



# AIMA Journal - Edition 116

Includes:

Alternative data

ESG

Cryptocurrency

Swiss fund distribution

Operational due diligence

UCITS

A low-angle, upward-looking photograph of several modern skyscrapers. The buildings feature glass facades and geometric patterns. The sky is filled with soft, white clouds. The overall composition is dynamic and emphasizes the height and architectural detail of the structures.

# Message from AIMA's CEO

Jack Inglis



Jack Inglis

**Welcome to our new edition of the AIMA Journal. As always, we are very fortunate to have such a wealth of insight from our membership, and we would like to express our thanks to all who contributed to this edition.**

This edition contains a wide variety of commentary.

The first article from State Street will help readers understand the ‘innovation transformation’ and how we now consume data. The article from **haysmacintyre** should catch the attention of those members attending the **AIMA Canada Investor Forum** looking to hear about ‘investing in

an age of disruption’. The piece presents reasons why cryptocurrencies are set to become a constant feature of the investment landscape.

Keeping on trend with key industry disruption themes, **Apex’s** piece on ESG lays out its importance as a strategy and the reasons for its increasing popularity among hedge funds and investors.

On the operational side, readers can find unique material from **Maples and Calder** on structural enhancements to Irish funds, including what makes the ICAV such an attractive legal structure for AIFs. **Oligo Swiss Fund Services** provides an informative overview of the current Swiss regulatory framework and contrasts it to the 2020 upcoming regulatory highlights and their impact on the fund industry. The issues created by migrating to the cloud are also discussed by **Eze Castle Integration**.

Lastly, for those that missed the Operational Due Diligence event sponsored by **BNP Paribas**, there is a great roundup of key takeaways from the panel of senior operational due diligence professionals at

investment managers, consultants and wealth advisors. Staying with operational discussions, **CME** leads an interesting debate on the inadequacies of financial risk models that rely on implied volatility.

On the regulatory side, **Pirum** discusses the challenges posed by the Securities Financing Transactions Regulation, **Clifford Chance** examines the potential issues of the Securitisation Regulation, due to come into force on 1 January 2019, and **Dechert** provides an update regarding a recent review carried out by the Central Bank of Ireland on the calculation and payment of performance fees by UCITS.

Last but by no means least, we include our usual update on recent key industry thought leadership from **KPMG’s 2018 Global CEO Outlook** and a recent paper that we did in conjunction with **PwC**, which looked at the latest trends regarding distribution in alternative investments.

We hope you find this latest publication of the AIMA Journal useful, interesting and insightful.

# The Innovation Transformation

by Paul Fleming, State Street Corporation

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We live in an era where we have instant access to information – on our phones, in our inboxes, through both traditional and social media, and so many more outlets. But for alternative asset managers, putting it to use can feel like an arduous task. To make sense of the data overload, it's time we transform how we look at and consume this information.



by **Paul Fleming**

**Global Head of Hedge Funds**

State Street Corporation

Up until now, temporary solutions to manage multiple platforms and large data sets gave a quick fix to a complicated problem. The challenge is likely to grow even more complex as new regulatory mandates around data generation and reporting are introduced. Finding a better way to gather and manage data – that also best fits the way you work – adds another layer of complexity. To achieve scale, improve performance and access industry-leading insights, smarter systems that aggregate and manage information are essential. A holistic view can help enhance performance, improve risk management and transform data into valuable insights.

The competitive landscape for the financial services industry is shifting as well. Large providers are up against small fin-tech shops who move much faster, have access to tremendous amounts of capital and easily attract talent. With investors hungry for information and a better way to consume and understand it, we're seeing a financial services market that's ripe for change.

### **Demanding more for your data**

Asset owners and asset managers are fundamentally changing how they compete and operate. Investment managers want to spend their time on getting the most value out of their data, not on gathering and preparing it. To gain an edge, they've increasingly turned to specialist firms for software to manage and analyze data. More recently, offerings have expanded to hosting services that offload the in-house burden of maintaining computing horsepower.

Our research underscores this trend. In a survey we conducted this year with 86 global institutional and alternative investors<sup>1</sup>, 54 percent said they predominately rely on external providers for their data analytics. That's an increase of five percent over nearly half (49 percent) of the institutions that we surveyed five-years prior. What's more, our research shows the figure is expected to rise even further over the next three years.

Client demands and new investment types – from passive portfolios to quantitative factor strategies and ESG criteria – are stretching managers in different directions. In short, the industry is facing

increasing demands for information that is more complex and rapidly changing, and needs to be summoned up in a shorter time frame. Every basis point is precious, giving relevant and timely investment information greater value.

