is that a significant minority of the population is sceptical about or hostile towards the industry. However, more people were found to be neutral or undecided. And the research also provided evidence that many sceptics could be won over if they better understood hedge funds’ relevance and value to them.

Why did we choose to measure public perceptions? Had we chosen to poll, say, the industry’s client base - such as pension funds, endowments and sovereign wealth funds - we would have had very different results. The hedge fund industry has grown at about 10% a year since the crisis, thanks to net inflows and amid consistently high levels of client satisfaction.

We also did not poll the regulatory community systematically, although the officials in London and Brussels whom we did approach were clearly reassured by increased levels of regulation and transparency.

But it is vital that we better understand why there are negative public perceptions if we want to prevent disproportionate or unworkable regulation or politically-motivated investor redemptions.

Armed with the findings of this research, the next step will be to develop a programme of engagement that is impactful and resonates with the general public. We will know we are making progress when more members of the public believe that the success of the alternative asset management industry is in their interests, as well as ours.



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## Regulatory and tax submissions and papers produced in Q1

DATE	AUTHORITY	DESCRIPTION
18 March		<a href="#">AIMA position paper</a> - Securitisation
16 March	CFTC	<a href="#">AIMA response</a> - Regulation Automated Trading
8 March	FCA	<a href="#">Joint AIMA/MFA response</a> - CP15/43 MiFID II Implementation Consultation Paper 1
3 March		<a href="#">AIMA summary</a> - Algorithmic trading and HFT regulation
26 February	SEC	<a href="#">Joint AIMA/MFA response</a> - Reg ATS Proposal
24 February	MAS	<a href="#">AIMA response</a> - Proposed Amendments to Reporting of Derivatives Contracts
12 February	FCA	<a href="#">AIMA response</a> - Proposed guidance for financial services firms outsourcing to the 'cloud' and other third party IT services
5 February	BIS	<a href="#">AIMA response</a> - Capital treatment for "simple, transparent and comparable" securitisations
4 February	FCA	<a href="#">AIMA summary</a> - MiFIDII Implementation Consultation Paper 1
3 February	HMRC	<a href="#">AIMA response</a> - Carried interest draft Finance Bill legislation
3 February	HMRC	<a href="#">AIMA response on behalf of the Alternative Credit Council (ACC)</a> - Carried interest draft Finance Bill legislation
1 February	ESMA	<a href="#">Joint AIMA/MFA response</a> - ESMA Consultation Paper on the Review of Article 26 of RTS No 153/2013 with respect to MPOR for client accounts
29 January	EC	<a href="#">AIMA response</a> - Call for Evidence on the EU Financial Services Framework
22 January	EBA, ESMA, EIOPA	<a href="#">AIMA response</a> - Joint Guidelines under Article 17 and 18(4) of Directive (EU) 2015/849
15 January	EC	<a href="#">AIMA response</a> - Public consultation on CRD IV remuneration

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DATE	AUTHORITY	DESCRIPTION
14 January	HMT	<a href="#">AIMA response</a> - Tax deductibility of corporate interest expense
13 January	SEC	<a href="#">AIMA response</a> - Proposed Rule on Open-End Fund Liquidity Risk Management Programs
8 January	EC	<a href="#">AIMA response</a> - Common Consolidated Corporate Tax Base
31 December	SFC	<a href="#">AIMA response</a> - Consultation Paper on Short Position Reporting



## Would you like to write for the next AIMA Journal?

The next edition of the *AIMA Journal*, the global forum for the alternative asset management industry, will be released at the end of June. If you are an AIMA member and would like to contribute to this edition, please contact Dominic Tonner by the end of April at [dtonner@aima.org](mailto:dtonner@aima.org).

*Only existing AIMA members may write for the AIMA Journal. If your firm is not currently a member and you would like to learn more about the benefits of joining, please contact Fiona Treble at [ftreble@aima.org](mailto:ftreble@aima.org).*



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# AIMA Regulatory Update



An update from AIMA's Government and Regulatory Affairs Team

The AIMA Regulatory Update strives to provide a succinct update to members on the current state of play on the most important files in the Government and Regulatory Affairs space. It is a one-stop-shop for members seeking to gain a quick overview of the main points of interest to the hedge fund industry while also providing links to a number of internal and external documents for those interested in greater detail. The issues treated in the update do not provide an exhaustive list of AIMA's work in the area and we encourage members to contact AIMA's Government and Regulatory Affairs team if they wish to be informed on the progress of work on issues which are not covered.

## Contents

### Asset management regulation

- Remuneration
- UCITS V
- AIFMD
- Securitisation
- Loan origination
- Anti-money laundering
- SEC
- Shadow banking
- Categorisation of investment firms
- Australia - portfolio holdings disclosure for super funds
- Hong Kong - New Professional Investor Regime
- Japan - licensing exemption

### Markets regulation

- Capital Markets Union
- MiFID2/MiFIR
- EMIR
- Cross-border derivatives issues
- SEC Reg ATS proposals

- CFTC Reg AT proposals
- EU rules on benchmarks
- Hong Kong - short position reporting
- Singapore - OTC derivatives trade reporting

### Tax

- EU Anti-Tax Avoidance Package
- Financial Transactions Tax
- Base Erosion and Profit Shifting
- Automatic exchange of information (AEOI)
- Carried Interest
- Partnerships WG
- US Tax
- Hong Kong - introduction of an open ended fund company

### Other files

- UK Referendum on membership of the European Union

## Asset management regulation

### Remuneration

#### *EBA remuneration guidelines*

The European Banking Authority (EBA) has [published](#) its final Guidelines on sound remuneration policies under the Capital Requirements Directive (CRD IV) along with an Opinion on proportionality. The EBA has stated that the Guidelines are to be applied in a manner and to the extent that is appropriate, but do not explicitly permit neutralisation of certain requirements. In its Opinion, the EBA calls for legislative change to support specific exemptions on the application of deferral

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arrangements and pay out of instruments, provided certain criteria are met. However, the EBA has clarified its view that the application of the ‘bonus cap’ should not be subject to any exemption.

The UK Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) have [notified the EBA](#) that the regulators will comply with all aspects of the EBA Guidelines on Sound Remuneration Policies, except for the application of the bonus cap.

## *EU Commission questionnaire on CRD IV remuneration*

AIMA submitted a [response](#) to the European Commission’s [public consultation](#) on impacts of maximum remuneration ratio under the CRD IV and overall efficiency of CRD IV remuneration rules. In the response, AIMA commented that it disagreed with the application of the bonus cap to CRD IV investment firms. AIMA noted that compliance with the bonus cap by CRD IV investment firms is likely to negatively impact CRD IV investment firms’ competitiveness in the sector, as CRD IV investment firms would only be able to compete with non-CRD firms from a remuneration perspective by paying higher fixed remuneration in order to attract the best staff.

- AIMA contacts: Jennifer Wood ([jwood@aima.org](mailto:jwood@aima.org)) and Anna Washington (née Berdinner) ([awashington@aima.org](mailto:awashington@aima.org))

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## UCITS V

The European Securities and Markets Authority (ESMA) has published a [document](#) setting out questions and answers (Q&As) on the application of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive. The document provides responses to questions posed by the general public and competent authorities in relation to the practical application of the UCITS framework and consolidates into a single document and replaces all Q&As relating to the UCITS Directive previously issued by ESMA i.e. the Q&As on: (i) the Key Investor Information Document (KIID) for UCITS (2015/ESMA/631); (ii) ESMA’s guidelines on ETFs and other UCITS issues (ESMA/2015/12); (iii) Notification of UCITS and exchange of information between competent authorities (ESMA/2012/428); and (iv) Risk Measurement and Calculation of Global Exposure and

Counterparty Risk for UCITS (ESMA/2013/1950). This document is intended to be continually edited and updated as and when new questions are received.

The FCA has published [final rules and guidance](#) implementing fifth Undertakings for Collective Investment in Transferable Securities (UCITS V) Directive. The FCA’s policy statement ([PS 16/02](#)) sets out Handbook changes which will affect managers and depositaries of UCITS and alternative investment funds (AIFs) and give the FCA’s response to the feedback received on their consultation regarding the implementation of the UCITS V requirements. The rules and guidance will come into force on 18 March 2016.

AIMA submitted a [brief response](#) to the UK HM Treasury (HMT) [consultation on amendments to the UCITS Directive to implement UCITS V](#). In the response, AIMA agreed with HMT that a copy-out approach is the correct way to implement the UCITS V provisions for depositary liability and that the provisions for the distribution of assets upon insolvency do not require substantial changes to the law. AIMA also commented that given the delay to the finalisation of the Level 2 measures, we would suggest that HMT should allow sufficient time for UCITS management companies to negotiate the details of their depositary agreements.

- AIMA contacts: Jennifer Wood ([jwood@aima.org](mailto:jwood@aima.org)) and Anna Washington (née Berdinner) ([awashington@aima.org](mailto:awashington@aima.org))

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## AIFMD

The European Securities and Markets Authority (ESMA) has published an updated version of its [Questions and Answers](#) (Q&As) on the Alternative Investment Fund Managers Directive (AIFMD). The document adds a new Q&A stating that the depositary liability regime does apply to those assets for which a depositary has safe-keeping duties on a look-through basis according to Articles 89(3), first sub-paragraph, and 90(5), first sub-paragraph of the AIFMD Level 2 Regulation. This document is intended to be continually edited and updated as and when new questions are received.

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## Securitisation

The Securitisation Regulation, which defined a new category of product, the Simple Transparent and Standardised (STS) securitisation, which has been approved by the Council, has now moved on for consideration by the European Parliament. AIMA has submitted a [position paper](#) to key parliamentary stakeholders, which sets out our concerns on the Securitisation Regulation as well as (i) including the definition of sponsor to ensure investment funds can participate, (ii) ensuring that actively managed funds are not disqualified from STS designation, and (iii) narrowing the scope of the definitions of institutional investors. AIMA has produced draft amendments to these ends and is now following up directly with the relevant MEPs. The timeline for the passage of the Securitisation Regulation is anticipated to be protracted, with a final plenary vote not expected until January 2017.

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## Loan origination

The Italian government has passed a law decree that will permit EU AIFs to lend directly to Italian corporates without the need of an Italian banking licence or partnership with an Italian fronting bank. This is provided that the fund is an EU AIF, able to lend in a Member State other than Italy, is structured in a closed-ended way and that other laws on AIFs in that Member State, notably leverage, are similar in nature to Italian law. The Bank of Italy will now produce secondary regulations which we hope will bring further clarity on this decree. In particular it will provide more detail on equivalence. AIMA is compiling a note to set out where we feel further detail is necessary to increase certainty and will submit this to the Bank of Italy and Ministry of Finance.

- AIMA contact: Simon Horner ([shorner@aima.org](mailto:shorner@aima.org))

## Anti-money laundering

AIMA has [responded](#) to the Joint Committee of the three European Supervisory Authorities' (EBA, EIOPA and ESMA - ESAs) [public consultations](#) on two sets of

anti-money laundering and countering the financing of terrorism (AML/CFT) Guidelines, which are to be produced by the ESAs under the Fourth AML Directive. In the response, AIMA agreed with the ESAs that firms should be encouraged to take a holistic view and that the presence of isolated risk factors should not necessarily move a relationship into a higher or lower risk category. AIMA commented that it is imperative that firms are expected to carry out customer due diligence in a manner that is commensurate to the risk posed by a particular client and that firms are aware of what is expected from them and how the adequacy of their processes will be assessed by competent authorities. AIMA also commented that examples should only be included in the Guidelines where they relate to an issue which would always indicate a higher or lower ML/TF risk and where they are directly related to the guideline to which they attach and that terms such as "offshore" should be avoided where a more specific standard can be referenced.

- AIMA contacts: Jennifer Wood ([jwood@aima.org](mailto:jwood@aima.org)) and Anna Washington (née Berdinner) ([awashington@aima.org](mailto:awashington@aima.org))

## SEC

The US Securities and Exchange Commission (SEC) has published a proposing release entitled "[The Use of Derivatives by Registered Investment Companies and Business Development Companies](#)". The proposed rules are meant to reduce the level of risk to investors associated with leverage from investments in derivatives and have three elements:

- **A portfolio limitation:** The proposal would place a limit on a fund's total aggregate exposure to derivatives instruments. A fund would be subject to either an exposure-based or a risk-based limit. The exposure-based limit would cap a fund's aggregate net exposure to derivatives and certain other financial commitment transactions (i.e., reverse repurchase agreements) to 150% of the fund's net assets. A fund's "exposure" for this purpose generally would be calculated as the aggregate notional amount of its derivatives transactions, together with its obligations under financial commitment transactions and other senior securities transactions. The risk-based limit would permit a fund to obtain exposure in

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excess of that permitted under the exposure-based portfolio limit where the fund's derivatives transactions, in aggregate, result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives, evaluated using a test based on value-at-risk. A fund electing the risk-based portfolio limit generally would be required to limit its exposure under derivatives transactions, financial commitment transactions, and other senior securities transactions to 300% of the fund's net assets.

- **Asset segregation requirements:** A fund engaging in derivatives transactions would have to segregate assets in the amount of the sum total of: (i) the daily mark-to-market amount, and (ii) a risk-based coverage amount. The risk-based coverage amount would be determined based on a reasonable estimate of the assets necessary to unwind a derivative position if the fund had to do so under distressed circumstances. In addition, a fund could satisfy the segregation requirement only by segregating cash and cash equivalents; and
- **A risk management program:** The proposed rule would require the boards of funds that exceed a 50% threshold of notional derivatives exposure or hold certain complex derivatives instruments to establish a formal risk management program specifically addressed to derivatives. The fund board would have to approve policies and procedures reasonably designed to prevent violations of derivatives rules and appoint a designated individual to act as derivatives risk manager. The board would have to regularly review the risk manager's report and reapprove the policies and procedures.

Comments on the proposal were due on 28 March 2016, at the time of writing. AIMA is in the process of developing a joint response with the MFA.

AIMA contacts: Jennifer Wood ([jwood@aima.org](mailto:jwood@aima.org))

## Shadow banking

The EBA has published [guidelines](#) entitled 'Limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395(2) of Regulation (EU) No 575/2013'. The publication of the Guidelines follows the [consultation paper](#) issued earlier in the year,

to which AIMA [responded](#). The EBA has modified its comments set out in the consultation paper that all alternative investment funds (AIFs) and UCITS that are money market funds should be considered to be 'shadow banking entities', but states that "the EBA is of the view that only AIFs with limited leverage could be considered to fall outside the definition of 'shadow banking entities'." In addition to this condition, only AIFs which are not allowed to originate loans or purchase third parties' lending exposures and add them to their balance sheets would be excluded from the definition of 'shadow banking entity'.

- AIMA contacts: Jennifer Wood ([jwood@aima.org](mailto:jwood@aima.org)) and Anna Washington (née Berdinner) ([awashington@aima.org](mailto:awashington@aima.org))

## EBA report concerning categorisation of investment firms

The EBA has published a [report on investment firms](#) in response to the Commission's call for advice of December 2014 on the suitability of certain aspects of the prudential regime for investment firms. The report presents the EBA's findings and makes certain recommendations that the EBA believes will lead to a more proportionate and risk-based prudential regime for investment firms. For example, the EBA recommends a new categorisation of investment firms distinguishing between systemic and 'bank-like' investment firms to which the full Capital Requirements Directive (CRD)/Capital Requirements Regulation (CRR) requirements should be applied; other investment firms ('non-systemic') with a more limited set of prudential requirements; and very small firms with 'non-interconnected' services.

Both for AIMA members who are MiFID firms regulated by CRD and for those that are not, this EBA advice has the potential to induce the Commission to change the prudential treatment for their types of firms, either to be more or less onerous. AIMA is engaging with members to collate feedback on the current regime and potentially submitting a short paper designed to shape the EBA's thinking when it comes to creating any new regulatory regime that would apply to this new category of investment firm.

- AIMA contacts: Jennifer Wood ([jwood@aima.org](mailto:jwood@aima.org)) and Anna Washington (née Berdinner) ([awashington@aima.org](mailto:awashington@aima.org))

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## Australia - Portfolio holdings disclosure for super funds

In welcome news for Australian superannuation funds and their investment managers, the Australian Government has released [exposure draft legislation](#) to refine the framework for portfolio holdings disclosure for superannuation funds.

The release is a response to concerns about compliance costs for the superannuation industry and the complexity of the current disclosure regime which led to a deferral of the commencement date.

The requirements are currently proposed to come into effect on 1 July 2016 and the trustee of a registrable superannuation entity (RSE) (other than a pooled superannuation trust) will be required to report details of portfolio holdings twice annually (at each reporting day of 30 June and 31 December) on its website, within 90 days of the reporting day.

The draft legislation proposes to:

- Limit disclosure of a superannuation fund's portfolio holdings to assets that the fund, or an associated entity, has directly invested in, instead of requiring disclosure for all fund assets on a 'look-through' basis with respect to multiple levels of investment. The obligations to include information about financial products or other property that non-associated entities have directly invested are proposed to be repealed;
- Allow a superannuation fund to choose not to disclose up to 5% of the assets attributable to each investment option, which provides flexibility to exclude from disclosure a limited number of investments considered to be commercially sensitive; and
- Repeal the reporting obligations on parties to contracts and arrangements that acquire a financial product using the assets, or assets derived from assets, of an RSE.