To compete in today's landscape, our 2017 research<sup>2</sup> summed up the three keys to success as data integration, data intelligence and data integrity. An effective infrastructure applies these three keys to success. Data-as-a-service platforms provide a scalable, cloud-based solution that allow users to more completely measure and evaluate risk, address regulatory concerns and make more informed, real-time trading decisions. By integrating forward-looking risk analysis, streamlined workflows, access to information and transparency, and improved accuracy and reliability, managers have end-to-end support for their business processes.

### **Gearing up for an innovation transformation**

Machine learning algorithms and natural language processing are another set of tools changing the way we consume data. But in an industry well known for policies and procedures, the inherent

risk and uncertainty of new technology and innovation can create an adoption challenge.

Steve Marshall, who heads the development of a mobile-first platform at State Street which helps users understand the connection between news and their portfolios, can relate to the struggle. He points to Clay Christensen's best seller, "*The Innovators Dilemma*," to help explain why transformational or "disruptive" innovation is difficult inside a mature enterprise. It doesn't mean change can't happen. It just means we have to think about the problem differently.

When Steve thinks about the information overload confronting his clients, he explained there are three thoughts going through his head: What problems do clients see every day that haven't been addressed? What type of solution might solve those problems? And how can his product development team build something clients want, that's technically feasible to build and operate, and viable from a business perspective?

### **Focusing on new milestones**

My colleague's thinking on innovation transformation can easily be applied toward a broader vision of supporting institutional investors as they grow their businesses. Data is just one piece of the puzzle. Our clients' needs are constantly evolving and they're always on the hunt for new ideas and solutions that will make their business hum even more efficiently.

In talking to our clients, what we hear time and again is that they want a holistic view of their investment portfolios and operations throughout the trade lifecycle. From cash management and regulatory reporting to data and risk analytics, an integrated servicing platform offers an efficient and seamless front-to-back way for clients to see their full investment process. It's information that helps them to understand the ins and outs of their business and supports them in their decision making. By creating new ways that help our clients to get even more value out of an interoperable platform – without having to create the infrastructure themselves – we help support our clients' ambitions.

**Footnotes:**

1 - State Street DataGX 2018 Survey by PollRight

2 - 2017 State Street Finance Reimagined study.  
Survey done in conjunction with Roubini  
ThoughtLab of 2,000 investors and 500 wealth  
managers worldwide.

**Important Information**

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# Dissecting ESG: ethics and profitability

by Rosie Guest, Apex Fund Services Holdings  
Ltd.

There is a wide spectrum of ethically focused investment strategies around, various ways of referring to them and a lot of acronyms.

Divesting, ESG, Negative Screening, Shareholder Activism, Shareholder Engagement, Positive Investing, Impact Investing, SRI, Ethical Investing, Faith based Investing, Norms-based Investing, Values-based Investing, Thematic investing, Philanthropic investing... the list goes on.



**By Rosie Guest**  
**Global Marketing Director**  
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**The societal milieu has ultimately led to an explosion of ethics based and morally driven investment strategies in the financial services segment and in turn to the growth of the ESG investment space.**

Environmental, Social and Governance (ESG) are the three core factors for measuring the sustainability, responsibility and ethical impact of an investment. To understand the importance of the ESG strategy, where it sits on the spectrum and the reasons for its rise to the top of the strategy popularity contest, we must first differentiate it from other similar types of ‘ethical’ investment strategy.

The overarching category under which each of these sits is Sustainable Investing (SI).

**SI is Not a New Phenomenon**

Faith based investing (aligning investments with faith-based values) has been around since the 1800's. At that time religious communities such as

the Methodists, quickly followed by the Quakers, implemented socially responsible investing guidelines for their congregations. The Vietnam War signalled another boost for ethical investment vehicles in the 1970's, when investors started to question how their money was being used.

Fast-forward to today and the world we now live in sees the merging of finance and ethics becoming a mainstream expectation, a requirement even. The societal milieu has ultimately led to an explosion of ethics based and morally driven investment strategies in the financial services segment and in turn to the growth of the ESG investment space.

**Where does ESG fit in?**

ESG takes into consideration the social, environmental and governance impacts of investments, yet it is still focused on financial performance and generating positive returns. As a values-based approach to investing, ESG prioritises ethical types of investment whilst seeking to maintain investor returns. It is often referred to as “norms-based” investing/screening. Norms-based screening ensures that investors can scrutinise a firm’s ethical and responsibility policies and

procedures. The European Sustainable Investment Forum (Eurosif) describes norms-based screening as the “screening of investment according to compliance with international standards and norms”.

ESG investments are different from other SI strategies such as ‘impact investments’ and ‘philanthropic investments’, in which the key difference lies in a reversal of priorities. Unlike ESG, an impact strategy ranks the result of a positive influence on society and/or the environment higher than the need for financial gain, yet still sees any profit as positive.

Its evenly weighted focus on ethics and profitability means that ESG slots well into the asset management space in the age of the millennial. It provides an ethical and responsible way of investing whilst generating returns, yielding dual satisfaction for investors.

### **The Facts and Growth Stats**

In 2016 the Global Sustainable Investment Alliance suggested in its report that there were \$22.89 trillion of assets being professionally managed

under “responsible investment strategies”, adding that there had been a 25% growth in the area since 2014. It was ten years prior to this report that the United Nations introduced a set of six investment principles, namely the UN Principles of Responsible Investment (UNPRI). UNPRI was created by investors for investors and was put in place to guide the investment community toward a more sustainable and ethical approach to investing.

More recently the UNPRI published a report (November 2017) stating that impact investing is forecast to grow by \$250 billion annually. Based on this, we can safely assume that ESG is also here to stay. Diversification and the growth of the hybrid fund also bolsters the need for ESG on a global basis. Hybrid funds are increasingly including environmental, social and governance outcome-based strategies to fulfil investor requirements and mitigate risk.

The PwC report *‘Asset & Wealth Management Revolution: Embracing Exponential Change’* states, “Whether millennials, HNWIs or institutional investors, there is a rapidly rising demand for forms of ESG investing evident in thematic and ESG-

integrated styles across mutual funds, impacting investing private equity and bespoke institutional mandates”. [Full Report](#)

The trend is more developed in Europe, but the APAC and Americas regions are now tuning-in to asset managers with ESG competencies. As the need for transparency increases from allocators and regulators across the globe, the focus is not only on fees but also operations and governance. Naturally, CSR activity, or lack thereof, from managers and their service providers is further exposed. As younger investors become increasingly active and influential, ESG certainly fills a requirement.

As a result, many firms are now improving their ability to disclose ESG indicators which often positively impacts long-term profitability. ESG’s proliferation is being driven by a combination of genuine investment rationale, alongside the need to demonstrate a responsible investment methodology in an increasingly socially and environmentally aware world.

## Sustainability is Key

Risk factors increase as complexities in regulation, pollution, political unrest, migration, weather disruption etc. combine. This perfect storm of global change is forcing the investment management space to be fluid and respond accordingly to mitigate those risks. The increasing global nature of asset management only serves to increase the influence of these factors and the subsequent risks. What might have been previously localised issues are becoming globally significant as the use of multi-jurisdiction investing and multi-asset strategies increase.

In 2016, JP Morgan produced a report title '*ESG – Environmental, Social & Governance Investing – A Quantitative Perspective of how ESG can Enhance your Portfolio*'. The report states that "not having ESG factors in your portfolio significantly increases volatility, lowers potential Sharpe ratios and leads to a higher probability of suffering larger drawdowns during times of market stress". In addition to this, long-term financial performance is evidenced as being impacted in a positive way by identifying "better-managed" companies to invest in, which ultimately acts to moderate risk and enhance long-

term sustainability in financial performance. [Full Report](#)

The CFA Institute conducted a survey of over 1,300 financial advisors and research analysts in 2017 which unequivocally demonstrates the importance of ESG as a mainstream strategy in today's world. The survey found that 73% of respondents take ESG issues into account in their investment analysis and decisions. [Full Report](#)

In our own informal poll taken at a recent Apex ESG event held in New York (June 2018), over 80% of respondents stated the same. The CFA survey strongly demonstrated that the main reason for consideration for integrating ESG into investment analysis and decisions came from investor and client demand, with 66% stating that as the core driver.

Interestingly, the asset class leading the pack with ESG is Listed Equity, with 76% of CFA survey respondents noting it as being the predominantly appropriate asset class. It was followed by Fixed Income at 45% and right at the bottom were hedge funds at only 8% considering ESG analysis in that

space.