The easing of a trustee's portfolio holdings obligations so that they are limited to the first investment by the fund in a non-associated entity or by associated entities may facilitate super fund investment in certain funds where public disclosure of underlying investments and values is commercially sensitive, for example, hedge fund investments.

The proposal also means that parties to contracts and arrangements in relation to the acquisition of a financial product using assets derived from a super fund (which may include investment managers in some circumstances) would not have a legal obligation to inform investee entities that the assets invested derived from a super fund or to report information to super funds for portfolio holdings disclosure purposes.

As some superannuation funds may also have sought to oblige investment managers, under their investment management agreements, to provide reporting to the fund to assist with the portfolio holdings disclosure obligations, the proposal may also ease compliance obligations for affected investment managers.

The Government is seeking to introduce legislation in early 2016 with effect from 1 July 2016.

- AIMA contact: Kher Sheng Lee ([kslee@aima.org](mailto:kslee@aima.org))

## Hong Kong - New Professional Investor Regime

As a reminder, key amendments to the Code of Conduct for Persons Licensed By or Registered with the Securities and Futures Commission (the "Code") takes effect 25 March 2016. Key changes are as follows:

- Intermediaries will no longer be able to waive certain investor protection provisions of the Code, including the requirement to ensure the suitability of a recommendation or solicitation, when dealing with professional investors who are individuals. Such individuals are to be treated under the new regime as non-professional investors for the purposes of the Code.
- For investment vehicles, family trusts and corporate professional investors that are not institutional investors (each referred to as a CPI), the intermediary may only dis-apply certain investor protection provisions if (i) the entity satisfies a principles-based assessment of knowledge and investment experience (also known as a corporate professional investor assessment, or CPI assessment) and (ii) has given its consent to be treated as professional investors.
- In conducting the CPI assessment, the intermediary

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should assess whether or not the CPI meets all three of the following criteria:

- i. the CPI has the appropriate corporate structure and investment process and controls (i.e., how investment decisions are made, including whether the corporation has a specialised treasury or other function responsible for making investment decisions;
  - ii. the person(s) responsible for making investment decisions on behalf of the CPI has(have) sufficient investment background (including the investment experience of such person(s)); and
  - iii. the CPI is aware of the risks involved which is considered in terms of the person(s) responsible for making investment decisions.
- If an intermediary is reasonably satisfied that a CPI meets all these criteria, the intermediary may treat the CPI as a “professional investor” so long as the intermediary has provided a full explanation of the consequences and the CPI has signed a consent.

AIMA contact: Kher Sheng Lee ([kslee@aima.org](mailto:kslee@aima.org))

## Japan - Amendments to the Article 63 exemption finalised

On February 3, 2016, the FSA adopted the [final rules](#) (only in Japanese) to implement the 2015 legislative changes to a licensing exemption on which many non-Japanese (as well as Japanese) fund operators of partnership-type funds have relied (“2015 Amendment”). As the result, the 2015 Amendment became effective on 1 March 2016. The FSA also published extensive guidance in response to comments it received during the public consultation in December 2015 (“[FSA 2016 Guidance](#)”) (only in Japanese).

- By way of reminder, the 2015 Amendment effectively limits the availability of, and requires additional requirements to rely on, a licensing exemption under Article 63 of the Financial Instruments and Exchange Act, which exempts fund operators of partnership-type funds (typically, general partners) from licensing requirements to offer partnership interests to or manage funds received from Japanese investors on certain conditions, including a prior Form 20 notification

(“Article 63 Exemption”).

- Existing Article 63 Exemption filers should know that:
  - From March 1, they are subject to the new bookkeeping requirement and partially to the standards of conduct imposed on licensed Japanese investment managers.
  - From March 1, they must provide nonprofessional investors with periodic investment reports.
  - By 31 August 2016, they are required to file a supplement filing to notify additional information required for the new Form 20, including information on a “Representative in Japan” designated by the fund operator, failure of which would result in disqualification from the Article 63 Exemption and potentially result in a criminal penalty. The FSA 2016 Guidance clarified that a “Representative in Japan” is essentially a contact point of that fund operator in Japan for the regulator; affiliates, Japanese brokers, lawyers or public accountants based in Japan can be candidates for such “Representative”.
    - Immediately after the supplement filing, they are subject to the new public disclosure requirement.
    - Beginning with the fiscal year starting on or after March 1, they are subject to the new annual public disclosure requirement.
    - Beginning with the fiscal year starting on or after March 1, they must submit an annual business report with the regulator within three months or such other period granted by the regulator after the end of the respective fiscal year.
- The 2015 Amendment also introduced new eligibility requirements for investors who are not qualified institutional investors (“QIIs”); from March 1, the FSA expects fund operators to take certain reasonable steps to verify the eligibility of an investor when offering partnership interests to non-QII investors.
- For non-Japanese fund operators, an alternative licensing exemption may be available in cases where

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a fund only has nine or fewer Japanese investors, all of which are QIIs, and their investments consist of less than one-third of the total contribution to the fund; however, such exemption does not extend to a Type II broker-dealer license that is required to offer partnership interests to Japanese investors.

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## Markets regulation

### Capital Markets Union

AIMA recently [responded](#) to the European Commission's [Call for Evidence on the EU Regulatory Framework](#); a key aspect of the Capital Markets Union project. AIMA's submission raised a number of areas where we have seen evidence of barriers preventing non-bank finance and capital markets from developing in the EU including: constraints on asset managers in participating on the supply side of the securitisation process; the impacts of bank capital measures on dealers' intermediation capacity leading to changes in secondary market liquidity in a number of asset classes; the time and cost implications of complying with regulatory reporting requirements; and the impact of the public disclosure of short sales on equity market liquidity. AIMA has put forward a number of solutions to remedy these and other issues.

The European Commission is continuing to progress its [Action Plan on Building a Capital Markets Union](#). Key areas of focus in 2016 will include a consultation on the main barriers to the cross-border distribution of investment funds and a report on national barriers to the free movement of capital.

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### MiFID2/MiFIR

The European Commission has formally adopted a [proposal](#) to push the MiFID2/MiFIR application date back until January 2018, providing welcome additional time for industry to implement the new rules. The Council and European Parliament must now ratify the

delay. As part of this process it is likely that they will also extend the transposition deadline for MiFID2, giving member states an additional 9 or 12 months for domestic implementation. A potential change to the Level 1 text to provide the means for the European Securities and Markets Authority (ESMA) to develop specific transparency rules for packaged transactions is also on the table.

In the UK, the FCA has consulted on aspects of the UK's MiFID2 transposition in a [Consultation Paper](#). While the FCA's work is largely procedural, given its general approach of direct copy-out of MiFID2 requirements, the CP did raise a number of important policy points, which AIMA and MFA [commented](#) on. In particular, we signal our strong support for the FCA's approach in respect of transaction reporting and its decision not to extend the obligation to asset managers that are not MiFID investment firms. We also express our support for the FCA's intention to make MiFID2 post-trade transparency waivers available in full, whilst encouraging the FCA to ensure that trading venues provide true open access to buy-side firms. We also express support for the FCA's decision not to require periodic reporting by firms on their use of algorithms.

ESMA has also [consulted](#) on guidelines on MiFID2 transaction reporting.

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### EMIR

The European Supervisory Authorities have now published [final draft Regulatory Technical Standards](#) (RTS) on EMIR risk mitigation techniques related to the exchange of collateral to cover exposures arising from non-centrally cleared over-the-counter (OTC) derivatives. The RTS also specify the criteria concerning intragroup exemptions and the definitions of practical and legal impediments to the prompt transfer of funds between counterparties. The draft RTS contain the following provisions:

- For OTC derivatives not cleared by a Central Counterparty (CCP), the draft RTS prescribe that counterparties have to exchange both initial and variation margins. This will reduce counterparty credit risk, mitigate any potential systemic risk

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and ensure alignment with international standards.

- The draft RTS outline the list of eligible collateral for the exchange of margins, the criteria to ensure the collateral is sufficiently diversified and not subject to wrong-way risk, as well as the methods to determine appropriate collateral haircuts.
- The draft RTS lay down the operational procedures related to documentation, legal assessments of the enforceability of the agreements and the timing of the collateral exchange.
- The draft RTS cover the procedures for counterparties and competent authorities related to the treatment of intragroup derivative contracts.

The Commission must now adopt the RTS, which will need to be approved by Parliament and Council. If things proceed as planned, the requirements will enter into force on 1 September 2016.

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## Cross-border derivatives issues

In February, the European Commission and US Commodity Futures Trading Commission (CFTC) [announced](#) a common approach regarding requirements for central clearing counterparties (CCPs). To implement the agreement, the European Commission and CFTC have issued reciprocal determinations to enable CCPs to provide clearing services in both the EU and US while remaining subject primarily to their local requirements.

Under the European Commission's [Implementing Decision 2016/377](#), a US CCP (referred to as systemically important and opt-in derivatives clearing organisations (SIDCOs and DCOs)) will have to apply to ESMA for recognition and confirm that their internal rules and procedures meet a number of conditions related to the default fund and the calculation and collection of initial margins, to align with EMIR (see Article 1 of the Implementing Decision).

The CFTC [confirmed](#) that its substituted compliance framework was unanimously accepted. The CFTC is also issuing a no-action letter to provide limited relief

from CFTC regulations for discrete aspects of DCO/CCPs' non-US clearing activities. The [substituted compliance determination](#) enables DCO/CCPs to comply with the relevant CFTC rules by complying with the corresponding requirements under EMIR. The CFTC has also announced that they are streamlining their registration process for DCO/CCPs. The Determination will be effective upon publication in the Federal Register.

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## SEC Regulation of NMS Stock ATSS

Following calls from industry, the SEC in late 2015 published proposed rules amending Regulation ATS to enhance the operational transparency and regulatory oversight of all US Alternative Trading Systems (ATSS) that offer trading of stocks listed on a national securities exchange (NMS Stocks). The headline proposal is for operators of such NMS stock ATSS to make a new publicly available filing - 'Form ATS-N' - that will have to be approved by the SEC for the ATS to continue enjoy its exemption from authorisation as a national securities exchange.

Form-ATS-N will include information about the ATS operator, its affiliates, the types of orders and market data used on each of its ATSS, as well as each ATS's execution and priority procedures. This is a significant departure from the current regime which requires notification alone by ATS operators to enjoy the exemption from authorisation as a national securities exchange.

This quarter, AIMA co-signed a [joint response](#) with the MFA expressing strong support for the SEC's proposals to extend additional transparency obligations and for 'Form ATS-N'. The response also suggests the extension of the obligations beyond NMS Stock ATSS to include fixed income and government securities.

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## CFTC Regulation AT proposals

This quarter, AIMA has responded to the CFTC's Regulation Automated Trading (Regulation AT) proposals which were published late last year. As has been highlighted in previous AIMA publications, Regulation AT is a significant rulemaking intended to regulate the entire algorithmic trading landscape of futures on US Designated Contract Markets (DCMs) - from trading firms through to the DCMs themselves. AIMA's response builds on our position supporting proportionate and well-tailored regulation of all participants in the algorithmic trading chain - ensuring that all 'AT Persons', Clearing FCMs and DCMs maintain their own pre-trade and other risk controls, as well as utilising robust testing and development processes. Nonetheless, we express specific concerns about the current definitions contained within Regulation AT - for example, the fundamental definition of 'Algorithmic Trading' which we argue is far too broad and would capture activities which are demonstrably not algorithmic trading. Another area of principal concern for AIMA members are the CFTC's proposals to obtain summary access to all AT Persons' source code as part of the Regulation AT 'source code repositories' framework. AIMA's response strongly pushes back on this proposal on the basis of security risks to extremely commercially sensitive information and the lack of any commensurate supervisory benefit resulting from such source code access. AIMA will continue to engage with the CFTC as part of its ongoing work to develop a final rulemaking for Regulation AT.

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## Market Abuse Regulation

After a significant period of waiting, ESMA has now published its consultation paper on draft Level 3 guidelines under the EU Market Abuse Regulation (MAR), which is due to enter into effect on 3 July this year. The draft guidelines cover, among other things, the obligations on persons receiving market soundings (MSRs) under Article 11 of MAR, such as what to do in the event of a discrepancy of opinion between the MSR and disclosing market participant as to whether information that is the subject of the market sounding is inside information, and processes for the internal handling of information passed during

the course of a market sounding. The deadline for comments is 31 March after which ESMA will adopt its final guidelines. AIMA attended an open hearing at ESMA on the consultation, during which ESMA noted that it is unlikely that these guidelines will be finalised in time for 3 July this year. ESMA's current intention is to finalise the guidelines during Q3, following their Board of Supervisors meeting in July.

Also, further to the implementation of MAR, certain Level 2 delegated regulations containing regulatory technical standards (RTS) have recently been adopted by the European Commission. These RTS deal with (i) [preventing, detecting and reporting abusive practices](#) (suspicious transaction and order reporting); (ii) [buy-back programmes and stabilisation measures](#); and (iii) [investment recommendations](#). Before these can be published in the Official Journal of the EU, the delegated regulations must undergo a period of scrutiny by the European Parliament and Council. The most important of these from the perspective of AIMA members is the final RTS dealing with suspicious transaction and order reporting by persons 'professionally arranging or executing transactions' - further to the obligation contained under Article 16(2) of MAR. We still await the finalisation of other key Level 2 provisions, such as final RTS on the obligations of disclosing market participants during market soundings.

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## EU rules on benchmarks

In December, the EU legislative institutions reached an agreement on the Level 1 text for the EU Regulation on indices used as benchmarks in financial instruments and financial contracts. The Regulation, first proposed in 2013 in response to the LIBOR rigging scandals, is intended to place particular requirements on the administrators of any EU benchmark or any third-country benchmark used by a supervised entity in the EU. The European Parliament is due to vote on the Level 1 text in April, and while it is expected to pass largely unchanged, a number of changes have been under consideration to address inconsistencies between the treatment of EU and third-country benchmark administrators. The Regulation is expected to enter into force in June 2016, however, there is some uncertainty regarding the timeframe for application.

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At the earliest, the requirements may apply from around early 2018.

In order to meet the tight timeframes for implementation, ESMA released a broad [Discussion Paper](#) on the Level 2 measures in February for public consultation, on the basis of the current Level 1 text before the Parliament. There are early indications that the first Discussion Paper may have diverged from the intent of the Level 1 text. ESMA will subsequently release a Consultation Paper with the full draft text of the technical standards or the technical advice. AIMA will continue to monitor and report on potential impacts on members, including the use of third-country benchmarks.

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## Securities Financing Transactions

The European Regulation on transparency of securities financing transactions and reuse (SFTR) entered into effect back in January of this year. The key obligations contained within the SFTR include: (i) SFT reporting and recordkeeping - two-sided reporting of the details of all SFTs to trade repositories by all EU established counterparties and branches; (ii) investor disclosures - pre-contractual and periodic disclosures by authorised AIFMs and UCITS managers to investors as to their funds authorisation and use of SFTs and total return swaps; and (iii) reuse risk disclosure and consent - obligations on persons receiving collateral further to any contract, not just SFTs, to make risk disclosures and obtain consent from their counterparty in order to be able to exercise reuse rights over that collateral.

These main obligations are subject to varying phase-in periods, with the SFT reporting phase-in only starting once Level 2 measures further specifying the details of reports have been developed and published by ESMA and the European Commission. Pre-contractual disclosures will apply to any new funds constituted after the entry into force of SFTR and 18 months later for existing funds. Periodic investor disclosures will start in January 2017. ESMA are empowered to adopt RTS further specifying the details of such investor reports, however, ESMA has stated that it does not intend to use this power for the time being; it's focus will be on developing Level 2 measures for SFT reports.

All counterparties exercising reuse over received collateral have six months to comply with the relevant SFTR reuse obligations.

An important outstanding question for AIMA hedge fund manager members is the scope of the SFT reporting and recordkeeping obligation under SFTR, with non-EU counterparties only caught if they use an EU branch to undertake the SFT. AIMA has identified that the explicit wording of SFTR, therefore, excludes non-EU AIFs from scope of Article 4 SFT reporting and recordkeeping, regardless of the location or authorisation of its AIFM. We have discussed the matter with the European Commission, who noted their agreement with our interpretation. We now await formal confirmation through European Commission 'FAQs' on the interpretation of SFTR.

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## Hong Kong - SFC publishes consultation conclusions on expansion of the scope of short position reporting

The Securities and Futures Commission (SFC) released its [Conclusions](#) on a consultation regarding new rules to expand the scope of Hong Kong short position reporting. As a recap, key highlights of the policy proposals were as follows:

- Expanding the present short position regime to cover all securities that are determined by The Stock Exchange of Hong Kong Limited (SEHK) to be "Designated Securities";
- The reporting threshold trigger for Designated Securities that are stocks remains the same i.e. equals to or exceeds 0.02% of the market capitalisation of the listed issuer concerned or HKD\$30 million, whichever is lower; and
- For CISs that are now caught under the expanded scope, the reporting threshold trigger is proposed to be set at HK\$30 million.

The SFC has concluded that short position reporting will be expanded to cover all securities that can be short sold under the rules of The Stock Exchange of

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Hong Kong Limited. The reporting threshold for stocks will remain unchanged (being the lower of 0.02% of the stock's market capitalisation, or HK\$30 million), while the threshold for collective investment schemes will be set at HK\$30 million.