It is perhaps not a coincidence then that as the private equity space continues to grow, so too does ESG. Tim Hames, Director General of the British Private Equity and Venture Capital Association said, "The integration of ESG into a GP's operations has been high on the industry's agenda for some years now. Many firms have demonstrated that ESG integration can add value to a portfolio and there is growing support for adopting the Principles of Responsible Investment". [Source](#)

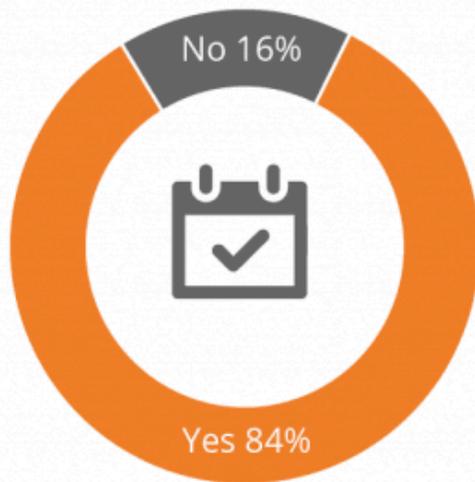
We know that the current disruptive nature of the asset management space suits private equity managers. It makes sense then that this is the asset class embracing ESG. The long-term view private equity managers take means that through ESG integration they can capitalise on the opportunity to create social value, improve the environment and in doing so, increase their financial returns.

## Contact the author

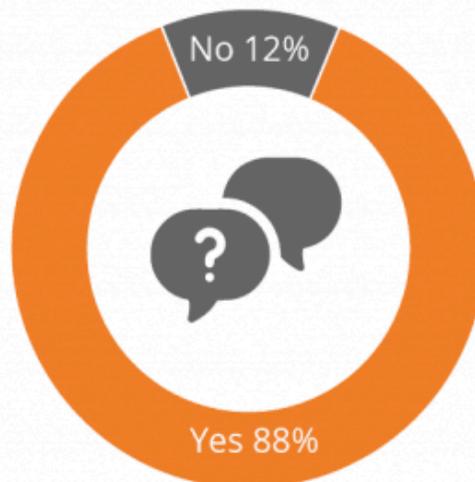
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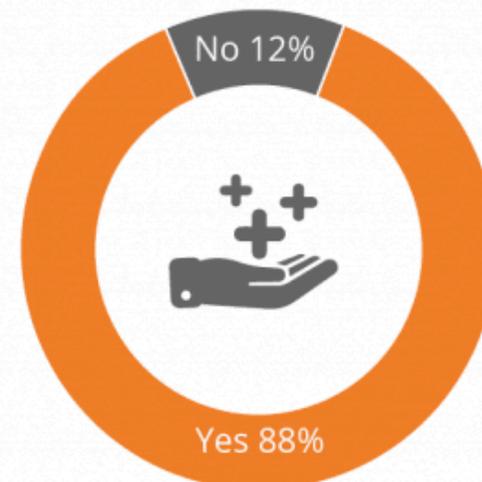
Are you adopting ESG strategies within your firm now or within the next year?



Are your clients/investors asking you about your ESG strategy?



Does ESG have a meaningful role to play in generating portfolio alpha?



\*Stats from a poll taken at Co-hosted Apex and Broadridge ESG Event in NYC (June 27, 2018).

# Cryptocurrency – how to account for them and how to tax them

by Christopher Cork,  
haysmacintyre



While it's doubtful that cryptocurrency (CC) values will return to late 2017 levels for the foreseeable future, their continued volatility and proliferation of commercial applications mean they are set to remain a constant feature in the investment landscape.

**By Christopher Cork**  
**Senior Manager**  
haysmacintyre



Authorities in most major markets now acknowledge the place of CCs, and the need to accommodate them in legislative frameworks, but progress has been slow. To date, regulators in both the EU and US have issued guidance that applies CC related issues against pre-existing principles, and a similarly logical approach has been taken by accounting and tax practitioners.

### **Accounting for cryptocurrencies**

Perhaps counterintuitively, CCs are not considered cash or equivalent because they are not legal tender and exhibit volatility and relative illiquidity that precludes them from being considered fiat currency – a view shared by the FCA in their April 2018 statement on crypto assets.

Nor are CCs financial instruments, as the purchaser of a CC has not entered into a contract to be settled in return for cash or other financial instruments (namely debt or equity). An exception here is short selling: the blockchain underpinning CCs does not allow for short positions and therefore, where investors have short-sold CCs, the position would be accounted for in the same way as any other. Classification as an intangible asset is

considered the most appropriate treatment for those investing in CCs, with recognition at the cost of investment on the date of purchase. Rather than being amortised, CCs should subsequently be subject to periodic revaluation – this is permitted under mainstream accounting standards because active markets exist for these assets.

Any gains arising from an upward revaluation in a CC are not reflected in an entity's profit and loss account, rather they are recorded in a separate reserve until the CC is disposed of, at which point a gain is transferred to the profit and loss account. It's important to note that if a CC is considered impaired, then the loss is realised immediately in the profit and loss account.

If firms are regularly undertaking day to day transactions in CCs, they should be classified as inventory. Changes in value will only be accounted for when subsequent transactions take place, or if the exchange value falls below the initial cost of the CC on an expectedly permanent basis.

This logic-based approach is considered valid both under UK and international accounting standards.

## Taxation factors

Where an investing company is based in the UK, CC trading should be considered similar to equity and security investing, specifically that a tax liability will only arise on disposal of a CC. Similarly, tax relief will be given to companies who make chargeable losses from the disposal of CC.

A common pitfall arises on trading between CCs (say, selling Litecoin to purchase Bitcoin). Here, a disposal has still occurred, so a tax charge may still arise even though there has been no re-conversion to fiat currency.

For non-company UK entities where personal tax regimes apply (i.e. LLPs and LPs), CCs held as investments are subject to capital gains tax (CGT). The same principles will nonetheless apply in that gains and losses will only be considered taxable on disposal.

Our view is that other territories will likely adopt similar regimes but as always, local expertise should be sought.

It is also important to remember that if an entity is VAT registered, any transactions carried out in CC will be still be subject to VAT at the sterling value prevailing on the relevant date.

## Initial Coin Offerings (ICOs)

ICOs are the issuing of a token offered by a new venture in return for fiat currency or other CCs. As one of the newest manifestations in the evolution of CCs, ICOs have had a significant impact on the fundraising landscape, with a cumulative \$3.6bn raised in 2017 according to the Financial Times.

For investors, ICOs can offer very significant returns with equally high levels of volatility. EOS, a token that provides application services on the decentralised hosting platform EOS.IO, launched in June 2017 at parity with the US Dollar, and now trades around the \$5 mark (having peaked at \$22 in April).

There is clearly a long evolutionary road ahead for ICOs; underlying value exists when the business proposition underpinning them is feasible. However as with CCs generally, it will take time for regulators and investors to become comfortable with the

process and put in place structures around them, which will ultimately enhance their popularity with, and value to, larger investors.

It is worth noting that ICOs do not necessarily give an investor equity in the entity offering the token, more likely the right to receive the goods and services offered by that entity. This is not an issue for many ICO investors who will subscribe with a view to holding CCs for trading. Where this is the case, investments that arise from ICO subscriptions follow the same accounting and tax principals as any other CC holding.

## Looking forward

Since issuing a briefing note in 2014, HMRC has provided little in the way of further taxation guidance regarding CCs, while the International Accounting Standards Board discussed the CC issue in January 2018 but, to date, has only confirmed it is 'actively monitoring developments in this area'.

As CCs grow in size and scope, particularly given the increasing prevalence of Initial Coin Offerings, so too will the pressure for more detailed guidance. Until then, approaching accounting and tax logically within the existing frameworks remains the lowest risk approach for investors and practitioners alike.

# Structural Enhancements to Irish Funds – the ICAV and the Investment Limited Partnership 2.0

by Ian Conlon and Aaron Mulcahy, Maples and Calder

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**By Ian Conlon**

**Partner**

Maples and Calder



**by Aaron Mulcahy**

**Associate**

Maples and Calder

Assets under management of Irish alternative investment funds (AIFs) are at an all-time high. The strategies being pursued by Irish AIFs continue to expand, hand in hand with the introduction of additional legal structures, particularly the Irish collective asset management vehicle (ICAV). Work is also currently ongoing on reforming the Irish investment partnership structure (ILP) and, once complete, there is scope for the further expansion of the strategies being pursued by Irish AIFs, particularly private equity (PE) and real economy investment strategies.

In this article, we highlight what makes the ICAV such an attractive legal structure for AIFs and how its introduction has seen the expansion of strategies being pursued. We also introduce the ILP and highlight the proposed enhancements that are designed to make it a "best of breed" partnership structure.

### **What is the ICAV?**

The ICAV is a corporate vehicle tailored specifically for Irish investment funds, established by way of a registration and authorisation by the Central Bank of Ireland (CBI). It has a distinct and separate legal personality, (i.e. it may enter into contracts itself, can own property itself etc.) and is represented by its board of directors which retains overall responsibility for managing the business of the ICAV.