The proposed amendments to the rules will be submitted to the Legislative Council for negative vetting. To give the market a reasonable lead time for preparation, the SFC plans for the amended rules to come into effect on 15 March 2017, subject to the legislative process. The SFC will make further announcements regarding operational reporting arrangements for the expanded regime in due course.

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## Singapore - AIMA responds to the MAS's Consultation on OTC Derivative Trade Reporting

AIMA has submitted a [response](#) to the Monetary Authority of Singapore (MAS)'s recent consultations on proposals to implement reporting of commodity derivative contracts and equity derivatives contracts (other than exchange-traded equity derivatives contracts), as well as revisions to fine-tune the reporting obligations for certain non-bank financial institutions.

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## Tax

### EU - Anti Tax Avoidance Package/CCCTB

The EU Commission has presented an Anti-Tax Avoidance Package intended to reform corporation tax within the EU. Firstly, there is a proposal for a Council Directive ([ATA Directive](#)) laying down rules against tax avoidance practices including: (1) a limitation on relief for interest payments; (2) an exit taxation provision and switch over clause which will limit tax exemption on profits received from companies in low-tax jurisdictions; (3) a general anti-abuse rule (GAAR); (4) controlled foreign company rules; and (5) a framework to tackle hybrid mismatch arrangements. In addition, the Commission proposes to amend the Directive on

administrative cooperation (to be [DAC4](#)) to include the exchange of tax-related information on multinationals (and so enacting the OECD's country-by-country reporting rules). Both measures will be submitted to the European Parliament for consultation and to the EU Council for approval.

The Commission is also endorsing (i) a [recommendation](#) on measures against abuse of tax treaties that will build on a GAAR and the revised OECD definition of permanent establishment; and (ii) an [external strategy](#) to ensure effective taxation. As part of this strategy the EU will develop a process for assessing and listing third country tax regimes (in line with the current non-cooperative jurisdiction list). The ATAP measures build on the OECD BEPS project but go further in a number of respects.

With regard to DAC4, the ATAP includes a Commission proposal for a Council Directive to amend the DAC (2011/16/EU). The DAC has been the subject of a series of amendments in recent years, and its current form can be explained (as the EU has done [here](#)) as follows: (1) the original [DAC\(2011\)](#) set out to enhance administrative cooperation in the field of direct taxation, and included provision for the exchange of tax information on request; (2) in December 2014, the DAC was amended to incorporate the OECD's Common Reporting Standard (CRS) framework, which facilitates automatic exchange of financial account information ([DAC2](#)); and (3) the latest text agreed is [DAC3](#) which extended automatic exchange of information to advance cross-border rulings and advance pricing arrangements (applying from 2018). To this will be added the proposed new Directive - [DAC4](#), which would apply country-by-country reporting to certain MNEs from 2017.

In parallel, the Commission published last year a [consultation](#) to help identify the key measures for inclusion in the relaunch of the proposal for a CCCTB, as part of the implementation of the Commission's Action Plan for Fair and Efficient Corporate Taxation which was presented in June 2015. AIMA [responded](#) to the consultation, submitting that the special nature of collective investment schemes needed to be taken into account when designing the proposed framework and that its interaction with other initiatives such as BEPS, TRACE, and the anticipated CMU would also need to be evaluated.

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## Financial Transaction Tax (FTT)

FTT has not seen any significant progress in the first quarter of 2016. The ECP Member States, now reduced to ten as Estonia has withdrawn from the group, have not met their self-imposed deadline for application of the FTT as from January 2016, and at this point even meeting a January 2017 deadline seems to be unlikely. The ECP Member States disagree on core aspects of the FTT and differences remain in satisfying the different needs of small and large participating jurisdictions. There must be progress at a technical level before any negotiations are taken forward to the representatives of the Member States. The Council Legal Services has produced a paper which sets out the voluntary and flexible character of ECP and confirms that a Member State may withdraw prior to a directive being agreed.

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## Base Erosion and Profit Shifting (BEPS)

The OECD released the 2015 Base Erosion and Profit Shifting (BEPS) [deliverables](#) which form a comprehensive set of changes to the international basis of corporate taxation. The proposed framework operates as a combination of minimum standards, reinforced international principles and best practices, and includes these areas: (i) the interaction between different domestic tax rules (such as controlled foreign company regimes, hybrid mismatch arrangements); (ii) the substance of international tax provisions and model tax conventions (anti-avoidance provisions to prevent treaty abuse, changes in the definition of a permanent establishment, transfer pricing principles); and (iii) transparency and certainty of MNE tax liabilities (country-by-country reporting).

### *Action 6 - Prevent the granting of treaty benefits in inappropriate circumstances (treaty abuse)*

Additional work remains to be done in 2016 in various areas, in particular in the context of treaty abuse (Action 6 - [final report](#)) where the ability to access tax treaties may be restricted as the draft limitation on benefits (LOB) clause has limited protection for regulated collective investment vehicles (CIVs) and does not offer a carve out for non-CIVs such as alternative funds. Although the final report now seems

to acknowledge the general principle of tax neutrality, the treatment of non-CIVs is to be developed further by the OECD. AIMA intends to continue to put the case of non-CIVs to the OECD and to respond to concerns expressed by the OECD that non-CIVs are used by investors that are not themselves entitled to treaty benefits and that investors may defer recognition of income through non-CIVs. AIMA has been in contact with the UK Treasury to inform the commentaries of a Principle Purpose Test (PPT) should it be included in future tax treaties, but will also respond to future [OECD consultation](#) published on 24 March.

In a development that may be relevant to the ability of EU member states to adopt a LOB in their tax treaties rather than the more general PPT, the Commission has declared that the proposed LOB would in its nature be contrary to the principles of the Single Market, and therefore, if restrictions were to be included to access MS tax treaties, they would take the form of a PPT.

### *Action 4 - UK HMT consultation Response*

HM Treasury published last year [consultation on tax deductibility of interest expense for companies](#). The consultation followed the OECD report on Action 4, which provides recommendations for a best practice approach to the design of rules to prevent base erosion through the use of interest deductions. The OECD report recommends the combination of a fixed ratio rule (under which a company may deduct net interest expense up to a net EBITDA ratio between 10%-30%) and a group ratio rule as general principles together with other targeted provisions (such as specific rules for the banking and insurance sectors). AIMA's response to that consultation was submitted earlier this year, where the Secretariat stressed the need for developing further the rules targeted at the financial services industry (in particular with regards to the securitisation market), as well as technical considerations on grandfathering period, *de minimis* thresholds or FX gains and losses.

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## Automatic Exchange of Information (AEOI)

The OECD's Common Reporting Standard (CRS) went live on 1 January 2016. Financial institutions (FIs) established in participating jurisdictions are required to implement due diligence procedures when new

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accounts are opened and to review existing accounts. Reporting will commence in 2017. The evolution from FATCA to the broader automatic exchange of information under CRS will be challenging, and AIMA will continue to take up members' concerns with the OECD, the EU Commission and tax authorities, while encouraging sound practices in the industry.

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## Carried interest (UK)

The [Autumn Statement](#) delivered on 25 November 2015 included few tax measures alongside the spending review for the next financial year. Draft Finance Bill legislation (released on 9 December) contained measures restricting the opportunities for full capital gains tax treatment in respect of managers' receipts of carried interest to funds with an average investment holding period of at least four years, now reduced to 40 months at the Budget Generally, hedge fund management businesses in the UK receive performance fees which are taxed as income, and will not be affected by the measure. AIMA has been involved in discussions on the proposals with HMRC and submitted a [response](#), on behalf of members forming the Alternative Credit Council, which focuses on the impact that these income-based carried interest rules could have on funds that are alternative credit providers, in particular those measures relating to direct lending funds. AIMA also submitted a more general [response](#). It is hoped that the Finance Bill to be published after the Budget delivered on 16 March will reflect some of the technical aspects raised in our submission and by other parties.

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## Partnership Working Group

AIMA's Partnership Tax WG was set up to consider changes to the UK taxation of partnerships which were subsequently enacted in Finance Act 2014. It is apparent that some members are experiencing difficulties in agreeing with HMRC the interpretation of the rules relating to the treatment of some members of LLPs as

salaried members and therefore employees. This WG has been refreshed with the mandate to engage with HMRC on some of the practical implications that the legislation has produced.

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## US tax

There have been a number of US tax developments in 2015 which may affect hedge funds holding US investments or managers operating in the US. These include the issue of final regulations governing withholding under section 871(m) of the Internal Revenue Code relating to deemed dividends, such as may arise on the change of terms of a convertible security, and also the treatment of basket option contracts. The House of Representatives and the Senate passed the [Bipartisan Budget Act 2015](#), which included significant changes to the Internal Revenue Service (IRS) partnership audit processes and adjustments which will be relevant to alternative investment funds and management entities which are partnerships which file US tax returns. Potential liabilities for non-US asset managers with investors in states such as California as a result of state tax market-based sourcing rules, even when the fund and fund manager have no physical presence in the state, have attracted a great deal of attention, although amended guidance issued in California seems to have reduced the risk.

The apparent tension between the need for international tax reform in the aftermath of BEPS and what US bodies see as unreasonable scrutiny of US multinational enterprises (MNEs), in particular, the EU state aid investigations, which may lead to a reduction in US tax revenues, has brought the debate centre stage in Washington. Following a full committee hearing on 23 February, where the EU action on BEPS and the growing number of corporate inversions moving US businesses offshore were discussed, the deadline for an international tax bill has been accelerated. This could include country-by-country reporting and an interest deductibility limit among other BEPS-based provisions. The US Treasury has also released a revised [Model Income Tax Treaty](#) with new measures on beneficial ownership and an amendment to the limitation on benefits provision (LOB) to incorporate a derivative benefits clause. At the same time, some politicians and business organisations are arguing that the US should

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reject the BEPS programme as harmful to US interests.

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## Hong Kong - Introduction of a HK Open-Ended Fund Company (OFC)

The Hong Kong government on 27 January 2016 commenced the legislative process to implement the OFC regime. It introduced the relevant bill into the Legislative Council (LegCo) with a view to securing the passage of the bill before the summer of 2016.

AIMA has been working for some years to promote the introduction of open-ended fund company legislation to establish Hong Kong as a successful domicile for private funds. AIMA [responded](#) to the Consultation Paper published in March 2014 by the Financial Services and the Treasury Bureau (FSTB). AIMA was also invited by the FSTB to provide comments on the draft legislative proposals in November 2015. A copy of AIMA's comments on the draft legislative proposals can be found [here](#).

On 20 January, the Financial Services Treasury Bureau (FSTB) issued a concept paper to gauge views on the possible extension of the profits tax exemption to onshore privately offered OFCs. On 29 January 2016, the Legco's House Committee agreed to form a Bills Committee to study the legislative bill for the OFC regime. The Bills Committee held its first meeting on 23 February 2016 with members of the administration in attendance.

The Hong Kong tax committee along with the OFC working group which AIMA has formed are assessing potential impact on members and considering a response to the concept paper.

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## Other files

### UK referendum on membership of the European Union

The UK is rapidly approaching an in-out referendum to determine its future relationship with the EU. On 23 June 2016, voters in the UK will decide whether the UK should (i) stay in the EU (in light of the UK government securing a limited EU reform package ('[HM Government settlement](#)')) (ii) or exit the EU. However, what the UK's relationship with the EU would look like after an exit is currently not clear and the outcome could be one of a number of scenarios that will affect asset management firms in different ways.

Although the withdrawal mechanism is included in Article 50 of the Treaty on the European Union (TEU), the potential outcome of the UK's withdrawal is difficult to predict as there is no precedent in the international context. Complex and lengthy negotiations and conflicting interests would probably have an effect on financial markets, but also on the wider UK economy. Moreover, the existing EU regulatory framework (and financial services specifically) will need a transitional period or a mutual recognition process to avoid regulatory gaps. Yet, what is clear is that if the UK were to leave the EU, the UK's ability to influence EU policy would not continue (in the future), and the UK's active engagement in key projects such as the Capital Markets Union (CMU) would be discontinued.

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# SHAPING OUR FUTURE

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**The Alternative Investment Management Association Limited (AIMA)**

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## Forthcoming AIMA events

### Canada - AIMA/PRMIA/CAIA Montréal Career Panel

*Date: 4 April 2016  
Time: 1330 - 1900  
Venue: Fairmont The Queen Elizabeth Hotel, Montréal, Québec*

### Singapore - Budget Briefing Q1 2016

*Date: 8 April 2016  
Time: 0845 - 1130  
Venue: EY, One Raffles Quay, North Tower, Level 14, Singapore*

### Canada - AIMA Canada Alberta Ski Day 2016

*Date: 8 April 2016  
Venue: Sunshine Village Ski & Snowboard Resort, Banff, Canada*

### Singapore - Networking drinks

*Date: 20 April 2016  
Time: 1800 - 2100  
Venue: The Black Swan (Powder Room), 19 Cecil St, Singapore*

### Hong Kong - Networking drinks

*Date: 20 April 2016  
Time: 1830 - 2130  
Venue: The Hong Kong Club, 1 Jackson Road, Central, Hong Kong*

### Canada - Toronto Quarterly Social

*Date: 25 May 2016  
Time: From 1715  
Venue: Stratus Restaurant, 79 Wellington St W, Toronto*

### Hong Kong - Networking drinks

*Date: 26 May 2016  
Time: 1830 - 2130*

### Canada - 12th Annual AIMA Canada Charity Golf Tournament

*Date: 6 June 2016  
Venue: Angus Glen Golf Club, 10080 Kennedy Rd, Markham, Ontario L6C 1N9*

### Canada - Vancouver Summer Social 2016

*Date: 23 June 2016  
Time: 1800 - 2000  
Venue: Nat Bailey Stadium, 4601 Ontario Street, Vancouver*

### AIMA Canada Hedge Fund Conference 2016

*Dates: 3 - 4 Oct 2016  
Venue: Sheraton Montréal, Montréal, Québec*

For information on these and our other forthcoming events and webinars, please contact [events@aima.org](mailto:events@aima.org).

## FEATURED EVENT IN Q2

### AIMA's Global Policy & Regulatory Forum 2016

AIMA's Global Policy & Regulatory Forum, held annually, is our leading policy and regulatory event. Speakers will include representatives of ESMA, the European Commission, the European Parliament, the FCA, the Central Bank of Ireland, the French Finance Ministry and the AMF.

*Date: 18 May 2016  
Time: 9am-5pm  
Venue: Lancaster Hotel, Lancaster Terrace, London W2 2TY*





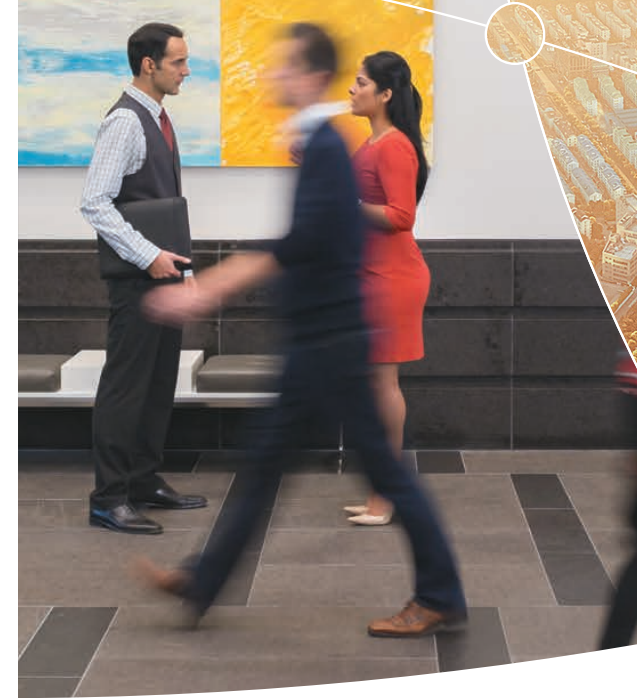
# Get Ready, Investment Strategies Are Evolving

Traditional investment strategies are strained. With shifting demographics, volatile markets and low interest rates, the financial industry is transforming. As diverse asset classes gain mainstream appeal,\* alternative investment managers have a powerful opportunity to deliver innovative solutions to the market. The question is: are you ready?

\* State Street 2015 Asset Owners Survey

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[www.statestreet.com/alternatives](http://www.statestreet.com/alternatives)



## AIMA launches Bermuda member network

AIMA is to establish a new volunteer network in Bermuda. AIMA members on the island will be represented by a new Executive Committee (ExCo). This ExCo and supporting committees will seek to boost membership and support the continued development of Bermuda's alternative investment community.

The initiative is being chaired by Craig Bridgewater, a Managing Director of KPMG in Bermuda, who called for volunteers to join the ExCo and contribute to AIMA initiatives locally and globally at a launch event at the Bermuda National Gallery attended by around 85 professionals on 3 March.

Other speakers at the event included Dr the Hon Grant Gibbons, JP, MP, Bermuda's Minister of Economic Development; Shauna MacKenzie, Director, Policy, Legal and Enforcement at the Bermuda Monetary Authority; and Sean Moran, Business Development Manager with the Bermuda Business Development Agency.

Mr Bridgewater said: "We look forward to AIMA Bermuda becoming the focal point and voice for the industry in Bermuda. We are keen to increase AIMA's activities in Bermuda and will be organising events and



*Craig Bridgewater of KPMG, pictured at the AIMA launch event in Bermuda on 3 March*

creating working groups and committees to encourage participation and collaboration among local AIMA members and other industry partners."