The ICAV is similar to existing Irish funds established as investment companies but with the significant advantage that the ICAV was specifically created for the Irish funds industry, enabling it to be more flexible than the investment company. The ICAV legislation essentially drew upon the best and most successful aspects of Irish company law, improving it in several material respects. The advantage of this is that with its own specific legislative code, the ICAV will not be impacted by amendments to European/Irish company law (which are targeted at ordinary companies and not funds), protecting the ICAV from any unintended consequences of such legislative changes. The result of this tailored legislative code is a more

straightforward set of legal rules applicable to the ICAV, and lower administration and operating costs.

## Key Features of the ICAV

Risk Spreading Rules	No legal risk spreading obligations, making ICAVs extremely useful for single asset funds and/or funds with very concentrated positions.
EEA Passport	As an EEA AIF, the ICAV can avail of the Alternative Investment Manager Directive (AIFMD) marketing passport where it has an EEA alternative investment fund manager.
Separate Sub-Fund Accounts	Umbrella ICAVs can produce separate financial reports and accounts for sub-funds with differing year end dates (as opposed to one consolidated set of accounts for the entire umbrella). This has proven attractive for fund sponsors of multi-manager or hosted platforms concerned by sensitivities in disclosing differing fee arrangements or portfolio compositions of individual managers within the same platform.
Ability to "check-the-box" for US Tax Purposes	ICAVs may elect to "check the box" and be treated as a pass-through entity for U.S. federal tax purposes.
Efficient Constitutional Changes	No requirement to obtain prior shareholder approval for changes to constitutional document, where the depositary of the ICAV certifies that the proposed changes do not prejudice the interests of shareholders, reducing administrative burdens.
Ability to Dispense with AGMs	Ability to elect to dispense with the holding of an AGM upon written notice to all shareholders.
Filing Annual Accounts	No requirement to file annual accounts with the Companies Registration Office.

## Structuring flexibility

The ICAV can operate as a standalone fund or as an umbrella fund with multiple sub-funds which automatically enjoy segregated liability between each sub-fund under the ICAV legislation.

The ICAV can be structured to suit all major investment strategies and can accommodate traditional as well as alternative investment

policies. It can also avail of a full suite of liquidity options making it suitable for mutual funds, hedge, real estate, infrastructure, credit, loan origination, PE, managed accounts and hybrid funds. ICAVs can also be established as part of global master-feeders, co-investment or joint-venture structures and use a full range of underlying special purpose vehicles and subsidiaries to hold investments. The flexibility of the ICAV can be seen through its use to facilitate closed ended PE style strategies that typically would be undertaken through a partnership structure.

Mirroring the global trend of hedge funds engaging in the provision of private credit, ICAVs, established to pursue credit strategies have been the stand out trend since 2017. The relaxation of regulatory rules on origination of loans by Irish loan origination qualifying investor AIFs (L-QIAIFs) in February 2018 now allows L-QIAIFs to undertake a comprehensive mixed asset credit strategy, whereby investment in debt securities, including asset backed securities, primary and secondary lending can all be carried out by the L-QIAIF. This further product development has been welcomed by fund sponsors who to-date have achieved a mixed credit

strategy indirectly by pooling L-QIAIF and non-L-QIAIF sub-funds of the same umbrella into fund of fund or master-feeder structures.

## Success of the ICAV

The ICAV has quickly established itself as the most popular vehicle for asset managers. As of 31 July 2018, 271 ICAVs have been registered with the CBI. More impressively, 80% of all Irish AIFs authorised by the CBI since its introduction have been established as ICAVs. In addition, approximately 12% of ICAVs have converted from investment companies into an ICAV, most notably the conversion of an umbrella scheme with over £43 billion of assets under management and comprising 154 sub-funds in April 2018.

## The Investment Limited Partnership 2.0

While the ICAV is sufficiently flexible to accommodate many PE strategies and PE-centric features (such as capital commitment/drawdown mechanisms, distribution waterfalls, carried interest and "excuse and exclude" allocation of assets), historically global asset managers have preferred the limited partnership as the legal form for a PE fund. The ability to establish regulated ILP

structures has been possible in Ireland since the implementation of the ILP legislation in 1994, however only a handful of asset managers have chosen to do so, with the general consensus being that this legislation had its limitations.

Against this backdrop, the Irish funds industry has made proposals to the CBI and the Irish Department of Finance (DoF) to enhance the attractiveness of the ILP, through a series of legislative changes to the ILP legislation.