Jack Inglis, CEO of AIMA, said: "I am delighted about the establishment of an ExCo for AIMA in Bermuda, and I very much look forward to collaborating with the group going forward. AIMA's expansion continues to gather pace, with offices and volunteer networks in every region of the globe."

## News in brief

### New set of hedge fund director DDQs released

AIMA published a set of Due Diligence Questionnaires (DDQs) for hedge fund directors in March. They were produced by a working group of more than 30 AIMA member firms who consulted with investment managers, investors, individual directors and professional director services firms globally during the drafting process. There are three versions of the new DDQ - an Illustrative Questionnaire for the Due Diligence of Individual Hedge Fund Directors (Investor Version); an Illustrative Questionnaire for the Due Diligence of Individual Hedge Fund Directors (Manager Version); and an Illustrative Questionnaire for the Due Diligence of Hedge Fund Boards of Directors. The new DDQs are complemented by AIMA's Fund Directors' Guide, which was published last year. Visit the AIMA website to request the DDQs (members only). A summary is [here](#).

### Guide to operational risk management published in Q1

AIMA released a new guide to operational risk management for asset management firms in February. The AIMA Guide to Sound Practices for Operational Risk Management focuses on a wide variety of risks that could result in loss from inadequate or failed internal processes, people and systems or from external events. It has been sponsored by Wells Fargo Global Fund Services group. The full Guide is available to AIMA members via the AIMA website. An executive summary, which is also available to non-members, can be downloaded [here](#).

## Basel III fundamentally changes how asset managers are connected to the financial system, says AIMA/S3 paper

Basel III reforms have fundamentally changed how asset managers are connected to the financial system, with hedge funds challenged to understand expense, usage and access to the financing power grid, according to a [joint survey and report](#) by AIMA and S3 Partners.

The survey of fund managers worldwide found that:

- Financing costs have risen for 50% of firms, with an even split between those who quantify the level of cost increase as being greater than 10% and below 10%.
- 75% of firms expect further cost increases over the next two years.
- The impact is consistent regardless of a fund manager's size, investment strategy or location.
- 75% have been asked to change how they do business with their prime brokers, while more than 67% have had to cut the amount of cash they keep on their brokers' balance sheets.
- Most alternative asset managers over the last two years have either maintained or increased the number of prime brokers they use, with the average number of financing relationships found to be four.
- Only 20% of fund managers have a clear understanding of how their prime brokers calculate their worth in terms of the revenue they provide relative to balance sheet impact, known as "return on assets" or RoA. Fewer still have the data necessary to calculate this themselves.

The survey, titled 'Accessing the Financial Power Grid: Hedge fund financing challenges under Basel III and beyond', also highlighted a lack of consensus around the meaning of a number of prime brokerage terms, such as "reconciliation", "collateral management" and "collateral optimisation". AIMA and S3 say this highlights the need for a common language to define key terms.

### Recommendations

Hedge fund managers can put themselves in a stronger position to deal with the changing nature of the prime brokerage relationships. To maintain access to the



"grid" of financing, manage their overall cost of doing business, and optimise the mutual value of their prime brokerage and counterparty relationships within the new regulatory landscape, hedge funds and other investment managers must increasingly:

- Make sure they have the right data, including unbiased data sources.
- Use a different set of analytic tools and calculation.
- Make sure that they and their financing counterparties are speaking a common language to promote beneficial financing relationships and effective collateral management activities.

The survey is comprised of 78 alternative asset managers with combined assets under management (AUM) of more than \$400bn. Respondents ranged from small single-strategy managers (under \$100m of AUM) to large global multi-strategy managers (over \$10 billion of AUM).

To download 'Accessing the Financial Power Grid: Hedge fund financing challenges under Basel III and beyond', click here: [www.aima.org/en/document-summary/index.cfm/docid/C2FB3D45-5BD8-4133-BB11BB6E401CF7C6](http://www.aima.org/en/document-summary/index.cfm/docid/C2FB3D45-5BD8-4133-BB11BB6E401CF7C6)

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## Opportunities in a volatile market

By Neil Mason, Senior Managing Director,  
Man GLG

### Introduction

The markets have witnessed an extremely volatile start to the year. Equities had been in retreat until mid-February but have recently rebounded. Despite this bounce, we still believe that a new downward phase of the cycle is possible. While we do not view another 2008-style scenario as a current threat, we do think that significant volatility (the S&P 500, for example, has already dropped 11% and risen 9% this year) and stock dispersion may continue.

Warren Buffet has been right so many times that his pronouncements have become platitudes. But with palpable oscillations between fear and greed on the financial streets, this could be the kind of environment in which investment opportunities may begin to show themselves. Below, we set out our four highest conviction ideas for potentially taking advantage of this volatility.

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### 1) Merger Arbitrage

M&A (mergers and acquisitions) arbitrage is a strategy in which managers seek to benefit from price discrepancies in the stocks of acquirers and targets undergoing corporate takeovers. 2015 was the best year for merger and acquisition volumes since the financial crisis<sup>1</sup>, and we think this pattern may continue through 2016. As macro risks escalate, we believe CEOs are going to be more likely to put their often ample war chests to work in order to combat volatility with diversification.

But if volume is increasing then so is complexity. M&A spreads - the difference between the target's current price and that which the acquirer has said they will pay - have widened noticeably since the middle of

1 The Wall Street Journal - 03/12/2015

continued ►

2015<sup>2</sup>. Wider spreads can be considered as an indicator that the market has less confidence the deal will be completed. We see this scepticism as having two causes. First deals appear to be getting bigger and more legally complex (think US tax inversions, for example), and secondly, the volatility described above seems to be making investors nervy that many proposed mergers will collapse.

So risk has increased, but so has opportunity. We believe that if you have the will and the expertise to really engross yourself in the minutiae of the regulatory landscape associated with these deals then attractive opportunities could exist.

## 2) *Bank Capital*

Despite staging something of a comeback in recent weeks, financials have been experiencing price movements that recall the sovereign debt turmoil of 2011 and the credit crisis 2008/9. We believe that price drops in the recent volatility may have represented significant buying opportunities, due to the clear differences between this panic and previous ones. In the two past crises, banks were at the centre of the panic due to their leaking balance sheets, bloated with dubious assets. Today, though, banks appear to be in improved financial health. The vast majority have less exposure to the energy and commodity firms who have been suffering due to China's travails. Since 2008, they have raised large amounts of high quality capital whilst reducing leverage. In addition, the large, government-backed lines of credit that have been put in place since the Global Financial Crisis (GFC) aim to avert any short-term liquidity crisis. There are of course exceptions - we are hesitant about whether Italian banks have actually recovered from the fallout of 2008/9 and 2011 - but why a stable UK lender such as Lloyds should have had such a white-knuckle ride this year is mysterious to us. We think there could well be further volatility to come and future troughs may provide more opportunities.

A space that warrants particular mention is AT1 (additional tier 1) contingent convertible bonds, commonly known as CoCos. These instruments sit between equity and subordinated debt in a bank's capital structure. They are issued as a source of additional capital in case the bank hits trouble. At the February nadir these bonds fell into the 80s on

a cash price basis. We believe this was partly due to technical pressure as daily liquidity income funds panic-sold on an indiscriminate basis - a turn of events which we believe may be repeated in the near future. Under such circumstances we feel the asset class could be considered for selective investment.

## 3) *CLOs*

Two years of low volatility and high prices in the levered loan market came to a dramatic end at the start of 2016. Much of the pain has been felt by companies associated with energy, mining and utilities. In the chaos we believe there are often instances of overreaction. Identifying them involves detailed work around the fundamentals of credit investing: poring over the numbers, running stress tests, talking to stakeholders, and undertaking in-depth collateral and documentation reviews.

One potential way of participating in loan market dislocations is to invest in tranches of CLOs - securities which reference a pool of underlying levered loans. Doing this requires a secondary level of analysis to find a manager with the expertise to look through to the underlying loans and employ rigorous credit selection in the construction of their portfolios.

Success in this analysis offers the opportunity of capitalising on a double dislocation with stressed, technically-driven pricing in both the underlying loans and in the CLO tranches which reference them. There is distress in the marketplace, certainly, but pricing levels have dropped across an entire universe of securities, in excess of what we see as being justified by underlying fundamentals. That splashing sound you can hear? In our opinion it's babies being thrown out with the bathwater.

## 4) *Distressed Securities*

Consistent with other views expressed in this article, we believe that a new distressed cycle has started. Energy has already been hit hard and could offer significant potential in our view. The sector appears to be rich with assets that are expensive to replicate. Energy businesses are also often highly operationally geared and so, if bought into at the right time, attractive returns may potentially be generated in a normalisation scenario. We think that price stabilisation over recent weeks may be further supported by supply-side contractions, noting the capacity reductions in the dry bulk market as evidence of this.

2 Bloomberg

We expect that the number of distressed opportunities will be bolstered by an increasing lack of access to financing. In our view there are a number of companies which are over-levered and have been limping along in recent years. We feel there is a significant possibility that banks would be ever-more capital-constrained and we believe there may be a reversal of the loose credit environment enjoyed by firms in recent years. We would not be surprised to reach a position where only the most credit-worthy companies will be able to access the debt markets to refinance their loans. Many others could well be forced to restructure, and further opportunities may arise.

### Conclusion

The general theme as we see it is this: the markets appear to be entering a new phase of the cycle and the more swiftly investors acknowledge and react to this, the better. Whilst recent weeks have seen a positive reversal in credit and equity markets, we believe volatility is more likely to persist and continue to produce potential opportunities for investors with the ability to act. We expect there will be recurring technical pressures on many in the markets. A clear head in response to these moments could help investors to identify situations where fundamental value is being ignored.

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## Not digital, not emotional, not aligned - why long-only funds are eating your lunch

By David Masters, Director and Partner, Lansons

The hedge fund sector has done well to recover its reputation a little in recent years, benefitting in part from managers that have re-invented themselves as institutional asset managers. More remains to be done, however, particularly as the long-only competition have been in that market longer.

The good news is that institutional investors are positively disposed towards alternative strategies at present, at least according to research from Deutsche Bank that says that investors are likely to increase allocations. But in this intermediated, consultant-driven environment, this will benefit a few managers running a specific set of strategies more than the industry overall. There are a few other challenges ahead as well. On the political front, there are some ominous rumblings from the US, and the situation in the UK and EU also stands to benefit those politicians with similarly extreme views. How positive investor sentiment stands up to any crisis in bond fund liquidity is hopefully a problem we won't have to face.

Investor sentiment is not a perfect gauge of reputation anyway, and remains short-termist if not downright skittish. Part of the issue is, I think, that while managers from the hedge fund world have made excellent inroads into the institutional markets (and many have taken the logical corollary of launching long-only funds as well), relationships are still young and skin deep.

The descriptive transition from 'hedge fund' to 'institutional asset manager' is never clearer than in how these managers describe themselves online. We surveyed the 20 largest hedge fund firms<sup>1</sup> and found that virtually none use the term 'hedge fund' in how they describe themselves online and those few who do are often businesses owned by banks, presumably for whom the association with alternative strategies is weakest. Institutional investors may like 'alternative strategies' but it seems they don't want to invest in 'hedge funds'.

<sup>1</sup> As ranked by Institutional Investor's Alpha

As the market for alternative strategies evolves, particularly through the use of liquid alternative vehicles, so it becomes more important to be able to engage with stakeholders on their terms - to demonstrate that extra layer of understanding. The research highlighted above shows that whilst hedge fund firms have moderated their descriptors, they are still engaging on a monolithic basis, whereas their competitors from the long-only world are much better at describing themselves in a way which is aligned to their client interests. Being client-centric does not make you more of an asset gatherer than an asset manager, but it might make you more of an asset retainer.

Is there really a correlation between the words firms use to describe themselves and their attitude to clients? Of the 20 largest firms we surveyed one in particular had a website that, despite containing a lot of depth, really didn't seem client-centric at all - the message it gave could be best summed up 'this is who we are, take it or leave it'. Funnily enough, a few weeks later they announced their decision to withdraw from managing external money...

The digital equation is important. Most of the major institutional asset managers formerly known as hedge funds have moved beyond simple landing pages for all but clients to provide a healthy level of detail about their business. The one or two that haven't done so do at least have LinkedIn pages or similar which give a sufficient overview of the company, particularly for potential recruits.

This latter point is not to be underestimated. The rise of employer review sites such as Glassdoor.com does more than provide disgruntled former employees the chance to vent their spleen online; it's also a useful source of information for manager selectors. A bad review on such a site isn't likely to be a deal breaker (no-one should ever take them at face value), but it can be a useful source of difficult questions to ask. Social media and the digital world provide an excellent channel to engage and reassure clients once you navigate the regulatory issues, but are largely underutilised. This

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is much less the case for those long-only firms who've been working the institutional market for longer, and it's time that the gap was closed.

One problem is that, overall, much of the sales and marketing approach from the asset management industry appears resolutely stuck in the 1960s - marketing and promotion is seen as just a sales aid. The world has moved on, and the importance of an emotional connection with audiences remains important - and a vital counter-balance to the ever increasing emphasis on digital. Again, the 'emotional' approach can seem counter-intuitive to the investment world as it moves away from the traditional performance message - but given that few managers achieve really consistent outperformance for any period of time, surely that's a good thing.

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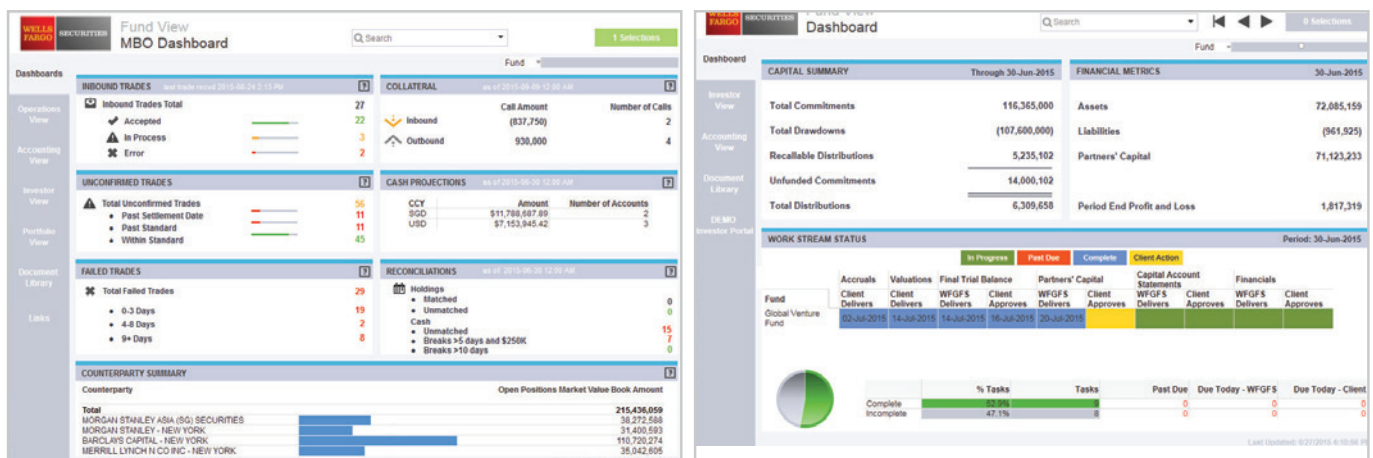
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## Implementation considerations within discretionary global macro

*By Josh Palmer, Senior Investment Analyst, Willis Towers Watson*

Perhaps in contrast to other investment strategies, discretionary global macro (“macro”) managers cannot be easily categorised into homogeneous groups. Macro funds will vary by a number of characteristics, including but not exclusive to, asset-class focus, geographical focus, trading style (thematic versus idiosyncratic), investment horizon and structuring sophistication. The focus for a particular manager will of course be influenced by the skill set and experience of the portfolio managers and their team.

The result is that the portfolio manager will approach the markets in their own specific style and each fund will be an organic aggregation of its specific underlying discretionary views and subsequent investments. This, coupled with the significant breadth of macro trading, results in differentiated funds, even within sub-sets of macro - such as developed markets (DM) macro. This is reinforced by the typically low, long-term correlations between macro funds, as well as macro in general, and other hedge fund strategies and market betas. As a result, we believe that macro managers warrant a long-term strategic allocation within investors’ portfolios.

In what follows, we discuss the implementation options available within macro to investors. We start with DM macro and analyse how this sub-strategy has been impacted by the market environment in the past few years. We then argue why the outlook for DM macro appears to be improving and outline how the opportunity set may evolve. Later we discuss emerging market (EM) macro and the evolution of the manager line-up and opportunity set here. We finish by considering how, for higher governance investors, an allocation to EM macro could supplement that of DM global macro.

### The case for DM macro

As alluded to above, we believe that macro managers warrant a long-term strategic allocation within investors’ portfolios. The strategy provides diversification through low long-term correlations with

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other strategies and asset classes, it tends to profit in times of rising uncertainty and volatility (due to a structural long volatility bias), and provides significant exposure to skill premia rather than bulk-market betas.

Historically, allocations to macro have been tilted to DM for several reasons. First, there are a large number of managers with a DM focus possessing strong and long track records. Second, the size and depth of liquidity in DM markets create an attractive opportunity set by allowing for the flexibility to react quickly as market drivers change in real-time and macro-economic trends play out. Third, there has been a large amount of investor appetite for such strategies historically aimed at diversifying away from DM bulk betas. Last, DM managers were well established and large and presented much less business risk than EM managers that were generally still finding their feet.

However, DM macro has not fared too well in recent years. Part of the reason for the strategy’s underwhelming returns has been the protracted period of quantitative easing and coordinated central bank policy setting across the developed world. This has vastly reduced the opportunity set by anchoring current interest rates close to zero and subsequently reducing uncertainty in the interest-rate-futures market. This has weighed on performance through the reduction in directional and arbitrage opportunities, as well as the payoff to trades due to suppressed volatility.

It was difficult to predict the extended duration of central bank co-ordination. However, we are now seeing a significant improvement in the opportunity set in the form of so-called policy divergence. Indeed, the Federal Reserve has embarked on its first interest rate hike in nearly a decade, while the Bank of Japan (BoJ) and European Central Bank (ECB) defy the lower bound for interest rates. These opposing monetary policies have created an attractive divergence trade for DM macro managers to capture as it develops. Furthermore, this divergence of monetary policy is unlikely to be smooth,

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despite attempts to provide forward guidance- which currently many market participants feel resembles *forward deception*. This will further enhance the opportunities for DM macro managers who should be able to profit from their insight, structuring skills and broad tool kit across asset classes.

In conclusion, the outlook for DM macro appears to be improving as the opportunity set evolves. With the benefit of hindsight, an allocation to DM macro would not have been the best decision over the last three years, however now is not the time to cut exposure.

### The case for EM macro

An allocation to EM macro could also be considered by high governance investors as a supplement to their existing (likely DM) macro allocation. The emerging markets are becoming increasingly institutionalised and liquid, becoming more suitable for a discretionary macro strategy since this allows for the flexibility to react quickly as market drivers change in real time and macro-economic trends play out. In addition, the broadening and deepening of capital markets allows for more sophistication in trade expression.

However the most salient benefit of supplementing DM with EM macro is diversification. Given their differing, and increasingly broad, opportunity sets and the heterogeneity within EM itself, it is much less likely that both will suffer from the same headwinds such as developed world central bank policy coordination. Even if this were the case - some EM economies are actually cutting interest rates - there are greater inefficiencies in EM as a result of less coverage from investment banks, less focus from investors and less capital chasing the opportunities.

There are issues, however, associated with investing in emerging markets, such as the availability and quality of information, communication barriers and market regulations. Therefore we feel it is clear that having a specialist immersed in these economies is critical in order to capitalise on the alpha opportunities and to obtain an edge.

To summarise, emerging markets offer a ripe opportunity set due to their scale, diversity and generally desynchronised business cycles and policy frameworks. However investing in this opportunity set comes with many issues that need to be understood so as to mitigate risk and capitalise on opportunities. Therefore, for an investment in EM macro, we recommend hiring a specialist manager

who is immersed in these economies and possesses the requisite skill set.

### Discretionary macro manager implementation considerations

As discussed, each macro fund is the organic aggregation of its underlying discretionary, opportunistic investments which will be influenced by the particular skill set and experience of the portfolio managers and their team. So simply having one DM focused manager does not necessarily provide exposure to all of the opportunity set within DM. Similarly, having exposure to a single EM macro manager will not provide exposure to all emerging markets.

For higher governance clients, an allocation to EM macro could supplement an allocation to DM global macro. As has been argued throughout, DM and EM macro managers possess very different skill sets and experiences which are required in order to capitalise on their respective opportunity sets. In times of central bank policy coordination in developed markets, the EM macro funds can provide alternative return drivers. Conversely, the lift-off from zero rates in the US combined with the ECB and BOJ's ongoing battle with deflation is an opportunity not to be missed.

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## MiFID II and paying for research: To bundle or unbundle? That is no longer the question

*By Sean Steinmetz, Global Head of Managed Brokerage Services, Bloomberg Tradebook, and Andrew Ezekiel, EMEA Commission Management Specialist, Bloomberg Tradebook*

The European Commission's (EC) draft of MiFID II delegated acts, which was leaked in December 2015, caused a stir regarding the use of commission sharing arrangements (CSAs) in paying for research going forward. While the final drafts are not expected to be released until later this year and each individual national regulator will still need to make its own interpretation, the leaked document prompted industry speculation that CSAs may be allowed to coexist with research payment accounts (RPAs) in a post MiFID II environment.

Regulators are seeking greater transparency throughout the trading process, part of which will entail separating the costs of trading activity from research spend. The concept of unbundling is now very much on the table. However, it is important to understand the distinction between CSAs, RPAs and how bundling vs. unbundling works in practice.

A CSA breaks down the commission a buy-side firm directs to its brokers into a distinct execution component and a distinct research (CSA) component. This allows a buy-side firm to use the CSAs accrued with its brokers to pay for research from a provider of choice, including independent research houses. Prior to CSAs, any particular piece of research did not necessarily have an absolute price. For example, if commission rates remained unchanged, but a firm traded 50% more this year than last year, essentially they would pay 50% more for the same research service.

MiFID II has proposed the creation of RPAs, which would allow firms to set an absolute monetary budget to pay for their research to help divorce the relationship between trading activity and research spend. Reviewing the language that ESMA and the EC

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## Bloomberg

have used to describe an RPA, it is possible to conclude that an RPA is merely an enhanced CSA. RPAs could also be interpreted as separate accounts.

Currently, buy-side firms have several ways to pay for research—depending on their approach to the “unbundling” of the relationship with their broker. A firm that has a bundled approach pays one rate of commission to its broker and essentially receives its research as an add-on. Regulators are looking to bring more transparency to this process, since bundled commission and research spend do not provide clarity on the actual cost of the research.

Unbundling is the process by which a firm separates its execution commissions from its research spend. It will generally use CSAs or other mechanisms to manage that process. Many firms use the CSA mechanism to build up a research “pot” during the early part of a year and then switch to “execution only” commission rates once an acceptable research budget has been established. Other buy-side firms set up CSA accounts with as many of their executing brokers as possible in order to satisfy their own liquidity or “best execution” requirements. Clearly, this leads to confusion about the various options available.

We recently conducted a survey of over 100 European buy-side clients to gauge market sentiment around some of these issues. Of those respondents whose firms pay for research, **45% are presently paying with bundled commissions**, something that will not likely be possible once MiFID II is implemented. It will be interesting to see how these firms adapt; they could institute CSAs or RPAs, pay directly from their own resources, or possibly stop paying for research all together. **37% are paying for research using mainly CSAs**, and have therefore already made strides toward

continued ►

unbundling—a step closer to what the regulators are looking for.

When asked if their interpretation of the MiFID II drafts mean that research payment accounts will allow for CSAs, **a majority of respondents – 67% – didn't know**. This underscores the level of uncertainty in the market and also the reluctance to make decisions until more clarity is offered on the final release. 61% have not considered how they will pay for research once the new regulation is implemented.

The path to compliance will be smoothest for UK-based firms where CSAs have been in place since 2006. Throughout much of continental Europe, local regulators still do not endorse CSAs, so bundled commissions are much more common. Despite the lack of clarity, we think that firms should examine the benefits of thoroughly budgeting and accounting for their research spend before the regulations come into force. Irrespective of whether CSAs do eventually gain clearance, regulators will certainly require increased accountability and attribution in some way. Additionally, there are savings to be made. With the microscope on buy-side research spend and a movement away from bundled costs, we anticipate the total spend by firms on research to decrease. 80% of our survey respondents agreed, expecting their total amount paid for research to either stay the same or decrease.

With all the above factors in mind, investment managers will need to start evaluating budgeting tools that can help them meet their research transparency requirements. Firms will also need clear audit trails and the ability to provide full disclosure to their end-clients in order to demonstrate how they are staying MiFID II-compliant. Further attribution and accountability are the underlying themes of the new regulation. Tools that help investment managers in that process will be necessary moving forward.

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# The Pulse of Fintech, 2015 in Review

**Global Analysis of Fintech  
Venture Funding**

March 9, 2016

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## Implementing SFTR - what is required for hedge fund managers?

*By Owen Lysak, Senior Associate, Clifford Chance, and Jacqueline Jones, Senior Professional Support Lawyer, Clifford Chance*

A new European regulation has come into force which will be important for EU and third country hedge funds engaging in securities financing transactions, such as repo and securities lending, or transactions which involve the reuse of collateral.

The Securities Financing Transactions Regulation, or SFTR as it is known, came into force in January 2016, imposing new rules, most - but not all - of which will be phased in over the next two years or so.

This article focuses on the key requirements for hedge fund managers and highlights some of the issues that need to be addressed by the market as it moves towards implementation.

### SFTR requirements

The SFTR imposes requirements in three key areas:

- In relation to the re-use of collateral received through a security or title transfer collateral arrangement;
- Disclosure to investor requirements for managers of UCITS and AIFs;
- Trade reporting requirements, to a trade repository following the model in EMIR.

Perhaps surprisingly, given its name, the regulation is not restricted to securities financing transactions, as it also applies in some instances to commodities financing transactions, to total return swaps and to any transaction where collateral is received under securities or title transfer collateral arrangements. This is because the scope of the three key requirements differs, applying to different trades or to different parties.

The starting point, therefore, is for managers to give the scope requirements of the SFTR careful consideration.

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### SFTR highlights

- New information and execution conditions on the reuse of securities collateral
- Disclosure requirements on the use of SFTs and total return swaps by fund managers to fund investors
- New requirements to report SFTs to a trade repository by T+1
- Applies to financial and non-financial counterparties and fund managers
- Applies to a broad range of transactions in addition to SFTs - derivatives collateral, total return swaps and some commodities finance transactions
- Extraterritorial scope
- Very limited exemptions
- Phased implementation of most requirements
- Some requirements (e.g. record-keeping and pre-contractual disclosure for new funds) apply from 12 January 2016

### Disclosure to investor requirements (Article 13 and 14)

The SFTR requires EU authorised managers of UCITS and AIFs to make disclosures with respect to SFTs and total return swaps. Managers must make detailed disclosure through:

- Periodic reports: including disclosure of certain prescribed information in the six monthly and annual reports required under the UCITS Directive or the annual report required under the AIFMD;
- Pre-contract disclosure: including disclosure of certain prescribed information in the prospectus, as required under the UCITS Directive or relevant pre-contractual/offering documentation required under the AIFMD.

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Managers already have to comply with the pre-contractual requirements in respect of funds constituted after 12 January 2016, which was the day the SFTR came into force. Funds already in existence do not have to comply until 13 July 2017 because of the transitional provisions. For the periodic disclosure requirements there is a 12-month grace period, for both new and existing funds, so managers will have until 13 January 2017 to comply, although they will need to start thinking about those requirements now to ensure that they are capturing the required information for the coming year.

Not surprisingly, the issues which have emerged so far concern the pre-contractual disclosure requirements, as they already apply for 'new' funds. Questions have been raised about what this means in practice and, in particular, whether new sub-funds in an existing umbrella structure would be able to take advantage of the grandfathering provisions.

It appears that national regulators have different views on this. It is reported that the current view of the UK FCA is that the pre-contractual disclosure (prospectus) requirements in article 14 apply to all new sub-funds of UCITS and AIFs, as well as entirely new schemes, whereas other regulators, for example the CSSF in Luxembourg, have taken the opposite view, so that new sub-funds of an umbrella structure which existed before the SFTR came into force will be grandfathered.

Managers have also been considering the level of detail that has to be included in pre-contractual disclosures. The SFTR, in section B of the Annex, lists the information to be provided to investors, but gives no indication of the level of detail required. ESMA may develop RTS in respect of periodical reports and pre-contractual disclosure by managers of UCITS and AIFs, but no timeline is specified for these, as they are optional. These means that managers will need to reach a view on an appropriate level of detail and it would be beneficial for the market to come up with a consistent approach to this.

### Reuse of collateral (Article 15)

The SFTR imposes conditions on the reuse of financial instruments provided as collateral. From July 2016, all counterparties, not just financial intermediaries, will have the right to reuse financial instruments received as collateral under a security or title transfer collateral arrangement only if the disclosure and consent provisions in the SFTR are satisfied. Even if those conditions are satisfied, so that a party has the right

to reuse collateral, there is more to be done, as the SFTR also stipulates additional conditions which apply to the exercise of any right of reuse, namely: that the reuse must be undertaken in accordance with the terms of the collateral arrangement; and the financial instruments received under a collateral arrangement must be transferred from the account of the providing counterparty.

The requirements on reuse of collateral in Article 15 are broad. They apply to 'counterparties', which is any 'undertaking' established in the EU or in a third country, that receives collateral with a right of reuse. The requirements apply to counterparties established in the EU even if they are acting through a branch outside the EU.

They also apply extraterritorially to non-EU counterparties, but only if they are receiving collateral from counterparties established in the EU or if the non-EU counterparty is acting through a branch in the EU. Also notable the scope of the reuse provisions is wider than just SFTs, as they apply to the reuse of securities and other financial instruments provided as collateral under all security and title transfer collateral arrangements in any context, not just in the context of SFTs.

There are limited exemptions e.g. the reuse requirements will not apply to members of the European System of Central Banks (ESCB), but this does not apply to both sides of the trade as counterparties receiving collateral from exempt entities must still comply with the reuse requirements.

In order to give the market time to prepare, the reuse requirements will take effect six months after the SFTR comes into force, on 13 July 2016. However, the requirements will have retroactive effect, as they will also apply to collateral arrangements existing on the date the reuse requirements take effect.

The SFTR reuse requirements will impact hedge funds e.g. through their repo activity or prime brokerage arrangements. The main focus for the market now is on ensuring that there is adequate disclosure to providing counterparties, as the requirements seem likely to go beyond existing disclosures. Industry associations have collaborated to prepare market standard disclosures which would be sent to existing counterparties before the new rules come into effect and incorporated into new arrangements going forward. Aside from the wording of the disclosures, the market is thinking

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about the logistical exercise of making the disclosures, a challenge in itself, and is aiming for as a consistent approach as possible across the market.

### Reporting to trade repositories (Article 4)

The SFTR reporting regime generally follows the model for derivatives reporting under EMIR. Under the SFTR, both parties to a trade (whether they are financial or non-financial counterparties) will have to report new, modified or terminated SFTs to a registered or recognised trade repository by T+1 and must maintain records of SFTs for at least five years following the termination of the transaction. UCITS managers and AIFMs will have to report on behalf of their funds.

The reporting requirements apply to counterparties established in the EU, including their branches outside the EU, and to EU branches of third country counterparties. There is, however, some uncertainty as to the application of the reporting requirements to AIFs, in particular where a non-EU AIF is managed by an EU AIFM. It seems likely that these queries will be resolved by FAQs in the two to three years before the reporting obligation would apply to these entities. ESMA is expected to consult on the reporting requirements of Article 4 in the spring of 2016, so more information on the reporting requirements may be forthcoming shortly.

To allow the market sufficient time to prepare for SFTR reporting, the requirements will be phased-in over a period of between 12 and 21 months after the detailed rules (known as Regulatory Technical Standards or RTS) for trade reporting come into force and thus the full requirements are known. The length of the transitional period will vary depending on the type of reporting counterparty, with UCITS and AIFs having 18 months. Non-financial counterparties will not need to begin reporting their trades until 21 months after the relevant RTS comes into force.

In contrast to the reporting requirement, there will be no grace period for record-keeping. Counterparties must comply with the record-keeping obligation from 12 January 2016. This may be onerous for entities that currently do not keep records of SFTs in this way, even though the SFTR does not specify a particular form or content requirements for these records.

Although still some way off, it is already clear that there are a number of issues around SFT reporting. Much of these relate to overlapping reporting requirements. The SFTR sets out the information that must be

reported to the trade repository and further detail will be provided in the RTS and ITS to be adopted under the SFTR. These will need to ensure consistency with the reporting regime under EMIR and internationally agreed standards, in particular the Standards and Processes for Global Securities Financing Data Collection and Aggregation published by the FSB (November 2015).

However, other regulatory or supervisory authorities, such as the ECB are introducing SFT reporting regimes in addition to SFTR, and the requirements overlap to a degree. This is challenging from an implementation perspective and would lead to inefficiencies, so the industry is working with regulators to develop a consistent approach to the interpretation of the requirements and the collection of data in order to comply with as little duplication of effort as possible.

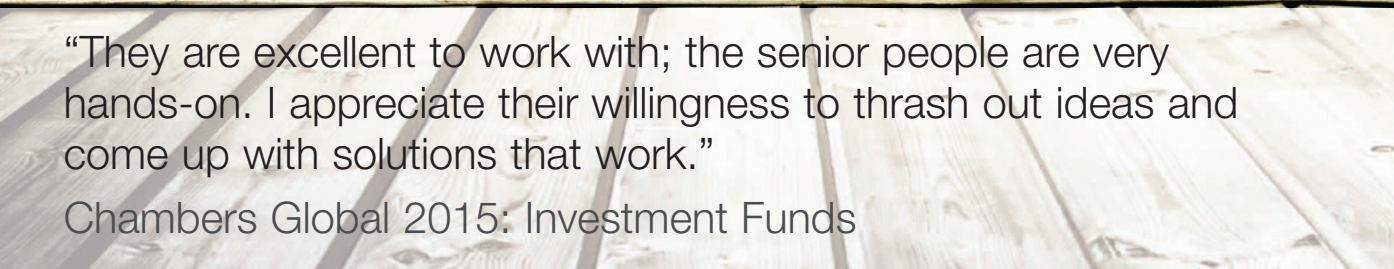
### Implementation

Although less extensive than other recent regulatory reforms, most notably MiFID2, the SFTR nonetheless presents significant compliance challenges. At the core will be identifying in-scope entities and transactions, which may require systems build and establishing internal processes e.g. to capture all new in-scope collateral arrangements by 13 July 2016. Some solutions, such as those for the collateral re-use disclosures and reporting, would be optimal if they applied across the market, so efforts by the trade associations to work collaboratively on this are to be welcomed. In some cases, notably trade reporting, further regulatory guidance will be required before the issues can be fully resolved. It is hoped that further clarity will be provided as the Level 2 process unfolds.