### **What is the ILP?**

The ILP is a regulated common law partnership structure, tailored specifically for Irish investment funds. It is established on receiving authorisation by the CBI and is constituted pursuant to a limited partnership agreement (LPA) entered into by one or more general partner(s) (GPs), who manage the business of the partnership on the one hand, and any number of limited partners (LPs) on the other hand.

### **Partners**

Typical to common law partnerships, the GP is the operative legal entity, responsible for managing the

business of the ILP and is ultimately liable for the debts and obligations of the ILP to the extent the ILP do not have sufficient assets. The GP must: (i) be authorised by the CBI to act as a GP; or (ii) avail of the right to manage an Irish AIF on a cross-border basis under AIFMD.

There are no restrictions on the number of LPs that may be admitted to an ILP. The liability of a LP for the debts and obligations of the ILP is limited to the value of their capital contributed or undertaken to be contributed, except where it becomes involved in conducting the business of the ILP. The ILP legislation helpfully includes a non-exhaustive list of 'safe harbour' activities that can be carried out by LPs without being deemed involved in conducting the business of the ILP. This safe harbour list provides additional legal certainty when considering Irish ILPs.

All of the assets and liabilities of an ILP belong jointly to the partners in the proportions agreed in the LPA. Similarly, the profits are directly owned by the partners also in the proportions agreed in the LPA.

### **Strategies**

Like the ICAV, the ILP can be structured to suit all major investment strategies and can avail of a full suite of liquidity options, making it a highly flexible product.

### **Enhancements**

The Minister for Finance announced that the Irish Government has approved the legal drafting of the amendment to the ILP legislation and it is understood that the Heads of Bill (Heads) will be published later this year. Upon making the announcement of the proposed ILP reform, the Minister confirmed that the intention was to enhance and reform the existing legislation in order to align it with international standards for PE funds and certain requirements of AIFMD and ensuring that Ireland remains one of the leading funds domiciles in Europe.

The exact changes included in the Heads will not be known until it is published. However, given ongoing dialogue between the Irish funds' industry, the CBI and the DoF, it is anticipated that the key enhancements shall include: (i) features which improve the operation of ILPs by clarifying the

rights, obligations and status of investors, (ii) align the structure fully with AIFMD and other Irish fund structures, (iii) allow for the establishment of umbrella ILPs and (iv) the migration of ILPs. It is also hoped that such enhancements will incorporate "best-of breed" features found in other leading fund jurisdictions that offer partnership structures.

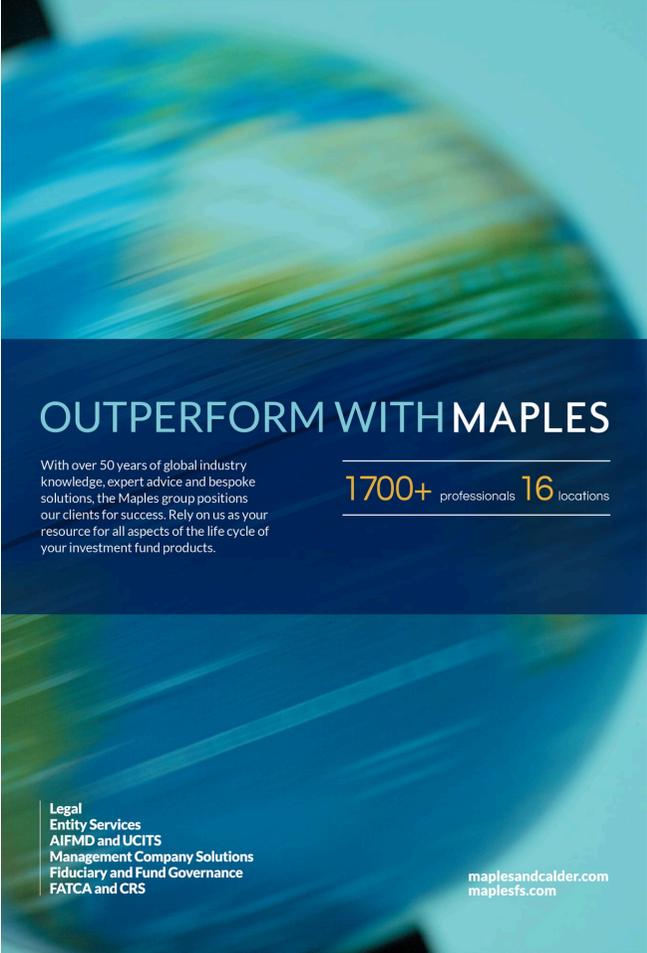
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# Distribution to investors in Switzerland

by Luis Pedro and Lisa Weihser, Oligo Swiss  
Fund Services





by **Lisa Weihser**  
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Oligo Swiss Fund Services