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## The changing landscape of major shareholding reporting in Europe

By Claire Farley, Head of Regulatory Products, Allen & Overy LLP (aosphere)

The rules across Europe requiring disclosure by investors of major shareholdings are currently undergoing the most comprehensive set of revisions since the Transparency Directive came into force in member states in 2007. Buy-side compliance officers are likely to need to increase their focus on this area while member states switch over to the new disclosure requirements and on an on-going basis as a result of the greater reach of the rules and heightened sanctions when things go wrong.

### Background

The Transparency Directive (2004/109/EC) (TD), together with implementing Commission Directive 2007/14/EC, has set out the framework for major shareholding disclosures across Europe since it came into force in member states in 2007. The TD contained the twin objectives of increasing the market transparency of major positions in issuers whose shares are traded on an EU regulated market and establishing a harmonised requirement across Europe for investors to notify major positions.

It became increasingly apparent that these twin objectives were not being met. First, there were variations in member states' rules from the outset resulting from the way member states transposed the provisions of the TD into national law and elected to exceed the terms of the TD (a practice known as gold-plating). Second, innovation in financial markets led to the creation of new instruments that gave investors economic exposure to issuers, the disclosure of which was never contemplated by the TD. A number of high-profile cases highlighted that cash-settled instruments could be used to secretly acquire positions, potentially resulting in market abuse and a false and misleading picture of economic ownership. In an attempt to shut the door on such practices, several member states implemented piecemeal changes to their national rules, resulting in a further fragmentation of the rules.

### Closing the loophole

The Amending Transparency Directive (2013/50/EU) (TDA) seeks to close off this loophole across all member states and requires disclosure of financial instruments that give investors an economic exposure to an issuer

which is similar to that experienced when holding shares. It also introduces other important changes to increase harmonisation of the major shareholding disclosure rules across Europe [see box on following page].

### Financial instruments with similar economic effect

The pre-TDA position required disclosure of major positions in (1) voting shares of issuers which are admitted to trading on an EU regulated market ("in-scope shares") and (2) financial instruments which give the holder an entitlement to acquire, at its own option, in-scope shares. The TDA has expanded the scope of disclosable financial instruments to include financial instruments with a similar economic effect to holding shares or entitlements to acquire shares, whether cash-settled or physically-settled<sup>1</sup>. Both the TDA and ESMA provide lists of instruments that may be disclosable as either financial instruments giving an entitlement to acquire or financial instruments with similar economic effect. Although these lists are helpful to some extent (two lists are better than none?), both are indicative only, as an instrument which is not on the lists may nevertheless be disclosable if its characteristics satisfy those of a disclosable financial instrument and conversely, an instrument which is included on the lists might not be disclosable. In addition, neither list specifies the category of financial instrument into which a particular instrument may fall. This distinction is important in practice because the disclosure notification must include a breakdown by instrument type across the three categories of disclosable instruments - shares, entitlements to acquire and instruments with similar economic effect - as well as distinguishing between cash-settled and physically-settled financial instruments<sup>2</sup>.

To determine whether an instrument is a disclosable financial instrument and, if so, what type, a holder

1 Article 13(1)(b) of the amended TD

2 Articles 13(1) and 13a of the amended TD

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### Amended TD notification requirements as holdings in shares and financial instruments change

Day	Position of direct/indirect holdings of voting rights (Art 9/10)*	Position in financial instruments (Art 13)	Total position (Art 13a)	Notification required?	Threshold triggered according to which basket (Art 9/10**, 13, 13a)?
1	7%	-	7%	Yes	Art 9/10
2	7%	2%	9%	No	-
3	8%	4%	12%	Yes	Art 13a(1)
4	11% (exercise of 3% financial instrument)	1%	12%	Yes	Art 9/10
5	8%	6%	14%	Yes	Art 9/10 Art 13
6	8%	4%	12%	Yes	Art 13
7	9% (exercise of 1% financial instrument)	3%	12%	No	-
8	9%	7%	16%	Yes	Art 13 Art 13a(1)
9	12%	7%	19%	Yes	Art 9/10

\*For convenience holdings under Article 9 and 10 are not separately represented.

\*\*This is an example of Article 13a(2), where the holder acquires the underlying shares of the financial instrument and crosses or reaches a threshold laid down by Article 9(1) and has to make a disclosure accordingly.  
Source: ESMA Q&As on Transparency Directive dated 22 October, 2015

should start by considering whether the instrument satisfies the criteria of a financial instrument that gives an entitlement to acquire<sup>3</sup>. If the answer is no (because, for example, the instrument contains conditions the satisfaction of which are outside the control of the holder, or is exclusively cash-settled), the holder should then go on to consider whether the instrument is a financial instrument with similar economic effect<sup>4</sup>.

A disclosure is required if (a) total shares, or (b) total financial instruments, or (c) total shares and total

3 Article 13(1)(a) of the amended TD

4 Article 13(1)(b) of the amended TD

financial instruments trigger a threshold. Not all member states currently require aggregation of shares and financial instruments<sup>5</sup>, so investors will need to re-assess their holdings post-TDA to see if their positions trip an aggregated threshold. ESMA has produced a helpful table of worked examples illustrating when notifications are required as holdings in shares and financial instruments change [see table on following page]. The number of voting rights attributable to financial instruments which provide exclusively for a cash settlement is calculated on a delta-adjusted basis and for all other financial instruments is calculated using the full notional amount of shares underlying the instrument.

5 For example, Cyprus, Luxembourg and Spain

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## Other Key Changes

- **Mandatory availability of trading book exemption:** All member states are required to operate a trading book exemption (previously trading book was not available in all member states). ESMA's Final Report on draft Regulatory Technical Standards contains very helpful commentary on horizontal and vertical aggregation rules for both the trading book and market making exemptions.
- **No standalone client serving exemption:** ESMA did not consider itself mandated by the TDA to establish a standalone client serving exemption and concluded that the trading book exemption should have a double function - the initial purpose it was designed for and also to cover client-serving transactions. The standalone exemptions in Germany and the UK have been removed to reflect this position.
- **Existing exemptions apply to instruments with similar economic effect:** Existing exemptions under the TD (such as the disaggregation rules for parents of management companies and investment firms) apply equally to voting rights held via financial instruments with similar economic effect.
- **Heightened sanctions:** Sanctions for breach of the shareholding disclosure rules have been strengthened and include fines of up to EUR 10 million or 5% of total annual turnover; or up to twice the amounts of profits gained from the breach, whichever is the higher, with suspension of voting rights in the most serious cases.

## Baskets/indices

Financial instruments referenced to a basket or index (whether actively or passively managed) are now disclosable if the underlying shares either represent 1% or more of voting rights attached to shares of the specific issuer, or represent 20% or more of the value of the securities in the basket/index. The 1%/20% thresholds represent the point at which a holder should start to aggregate interests in the underlying issuer represented by the financial instrument referenced

to the basket/index with other shares or financial instruments it may have in respect of the same underlying issuer, i.e. a disclosure is not automatically triggered if either the 1% or 20% threshold is met. There is no requirement to disclose financial instruments referenced to a series of baskets/indices which are under the thresholds individually but would exceed the thresholds if aggregated.

## Securities lending transactions

A lender who transfers securities to a borrower with the right to reacquire on maturity the loaned securities has a disclosable entitlement to acquire shares under Article 13(1)(a) of the amended TD. This is not new. The original TD position captured rights of recall as entitlements to acquire but their treatment was subject to national variation, resulting in an uneven disclosure position across Europe. ESMA acknowledged the resulting uncertainty regarding regulatory practices in this area in its Final Report on draft Regulatory Technical Standards<sup>6</sup> and the TDA includes the right of recall in the list of financial instruments which are subject to notification requirements, clarifying that, irrespective of previous regulatory practice, the right to recall shares is subject to disclosure.

## State of flux

Although the deadline for transposition of the TDA by member states into national law has passed<sup>7</sup>, implementation of the new disclosure rules by member states remains patchy. As at 15 January, 2016, 13 member states<sup>8</sup> have transposed the TDA into their national legislation, two member states<sup>9</sup> are operating a transitional regime, two member states<sup>10</sup> are permitting (but not requiring) investors to report on the basis of the new rules even though they are not yet

6 ESMA's Final Report on draft Regulatory Technical Standards dated 29 September, 2014 paragraphs 152 and 153

7 26 November, 2015

8 Austria, Croatia, Denmark, Estonia, Finland, France, Germany, Hungary, Ireland, Malta, Slovakia, Spain, UK

9 Italy, Portugal (both require compliance with the Commission Delegated Regulation (EU) 2015/761 despite the non-transposition of the TDA into national law)

10 Luxembourg, Portugal

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in force in national law and 13 member states<sup>11</sup> have yet to transpose the TDA and are continuing to require compliance with their pre-TDA disclosure rules.

Even amongst member states that have switched over to the new rules, there continues to be divergence in a number of key areas such as the initial disclosure threshold (with Austria, Germany, Ireland, Spain and the UK continuing to retain initial thresholds which are lower than the TDA standard of 5%), notification timing (with Austria, Denmark, Finland, Hungary, Ireland and the UK requiring notifications to be made more quickly than the T+4 TDA standard) and additional disclosures for holdings of share capital (with Denmark, Finland, France, Hungary and the Netherlands retaining their pre-TDA requirements to disclose shares in addition to voting rights). Of the member states that have not yet implemented the new rules, some are anticipating significant delays (such as Iceland, where implementation before autumn 2016 is unlikely), while others lack any certainty or even an indication of their potential timelines to implementation.

With a variety of disclosure regimes currently operating within Europe, a continued lack of harmonisation of the rule book even amongst member states that have adopted the new disclosure regime, the extension of the reach of the rules by the inclusion of financial instruments with a similar economic effect and heightened sanctions, it's clear that this is an area that buy-side compliance officers will need to continue to monitor closely.

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<sup>11</sup> Belgium, Bulgaria, Cyprus, Czech Republic, Greece, Latvia, Lithuania, Luxembourg, Netherlands, Poland, Romania, Slovenia, Sweden

## People and confidential information: Dealing with key employment risks

*By Hayley Robinson, Partner, Macfarlanes and Matthew Ramsey, Professional Support Lawyer, Macfarlanes*

Amongst a firm's key assets are its people and its proprietary information. This article looks at some of the risks affecting these two areas, and discusses strategies to ensure firms are adequately protected. In particular, we'll look at how to ensure confidential information is properly protected, and what steps are available to restrict key people moving to competitors.

### Confidential information

Firms naturally regard their proprietary information as critical to their success in the market - but people are leaky and IT systems are not fool-proof. The explosion of mobile devices and wearables in recent times poses an increased risk of confidential information leakage. Many financial services clients prohibit smartphones in the front office, for sound risk management and regulatory reasons. But what other steps can and should firms be taking to lock down business-critical information, whether that is investor lists, trading algorithms or employee data?

The answer usually comes in three parts: have a clear policy setting out what is acceptable; have an effective means of enforcing that policy; and have enforceable restrictions to operate during notice periods and post-termination.

### Policies

The common law gives an employer relatively little protection in relation to confidential information, generally only restricting the disclosure or use of trade secrets. Trading algorithms might fall within that category, but in order to protect other forms of information an employer will need clear contractual provisions coupled with a clear policy. These ought to describe in granular detail the types of information that are regarded as confidential and restricted, and should give employees clear guidance on what they may and may not do.

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### Monitoring and enforcement

Although setting clear rules is a necessary first step, in the modern age the real challenge lies in the policing. Employees are seldom foolish or naïve enough to use work email to prepare for their departures, so firms need to address all the myriad ways in which data can be disseminated. Instant messaging systems, smartphones and social media platforms all offer opportunities for unscrupulous employees, particularly in firms which operate BYOD, or 'bring your own device' arrangements. This is an increasingly popular means of reducing IT budgets, and sees proprietary software loaded onto an employee's own device (tablet or laptop etc) so the employee can efficiently work remotely.

As emails and messages continue to be routed through the employer's systems in a BYOD arrangement, firms should continue to be able to monitor usage as if the employee were at their desk. The European Court of Human Rights analysed in January what types of monitoring of behaviour are permissible, and the decision largely mirrors what is established best practice in the UK.

The court's judgment in *Bărbelescu v Romania* [2016] ECHR 61 was widely reported in the press as giving a green light to all forms of monitoring. In reality, the position is rather more nuanced and the case was heavily influenced by the particular facts. In brief, Mr Bărbelescu set up a Yahoo! Messenger account for work purposes and was very clearly told that no private usage was permitted. He used the account for private discussions notwithstanding that instruction, argued when challenged that he had never used it for personal matters, and then sought to argue that his employer should not have monitored the account to prove he had in fact done so.

Unsurprisingly, given those facts, the Court found Romanian law permitting the monitoring to be compliant with the over-arching human right to respect

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for private life and correspondence. But that is not the same as ruling in favour of unrestricted monitoring. In the UK, legislation and, in particular, the Information Commissioner's Employment Practices Code make clear that monitoring will usually be permissible if:

- The employer carries out a risk assessment before embarking on monitoring
- Employees are informed in advance (usually via the employer's policies) that monitoring may be carried out, what will be monitored, why, and what will be done with the results
- The employer acts in a reasonable and proportionate way: this covers every aspect of data processing and collection, from choosing the least intrusive method of monitoring, to considering how long the results will be retained and who will have access to them

If the confidential information provisions are well drafted, the IT and disciplinary rules are clear and the monitoring system is effective, firms should be able to feel safe in taking a robust line.

### Notice periods, garden leave and post-termination restrictions

Inevitably, misuse of confidential information usually takes place when an employee is contemplating a move and there are additional methods of protecting business-critical information at that stage.

Well-drafted employment agreements will typically allow the firm to send an employee home for part or all of their notice period - garden leave. Garden leave provisions will usually restrict the employee's contact with investors, other employees and clients, and contractual restrictions on the use of social media are now increasingly common.

Some firms use lengthy notice periods, often by agreeing to fixed-term contracts without a break clause or other notice provision. Even though employees continue to draw salary and benefits during notice, they are often reluctant to spend lengthy periods out of the market, and the courts will generally only force an employee to sit on their hands for a limited period.

Fixed-term contracts and long notice periods are also common methods of tying employees into a firm. Often coupled with closely-limited notice windows, they can be effective ways of blocking an employee from going elsewhere. But inevitably some employees will leave

and try to evade garden leave-type arrangements. For that reason it's important to have in place restrictions that operate post-termination. Restrictive covenants preventing an ex-employee from working for a competitor or soliciting clients or investors can be enforceable, but only if they go no further than is reasonable to prevent a firm's legitimate business interests. Those interests can include the protection of its confidential information, the stability of its workforce, and the maintenance of its client or investor relationships. Post-termination restrictions are often viewed as difficult to enforce, but there are numerous examples of the courts enforcing lengthy restrictions, particularly in the financial services sector. It would be a mistake to disregard them when developing a suite of strategies to protect key information or employees.

Firms may be able to achieve a higher degree of protection in relation to their LLP members, including by making use of the court's traditional willingness to permit longer restrictions against partners and other business owners. Some fund documentation also seeks to prolong a partner/member's period of restraint by using the (largely untested) tactic of indirect restraints often linked to a period of passive membership where the partner ceases to have any role in the firm, but continues to have an economic interest in one or more funds.

Firms cannot operate without good people and good information. Keeping the information flowing but secure, and keeping both people and information from competitors for as long as possible are key aims that, with care, do not need to be mutually exclusive or unattainable. The challenges posed by technological development and social media means that the law is often behind the curve, but as demonstrated in this article, there remain a number of sensible preventative precautionary steps firms should take to protect their positions.

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## ESMA Q&A on the application of the UCITS V Directive: Some breathing space to address compliance with the new rules?

By *Nicole Suignard, Senior Associate, Sidley Austin LLP*

The fifth iteration of the Undertakings for Collective Investment in Transferable Securities Directive (UCITS V) is scheduled to be implemented throughout the European Economic Area (EEA) by 18 March 2016 (Implementation Date). Although the scope of the UCITS V Directive is relatively modest and largely in line with equivalent provisions of the Alternative Investment Fund Managers Directive (AIFMD), timely compliance with the new rules ahead of the Implementation Date may prove challenging given the limited transitional provisions and the delay in finalising both the delegated Level 2 Regulation implementing the UCITS V Directive (Level 2 Regulation) and the ESMA guidelines on remuneration, the latter of which is expected to be issued by the first quarter of 2016. In this article, we will provide an overview of the additional guidance and flexibility introduced by ESMA in its Q&A on the application of UCITS V.

Acknowledging the potential difficulties UCITS funds and management companies face in updating their relevant documentation by the Implementation Date, the European Securities and Markets Authority (ESMA) published a Q&A on 1 February 2016, regarding the application of the UCITS V Directive. The Q&A provides valuable guidance and much needed flexibility on the timeframe for implementation of various aspects of UCITS V. This is particularly welcome given the lack of formal general guidance on implementation by national regulators of key UCITS jurisdictions, such as Ireland and Luxembourg. Until recently, the Financial Conduct Authority (FCA) was one of the few regulators formally voicing its position in favour of a transitional period to address compliance with the new requirements. In line with the ESMA approach, the final FCA rules and guidance on UCITS V have been consolidated in the FCA Policy Statement 16/2 published on 2 February 2016, which will come into force on the Implementation Date.

Depending on how compliance with UCITS V is approached, stakeholders will be divided into two camps: (i) those who will opt to benefit from the implementation flexibility brought by the ESMA Q&A and will not rush into updating their documentation and (re)negotiating their depositary agreement by the Implementation Date; and (ii) those who have already started revising their documentation in light of UCITS V and will continue to make necessary arrangements

with a view to becoming fully compliant by the Implementation Date. The 11th-hour implementation reprieve brought by the ESMA Q&A is arguably redundant to this second group. UCITS stakeholders should now keep an eye on any local UCITS V transposition guidance and requirements, the final Level 2 Regulation as well as the ESMA final guidelines on remuneration.

### Prospectus and KIIDs update

Under UCITS V, a number of additional disclosures will be required to be reflected in the prospectus, including: (i) details of the remuneration policy and procedures; (ii) description of any safe-keeping functions delegated by the depositary; and (iii) disclosure of any conflicts of interest that may arise from the delegation of safe-keeping duties by the depositary as well as any potential conflicts of interest between the UCITS (or its investors), the management company and the depositary. Each KIID must also specify that details of the up-to-date remuneration policy are available on a specified website and upon request. According to the ESMA Q&A, the deadline for compliance with the prospectus disclosure requirements will be either the date of the UCITS' next planned update or 18 March 2017, whichever is the sooner. KIIDs will need to be updated either at the next annual update after the Implementation Date, or on the first occasion after the Implementation Date on which the KIID is revised or replaced for another purpose, if the information is available at that point in time.

### Depositary arrangements

In addition to appointing a single eligible depositary, UCITS must ensure each depositary agreement (whether by update or by new agreement) reflects the following requirements introduced by UCITS V: (i) an updated description of the services to be provided by the depositary (as its duties will extend beyond safe-keeping and oversight to include cash-flow monitoring); (ii) changes to the liability provisions to reflect the new "strict liability" standard; (iii) new delegation requirements and restrictions; and (iv) references to the reuse of assets held in custody by the depositary (and its delegates) in line with the new Restrictions.

Whilst a number of existing depositary agreements contain liability clauses that are inconsistent with the

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depository liability rules set out under UCITS V, ESMA has clarified that such provisions will be void with effect from the Implementation Date. The stricter UCITS V liability provisions will therefore automatically apply as of such date and depository agreements will not be required to be updated by the Implementation Date to reflect the new liability requirements. That said, ESMA strongly encourages UCITS to “promptly” revise their depository agreements in accordance with any transitional arrangements outlined in the Level 2 Regulation. The Level 2 Regulation is currently being approved by the European Parliament and will become applicable six months after its publication in the Official Journal of the European Union.

### Annual report disclosures

Similar in scope to the disclosure requirements under AIFMD, UCITS annual reports will be required to disclose: (i) the aggregate amount of remuneration for the financial year, split into fixed and variable remuneration, together with the number of beneficiaries and, where applicable, performance fees paid by the UCITS; (ii) the aggregate amount of remuneration broken down by category of employees or other staff members; (iii) a description of how the remuneration and the benefits have been calculated; (iv) the outcome of the periodic reviews of the remuneration policy; and (v) a description of any material changes to the existing remuneration policy. Given the potential impact of the remuneration rules on delegates, third party investment managers are also likely to be caught within the above disclosure requirements.

The ESMA Q&A specifies that the above disclosures will only need to be reflected in annual reports relating to periods that end on or after the Implementation Date although, in any event, before the UCITS management company has completed its first annual performance period in which it has to comply with the relevant UCITS V remuneration requirements. In such cases, UCITS management companies are required to include the relevant disclosures on a best efforts basis and, to the extent possible, to explain the basis for any omission. Establishment of remuneration policies and procedures Remuneration is another key area where UCITS managers are likely to benefit from implementation leeway. Subject to final remuneration guidelines from ESMA, UCITS management companies and investment managers that fall within the scope of the remuneration rules will most likely not be required to apply the UCITS remuneration principles until they commence their first full performance period starting on or after the Implementation Date (e.g., if the accounting period of a UCITS management company ends on December 31

of each year, the remuneration principles will apply for the first time in relation to the accounting period ending on 31 December 2017).

On 29 October 2015, ESMA published responses to its consultation concerning guidelines on sound remuneration policies under the UCITS V Directive and the AIFMD (Consultation). ESMA is yet to publish its final remuneration guidelines based on the feedback it has received on the Consultation and, while these are expected to be published by the first quarter of 2016 (prior to the UCITS V directive transposition deadline), recent reports have indicated that the final text may not be issued until after this date. That said, in its Q&A, ESMA encourages management companies to publish on a website relevant details of the management company’s remuneration arrangements in light of the UCITS V requirements, to the extent available. Third party (sub)investment managers may consider, even at this stage, engaging UCITS management companies (or self-managed UCITS funds) as regards the implementation of remuneration policy requirements.

### Conclusion

Although the implementation of UCITS V has not been helped by the various delays and confusion over final rules and guidance, it seems that things are now clearer and that managers can confidently start implementing most of the requirements without having to rush into uncompetitive deals, document update and regulatory filings by the Implementation Date. Given the flexibility brought by the ESMA Q&A, the overall implementation process might take up to a year in certain cases, subject to any transitional arrangements in such UCITS’ home Member State. With UCITS V by and large resolved, focus is now turning to UCITS VI, which has been dormant since the publication of a consultation paper by the European Commission back in 2012. The consultation covers a number of sensitive topics including the application of sophisticated investment strategies by UCITS funds and the exposure to non-eligible assets through derivative instruments.

Although a formal UCITS VI proposal is yet to be issued and the consultation should not prompt UCITS funds and managers to recast their business model and management practices at this stage, the industry should begin to brace itself for future changes to the UCITS framework, which potentially may be far more disruptive to UCITS managers than the requirements introduced under UCITS V.

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## Section 871(m) - New US Withholding Tax on Dividend Equivalent Payments

*By Dan Farrell, Partner, Ernst & Young LLP, and Amanda Murphy, Director, Ernst & Young Ireland*

On 17 September 2015, the US government released final and temporary regulations under IRC Section 871(m) ("the regulations") affecting non-US persons that hold financial products such as certain notional principal contracts, derivatives and other equity-linked instruments (ELIs) with payments that reference (or are deemed to reference) dividends on US equity securities. Parties to such contracts may become responsible for imposing US withholding tax on any such dividend equivalent payments that are made to a non-US person, or, in certain circumstances, may also be required to self-assess tax on their own trading in such instruments as US withholding tax may not always be satisfied at source. In particular, asset managers that trade instruments that are within the scope of the rules will need to consider the application of the rules to each type of affected trade to determine their identification, withholding and reporting responsibilities.

### Background

Prior to Section 871(m) becoming effective, payments on notional principal contracts (NPCs) were generally sourced by reference to the residence of the recipient, thus making them non-US source and exempt from US withholding tax. In 2010, however, Congress enacted Section 871(m), which, at the time, affected dividend equivalent payments made on a narrow class of NPCs. On December 4, 2013, pursuant to statutory authority, the IRS released proposed regulations under Section 871(m) that would have broadened the scope of instruments on which withholding was required to include payments on derivative instruments over US dividend-paying stocks that have a delta (defined below) of 0.7 or greater at the time the instrument is issued. Under the final regulations, the delta measurement was changed to 0.8 or greater and a new test for contracts with indeterminate deltas was introduced. The regulations will be effective to payments made on transactions issued on or after 1 January 2017. As originally issued, the regulations also

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applied to specified ELIs issued on or after 1 January 2016, and before 1 January 2017, but only to payments on such contracts that were to be made on or after 1 January 2018. On 4 December 2015, Treasury and the Internal Revenue Service released corrections to the regulations removing specified ELIs entered into during calendar year 2016 from the scope of the regulations. Therefore, specified ELIs become subject to Section 871(m) and its regulations if they are issued on or after 1 January 2017.

### The delta and substantial equivalence tests

The "delta" of an instrument is a measure of the relationship between changes in value of the instrument and changes in value of the underlying stock. If an instrument has a delta of 1, changes in the value of the instrument should mirror changes in the value of the stock exactly. Under the regulations, any NPC or ELI that has a delta of 0.8 or greater at the time of issuance would be a Section 871(m) in-scope transaction subject to withholding on dividend equivalent payments, which is a taxpayer favourable change from prior proposed regulations which required continuous testing of the delta at each payment date and a more inclusive delta of 0.7. The delta test is used for simple contracts. The delta of certain types of "exotic" derivatives, such as "binary" and "digital" options, is indeterminate and thus the regulations introduced a new "substantial equivalence test" to deal with such complex contracts. Very generally, the substantial equivalence test uses an in-scope contract as a benchmark to compare with the complex contract using the level at which the short party would need to vary the number of shares of stock in its hedge as the price of the underlying security changes.

### Combined transactions

Long parties (and agents thereof) must treat two or more transactions as combined for purposes of testing and application of the rules if they reference the same underlying security and the combined transactions

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replicate the economics of a transaction that would be a Section 871(m) in-scope transaction. Funds could be trading the same or similar products across brokers which will need to be tracked in case such multiple transactions may need to be treated as a single transaction for Section 871(m) purposes.

This is particularly important where the payments on such products are not withheld on by the short party due to certain favourable presumptive rules that allow the short party, in certain instances, to not combine contracts that are in different accounts or that are separated by at least two business days. Note that such presumptive rules are not applicable to the long party. The burden of the tax is a joint and several liability, but the long party should be self-assessing the tax in circumstances where it is not withheld at source.

### What payments are affected?

Generally, for the purpose of these regulations, a “dividend equivalent” is defined as:

1. Any substitute dividend that references a US source dividend made pursuant to a securities lending or sale-repurchase transaction
2. Any payment that references a US source dividend made pursuant to a specified NPC
3. Any payment that references a US source dividend made pursuant to a specified ELI, i.e., forwards, futures, options, etc.
4. Any other substantially similar payment

The amount of the dividend equivalent is calculated slightly differently for each dividend equivalent defined above. Generally for a simple contract, the dividend equivalent amount is calculated by multiplying the per-share dividend amount with respect to the underlying security times by the number of notional shares of the underlying by the delta of the 871(m) transaction.

### Withholding under Section 871(m)

Generally, a withholding agent is not obligated to withhold on a dividend equivalent until the later of when a payment is made with respect to a Section 871(m) transaction or when the amount of a dividend equivalent is determined. A payment with respect to a Section 871(m) transaction must generally occur when the long party receives a gross payment, when there is a final settlement of the Section 871(m) transaction, or when the long party sells or otherwise disposes of the Section 871(m) transaction.

### Exceptions to the Section 871(m) rules

Certain transactions and payments may be treated as out of scope for Section 871(m) purposes such as compensation paid under certain restricted stock plans, return of capital distributions, “due bills” related to extraordinary dividends, specific insurance contracts, derivatives related to a qualified index, etc.

### Industry insight

Brokers serving the asset management industry in the US have begun preparing for the implementation of Section 871(m), and while some UK brokers have also started to analyse the impact, preparations for readiness are beginning to ramp up this quarter. Globally, asset managers are becoming familiar with the rules, and some are working to determine the impact on their business and understand the level of assistance that their service providers may be able to provide as well as the level of effort that will be required in-house.

### Next steps

Given the scope of transactions covered, the complexity of the regulations and the detailed rules on exempted transactions, Section 871(m) will require that affected parties spend time during 2016 to determine readiness, implement operational changes, make necessary changes to legal and service level agreements and make any necessary systems changes prior to the 1 January 2017 effective date. This would include:

- Identifying in-scope transactions
- Determining affected business units and process, system and data challenges
- Reviewing and updating internal and external communications and agreements
- Compliance program design and implementation

Application of the Section 871(m) regulations is complex, and it is strongly recommended that funds take specific advice where their strategies may be impacted.

*This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Member firms of the global EY organization cannot accept responsibility for loss to any person relying on this article.*

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## Reflections on the private debt market in 2015

By *Alistair Hill, Partner, Simmons & Simmons*

### Introduction

In the second quarter of 2015, AIMA published a [research paper](#) highlighting the growing and important role of private debt funds in financing Europe's economy. This research underlined that one of the most enduring consequences of the financial crisis is that Europe's debt markets have moved, particularly for the funding of SME and mid-market transactions, to a model more akin to that which prevails in the US, where bank loans only account for approximately 25% of corporate debt.

2015 saw a continued shift away from banks (traditionally accounting for between 80%-90% of financing for European companies) to a variety of new debt providers such as private equity, institutional investors, insurance companies, pension funds and a variety of alternative credit providers. This shift in funding sources for European corporates is now a permanent, structural feature across a number of different asset classes including corporate, real estate and infrastructure debt.

The principal reasons for this structural shift in the European financing markets are now well documented and focus on a combination of bank retrenchment in a number of lending markets (as the panoply of national and international regulatory frameworks introduced since the financial crisis have forced banks to strengthen their balance sheets) coupled with the unprecedented low interest environment which has forced institutional money to hunt for yield in less liquid corporate and other debt instruments. Given this background this article summarises a number of the key themes emerging in the private debt markets last year and looks at some of the challenges that may lie ahead for the industry.

### Wall of money

Whilst there is some evidence that the pace of fundraising for alternative debt slowed in the last quarter of 2015, the fact remains that very large sums of capital are being raised to invest in this asset class. In November 2015, BlueBay announced the closing of its second direct lending fund at EUR 2.1

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billion, some 160% bigger than its maiden direct lending fund. This theme has been repeated for a number of the larger private debt managers operating in the market, with ICG's latest direct lending fund almost double the size of its June 2013 fund.

According to data from Preqin, there are over 67 Europe focused private debt funds currently attempting to raise a combined amount of circa EUR 48 billion.

### 'Convergence' (and weakening) of documentary terms

One of the consequences of this wall of money is that, whilst there were a number of macro concerns in the world economy during 2015 (and these have become increasingly pronounced in the first quarter of this year), 2015 was, in the main, a good time to be a borrower. At the top end of the market the competition between the high yield market (when it was open for business) and the loan markets and, more generally throughout the mid-market, the competition between banks and alternative credit providers has meant that borrowers (and their lawyers) have been able to "cherry pick" terms from a variety of different products leading to what has been labelled as a "convergence" of terms as covenant-lite structures and terms from the US high yield and Term Loan B markets find their way into more and more European deals.

Whilst there is a view that private debt managers have "held the line" in the European mid-market and continue to insist on financial and other maintenance covenants, there is evidence that this discipline has not been able to withstand the competition for deals, particularly as banks fight for market share.

For example, in September 2015 debtXplained published research looking at sub EUR 250 million debt transactions to determine whether the more aggressive features of larger transactions had impacted mid-market deals (where private debt tends to feature more significantly). The research found that whilst in 2013 over 90% of sub EUR 250 million transactions

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featured the traditional four financial maintenance covenant package (leverage, interest cover, cash flow cover and capex), this had declined to less than 25% of transactions in 2015.

Whilst a leverage covenant remains sacrosanct for most private debt providers in the mid-market, borrowers, sponsors and their lawyers have continually been able to make incremental improvements to documentary terms and this is a theme which is likely to continue into 2016 and until the current credit cycle definitively turns.

### **Governments are playing their part**

Many European states have traditionally given banks a preferred status in lending transactions e.g. the requirement for bank licences in France and Italy in order to lend directly to corporates in those jurisdictions. In addition, in some countries only banks have been able to take certain types of security or benefit from certain withholding and other tax advantages. Whilst the credit crisis has led to the harmonisation of a number of financial regulations, there remain a large number of national regulations, particularly in relation to bank licensing requirements.

European governments have recognised however that in order for there to be a sustained economic recovery it is necessary to improve the mixture and overall resilience of funding sources to corporates and have therefore taken action to encourage this diversification.

For example in Italy, where direct lending has traditionally been reserved to banks and certain financial entities registered with the Bank of Italy which are subject to regulatory and prudential provisions similar to those applicable to banks, legislation became effective in 2015 with the specific aim of “liberalising” the lending market so that securitisation vehicles as well as Italian insurance companies are now allowed to lend directly to Italian companies provided they retain a “significant interest” for the life of the transaction. The changes also enable collective investment schemes to invest in loan receivables effectively enabling them to also lend directly.

Allied to this, the tax rules in Italy have been changed so that a withholding tax exemption (the withholding rate being 26%) will apply to payments of interest to certain non-resident lenders, including financial institutions established in an EU Member State and insurance companies established and authorised under

the law of an EU Member State.

### **Banks versus alternative credit providers**

It is important to recognise that whilst there is clearly a competitive threat to commercial banks from the variety of alternative credit providers now operating in the market and more generally by the deployment of more institutional capital in banks’ traditional markets, in many instances commercial banks and private debt managers are working together to structure transactions for the mutual benefit of clients. This structuring takes account of the fact that banks and private debt managers may have different risk appetites and can therefore structure (through a unitranche arrangement) a “one loan” solution for borrowers whilst at the same time apportioning the risk on that loan between themselves by virtue of an agreement between lenders or other intercreditor arrangement.

In addition, in all asset classes commercial banks will continue to be a key provider of hedging, working capital and other ancillary banking arrangements (often necessitating the use of bespoke super senior intercreditor arrangements). Whilst the co-operation between banks and private debt managers has in some instances been formalised into a joint venture arrangement, most banks and private debt funds seem to prefer a less formal series of alliances with a set of intercreditor documentation pre-agreed to take to market thereby shortening deal execution time and minimising legal cost.

### **What happens when the cycle turns?**

The three-year bull run in private debt has yet to be tested by a significant downturn in the credit markets and some have expressed concerns about how private debt managers will react when, inevitably, defaults in European corporate debt increase (and there is some evidence that this is now beginning to happen).

The first point to make is that, in many instances, private debt managers have tended to operate bilaterally or in very small syndicates (and often write very significant cheques when compared to, say, a maximum hold for a bank of EUR 20-25 million) and have not sold on their positions. This inevitably means that they will be very active participants in any debt restructurings as any losses they sustain will have a material impact on their fund’s performance.

Whilst it is a truism that each turn in the cycle begets predictions of ever more complex restructurings, it is

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inevitable that some of the intercreditor structuring on which private debt deals have been predicated in the last two to three years will make it harder and more complicated to restructure debt. This is particularly the case in unitranche transactions which have been structured using an agreement between lenders to which borrowers are not party. Based on recent court judgments in England, these structures could also provide an unpleasant surprise for “last out” creditors in those structures who may find that, because the agreement between lenders is structured without a contractual nexus to the borrower, their subordinated position won’t necessarily guarantee them their own separate class should a scheme of arrangement be used to cram down dissenting junior creditors.

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## Rum punch and taxes - Puerto Rico may serve as an island escape

By Adam J. Tejada, Tax Partner, K&L Gates and Frank W. Dworak, Tax Partner, K&L Gates<sup>1</sup>

Significant press has been devoted to the benefits that US individual investment managers compensated with a “carried interest” are afforded when the allocations attributable to such “carried interest” are attributable to long-term capital gains.<sup>2</sup>

Often overlooked, however, is that the preferential tax rate attributable to long-term capital gains is typically reserved for private equity fund or other investment managers with long-term investment strategies (e.g., real estate funds and hedge funds with sporadic trading activities) because the preferential tax rates apply only with respect to long-term capital gains (i.e., gains attributable to capital assets held for more than one year).

US individual hedge fund managers who are compensated solely with management fees, performance fees, performance allocations attributable to short-term capital gains, or a combination of such compensation (such compensation is collectively referred to herein as “ordinary income items”), are often left out of the party and subject to US federal income tax at the

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<sup>2</sup> The character of an item of income allocated from an entity treated as a partnership for U.S. federal income tax purposes is determined at the partnership level so that if a U.S. individual receives a “carried interest” allocation that is attributable to long-term capital gains, such “carried interest” will be considered long-term capital gains. Section 702(b). (Except as otherwise indicated herein, all section references are to the U.S. Internal Revenue Code of 1986, as amended (the “Code”), and all Regulation Section references are to the U.S. Treasury Regulations issued thereunder.)

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rates applicable to ordinary income. Nonetheless, such hedge fund managers may be able to reduce their overall tax burden (and either achieve, or come close to achieving, the benefits available for long-term capital gain “carried interest” allocations, or, as described below, realise a better result) by restructuring their advisory operations to or initiating their advisory operations in Puerto Rico.

Specifically, individual hedge fund managers that become bona fide residents of Puerto Rico and own an ownership interest in a Puerto Rican investment advisory corporation that qualifies as an export service company under the Puerto Rico Export Services Act (an “Act 20 Company” and “Act 20”, respectively) may be able to reduce their income tax burden on ordinary income items attributable to such advisory services to the extent such individual is compensated through the receipt of dividends from such corporation.

In addition, an individual hedge fund manager that does not become a bona fide resident of Puerto Rico but conducts his or her operations through an Act 20 Company may be able to significantly reduce his or her US federal income tax burden on ordinary income items attributable to his or her advisory activities to closely approximate the tax benefits afforded “carried interest” allocations of long-term capital gains.

### Overview of relevant US tax considerations

In general, US individual taxpayers (i.e., for purposes of this article, US citizens and lawful permanent residents) are subject to US federal income tax on their worldwide income regardless of where such resident individual is domiciled.<sup>3</sup> A US individual taxpayer may be able to renounce his or her citizenship or otherwise expatriate and thereafter be subject to US federal

<sup>3</sup> Section 7701(a)(30) and Regulation Section 1.1-1(b).

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income tax only with respect to his or her US source income. An “exit tax” may apply<sup>4</sup>, however, which generally imposes US federal income tax as if the expatriate sold all of his or her assets for their fair market value prior to the expatriation.<sup>5</sup> Nevertheless, the exit tax does not apply to a US individual who moves to Puerto Rico without renouncing his or her US citizenship or terminating his or her status as a lawful permanent US resident.<sup>6</sup>

The highest US federal income tax rate currently applicable to US resident individuals on ordinary income is 39.6%. The highest US federal income tax rate currently applicable to US resident individuals on long-term capital gain is 20%, and an additional tax of 3.8% may apply to some or all of a US resident individual’s “net investment income”.<sup>7</sup> “Qualified dividend income” received by a US resident individual generally is subject to US federal income tax at the rates applicable to long-term capital gains.<sup>8</sup> Dividends received by a US resident individual from a corporation organised in Puerto Rico generally are considered “qualified dividend income”.<sup>9</sup>

Notwithstanding the general rule that a US resident individual is subject to US federal income tax on a worldwide basis, Section 933 generally provides that a US individual taxpayer “who is a bona fide resident of Puerto Rico” during the entire taxable year is not subject to US federal income tax with respect to

such individual’s Puerto Rican source income.<sup>10</sup> The Regulations provide a detailed set of rules regarding whether income will be considered to be derived from Puerto Rican sources.<sup>11</sup>

Very generally, (i) compensation income received by a “bona fide resident” of Puerto Rico for services performed in Puerto Rico is considered Puerto Rican source income<sup>12</sup>; (ii) dividends received by a US individual taxpayer who owns less than 10% of a Puerto Rican corporation are considered to be Puerto Rican source income; (iii) dividends received by any US individual taxpayer who owns 10% or more of the total voting stock of a Puerto Rican corporation are considered to be Puerto Rican source income if (a) 80% or more of the gross income of the corporation during the prior three years (or the period during which such corporation was in existence if less than three years) was derived from sources within Puerto Rico, and (b) 50% or more of the gross income during the prior three years (or the period in which such corporation was in existence if less than three years) was derived from the active conduct of a trade or business within Puerto Rico<sup>13</sup>; and (iv) dividends received by a US individual taxpayer who owns at least 10% of the total voting stock of a Puerto Rican corporation not described in (iii) will be considered Puerto Rican source income only to the extent of such corporation’s Puerto Rican

4 Section 877A.

5 Section 877A. An inflation adjusted amount is excluded from an expatriate’s gross income in determining such individual’s taxable income resulting from expatriation.

6 Such an individual would not be considered an “expatriate” subject to Section 877A. Section 877A(g)(1) and (2).

7 Section 1411. “Net investment income” generally refers to passive income and gross income derived in a trade or business that constitutes a passive activity (within the meaning of Section 469) with respect to a taxpayer or a trade or business of trading in financial instruments or commodities. Section 1411(c).

8 Section 1(h)(11).

9 Section 1(h)(11)(B)(i), (C)(i); Section 936(d); Section 7701(d); Publication 570, *Tax Guide for Individuals with Income from U.S. Possessions*.

10 A U.S. resident individual generally will be considered to be a “bona fide resident” of Puerto Rico if (i) the individual is present in Puerto Rico during the taxable year for at least 183 days, (ii) the individual does not have a tax home outside of Puerto Rico during the taxable year, and (iii) the individual does not have a closer connection to the United States or a foreign country other than Puerto Rico during the taxable year. Section 937(a); Regulation Section 1.937-1(b)-(e). A further discussion of this “bona fide resident” test and the determination of whether a U.S. individual taxpayer may become a “bona fide resident” of Puerto Rico for the entire (or part of a) taxable year is beyond the scope of this article.

11 See generally Regulation Section 1.937-2.

12 Section 937(b)(1) generally provides that rules similar to determining whether income is from sources within the United States or is effectively connected with the conduct of a trade or business within the United States shall apply for purposes of determining whether income is from Puerto Rican sources.

13 Regulation Section 1.937-2(g)(1)(ii).

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source income.<sup>14</sup> While the source of capital gains generally is determined by reference to the residence of a taxpayer, a portion of capital gains realised with respect to property owned by a US individual taxpayer at the time of his or her move to Puerto Rico may remain subject to US federal income tax if realised within 10 years of emigration to Puerto Rico.<sup>15</sup>

### Overview and relevant Puerto Rican tax considerations

Act 20 and the complementary Puerto Rico Individual Investors Act (“Act 22”) were enacted in January 2012 with the objective of incentivising the emigration of businesses and individuals to Puerto Rico.

An Act 20 Company is not subject to graduated corporate tax rates in Puerto Rico but is instead subject to a flat tax of 4% with respect to export services performed by the company in Puerto Rico. Export services are services performed in Puerto Rico for service recipients located outside of and with no nexus to Puerto Rico. Investment management services performed by an Act 20 Company are considered export services for this purpose.

An Act 20 Company may be a start-up company or an existing business (although a new Puerto Rican entity generally must be established).<sup>16</sup> Transfer pricing issues must be considered if an Act 20 Company is part of a group business that operates both in and outside of Puerto Rico. In addition, Act 20 provides for a 100% dividend tax exemption (withholding or otherwise), a general 90% exemption from personal property tax for certain export service businesses and real property taxes, and a general 60% exemption from municipal taxes.

To qualify as an Act 20 Company, an entity must (i) provide qualified export services; (ii) employ at least three individuals residing in Puerto Rico (five individuals for applications filed on or after December

<sup>14</sup> Regulation Section 1.937-2(g)(1)(i).

<sup>15</sup> Regulation Section 1.937-2(f)(1)(ii); Notice 89-40, 1989-1 C.B. 681.

<sup>16</sup> If an Act 20 Company relates to an existing business, certain outbound transfer rules must be considered, including Section 367 and the anti-inversion rules under Section 7874.

1, 2015); and (iii) submit an application to the Office of Industrial Tax Exemption of Puerto Rico. Upon approval, an Act 20 Company will receive a tax exemption decree from the government of Puerto Rico. The tax exemption decree is a 20-year binding contract between the government of Puerto Rico and the Act 20 Company providing that the Act 20 Company will be entitled to the aforementioned tax benefits for such 20-year period regardless of any changes in Puerto Rican tax laws.

In general, Act 22 provides an exemption for passive income (i.e., dividends, interest and post-migration source capital gains) realised by bona fide Puerto Rican residents. Built-in gains accrued while residing outside of Puerto Rico and realised within 10 years of becoming a Puerto Rican resident<sup>17</sup> are subject to Puerto Rican income tax at a rate of 15%, and such built-in gains realised after 10 years of becoming a Puerto Rican resident are subject to Puerto Rican income tax at a rate of 5%.

Thus, together with the application of Section 933, a US individual taxpayer who becomes a bona fide Puerto Rican resident should not be subject to US or Puerto Rican income tax with respect to Puerto Rican source dividends, interest, and post-migration capital gains. Notably, however, not all passive income realised by a US individual taxpayer after his or her emigration to Puerto Rico is free from both US and Puerto Rican taxes. As such, individuals who qualify under Act 22 are incentivised to invest in Puerto Rican businesses and real estate after emigration to Puerto Rico because passive income from these sources generally may be exempt from both US and Puerto Rican federal income taxes.

Compensation income received by a bona fide Act 22 Puerto Rican resident is subject to income tax in Puerto Rico at graduated rates, with the maximum rate being 33% for net taxable ordinary income exceeding \$61,500. Double taxation of such income between the United States and Puerto Rico should not result because such income generally should not be subject to US federal income taxes under Section 933.

An individual who owns an Act 20 Company may choose

<sup>17</sup> Such built-in gains generally also would be subject to U.S. federal income tax when recognized, but a U.S. foreign tax credit may be available to avoid double taxation.

to limit the amount of compensation he or she receives from the Act 20 Company and instead receive dividend distributions from the Act 20 Company. In such a case, Puerto Rico may treat a dividend as compensation income to the extent that Puerto Rico deems the individual to have received less than reasonable compensation for his or her services.

Whether compensation is reasonable is based on the facts and circumstances in each case. Puerto Rico provides a safe harbor, however, under which it will not challenge an arrangement as providing for disguised compensation where an individual receives at least USD \$350,000 of compensation from an Act 20 Company.

To qualify under Act 22, an individual must (i) not have been a resident of Puerto Rico at any time during the 6-year period prior to the enactment of Act 22 (i.e., January 17, 2012); (ii) apply to and gain approval of the Office of Industrial Tax Exemption of Puerto Rico; and (iii) change his or her domicile to Puerto Rico.<sup>18</sup>

### The island vacation - putting it all together

On balance, Section 933, Act 20, Act 22 and the rules related to “qualified dividend income” may provide a US individual taxpayer with an opportunity to substantially reduce his or her aggregate tax burden where the taxpayer conducts investment advisory operations in Puerto Rico. The potential benefits of these provisions may be summarised as follows:

- A US-based individual investment manager who does not become a “bona fide” resident of Puerto Rico may be able to organize an Act 20 Company to conduct his or her investment management operations. In such a case, after accounting for the 3.8% tax on net investment income, the 4% Puerto Rican tax that would be imposed on the Act 20 Company, and assuming that the highest US federal income tax rates will apply, dividend income realised by a US individual taxpayer from an Act 20 Company will be subject to an effective combined US federal and Puerto Rican income tax

<sup>18</sup> Domicile refers to the intention of the individual to permanently reside in Puerto Rico and, therefore, this test is more subjective than the U.S. “bona-fide resident” test described in footnote 9 above.

rate of approximately 26.85%.<sup>19</sup> If the investment management business is operational prior to the formation of the Act 20 Company, the US individual taxpayer will need to consider certain rules relating to the outbound transfer of an existing US business (e.g., Section 367 and the anti-inversion rules under Section 7874), but the use of Act 20 is still possible.

- A US-based individual investment manager that becomes a “bona fide” resident of Puerto Rico may be able to organise an Act 20 Company to conduct his or her investment management operations and qualify for the Puerto Rican tax benefits afforded under Act 22. In that case (i) the Act 20 Company’s income would be subject to Puerto Rican income tax of 4%; (ii) the individual would be subject to Puerto Rican (but not US) income tax with respect to Puerto Rican source compensation received from the Act 20 Company; (iii) the individual generally would not be subject to Puerto Rican or US income tax with respect to dividend distributions from the Act 20 Company; (iv) the individual generally would not be subject to Puerto Rican and US income tax with respect to gains realised upon the sale of the Act 20 Company, provided that the company was organised following the individual’s emigration to Puerto Rico; and (v) the individual generally would not be subject to Puerto Rican or US income taxes with respect to Puerto Rican source capital gains recognised on capital assets acquired after becoming a bona fide Puerto Rican resident.
- In either case, transfer pricing issues must be considered if a group of companies under common control conducts investment management activities both in and outside of Puerto Rico. The relevant transfer pricing rules may require that a portion of the group’s income be allocated to the United States and subject to US federal income tax.

<sup>19</sup> For example, assume an Act 20 Company recognized income of \$1,000 and distributed its after-tax income to its sole shareholder, a U.S. individual. The Act 20 Company would be subject to \$40 of tax in Puerto Rico, leaving \$960 available for distribution to its shareholder. Assuming the application of the highest U.S. federal income tax rate on “qualified dividend income” (20%) and the application of the 3.8% tax on “net investment income,” the \$960 dividend would be subject to U.S. federal taxes of \$228.48 (23.8% \* \$960) with an aggregate U.S. federal and Puerto Rican income tax liability of \$268.48, or an effective tax rate of approximately 26.85%.

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## Conclusion

A US individual hedge fund manager who is not compensated with carried interest allocations of long-term capital gain generally is subject to US federal income tax on such compensation at ordinary income tax rates. In addition, a high net worth US individual generally cannot expatriate without potentially being subject to a US exit tax. Under current law, a US individual hedge fund manager may be able to take advantage of Act 20, Act 22, and certain US tax benefits related to ownership of a Puerto Rican corporation and/or Puerto Rican residency, with the result that the individual may be able to significantly reduce his or her aggregate income tax burden and/or redomicile without being subject to an exit tax. While organizing or reorganizing investment management operations to Puerto Rico may not be suitable for all US individual hedge fund managers, given these meaningful tax benefits a permanent vacation to the tropical island of Puerto Rico is certainly worth exploring.

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