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**CEO**  
Oligo Swiss Fund Services

### Distribution to investors in Switzerland

Switzerland is an attractive market for foreign investment funds with very specific, yet easy to fulfil, requirements for distribution. Switzerland is not part of the EU, and distribution legislation is different. This article provides an overview of the current Swiss regulatory framework and contrasts it to the 2020 upcoming regulatory highlights and their impact on the fund industry. To ensure that all regulatory requirements, including representation, paying agent and regulators authorisation are met, choosing a reliable Swiss representative is essential. Once funds have been authorised for Swiss public distribution fund managers and fund distributors will expand the scope of potential investors through access to big Swiss distribution platforms, including those from well-established banks.

### Switzerland, an attractive market for foreign funds

The Swiss fund market is the 5th largest in Europe, with a total volume of CHF 1134.4 billion (as of 20 August 2018)<sup>1</sup>. At the end of December 2017, the total volume was CHF 1086.9 billion, which

represents an increase of CHF 163.8 billion or 17.7% year-on-year<sup>2</sup>.

With a diversified and fragmented market made up of a large number of private banks, asset management firms, family offices, fund of funds and independent wealth managers, Switzerland is the 4th largest location for asset management in Europe and is the world leader in off-shore private banking according to the Swiss Bankers Association<sup>3</sup>.

Switzerland is a politically stable and neutral country and accounts for 1.7% of the top 1% of global private wealth. Over two thirds of Swiss adults have assets in excess of USD 100,000<sup>4</sup>. 8.8% of Swiss are US\$ millionaires, an estimated 2,780 are ultra-high-net-worth individuals (UHNWI) with over \$50m, and 1,070 have a net worth in excess of \$100 million<sup>5</sup>. These facts make the Swiss market particularly attractive for the sale of foreign investment funds. The number of funds approved by FINMA for public distribution has been constantly growing. Most of these funds follow the UCITS directive but there are also certain Alternative Investment Funds. When looking at the number of funds authorised for

public distribution in Switzerland, foreign funds outnumber Swiss funds by nearly five to one (7760 vs. 1642). Luxembourg and Ireland are the most prevalent domiciles for foreign funds, with over 6900 funds in total, followed by France, Liechtenstein and the UK.

Under the CISA, the Swiss investors are segmented into groups:

Qualified Investors		Non-Qualified Investors
Regulated	Unregulated	
<ul style="list-style-type: none"> <li>- Banks</li> <li>- Security dealers</li> <li>- Regulated fund management companies</li> <li>- Insurance institutions</li> <li>- Other regulated companies</li> </ul>	<ul style="list-style-type: none"> <li>- Pension funds with professional treasury management</li> <li>- Family Offices</li> <li>- UHNWI (subject to conditions)</li> <li>- Independent wealth managers</li> <li>- Companies with professional treasury management</li> </ul>	<ul style="list-style-type: none"> <li>- Investors other than Qualified Investors</li> </ul>

### The Swiss regulatory framework today

Switzerland is not part of the EU and is hence not subject to the AIFMD rules<sup>6</sup>. The distribution of foreign funds in Switzerland is regulated by a specific set of rules, where the function of the Swiss representative plays a central role. The Collective Investment Schemes Act (CISA) came into full force on 1 March 2015. The modifications introduced by the CISA require that all foreign funds distributed

to Swiss investors have a Swiss representative<sup>7</sup>. For the FINMA, any activity that promotes a fund is considered distribution<sup>8</sup>.

### The 2020 upcoming regulatory highlights

The Swiss Federal Financial Services Act (FFSA) and the Swiss Federal Act on Financial Institutions (FAFI) are expected to enter into force in 2020. They were drafted as a response to the 2009 financial crisis and with the purpose of meeting international standards, most importantly the recognition of the so-called “equivalence” under the “third-country rules” under MiFID II<sup>9</sup>. Through the legislative proposal of FFSA and FAFI, Switzerland envisages the harmonisation of its financial markets regulation with MiFID II in order to facilitate cross-border activity of Swiss financial institutions and to simplify the recognition of equivalence.

The FFSA introduces two client categories.

Professional clients	Private clients
<ul style="list-style-type: none"> <li>- Institutional clients and among others, Swiss pension funds, companies with professional treasury, private wealth holding vehicles subject to certain requirements</li> </ul>	<ul style="list-style-type: none"> <li>- Non-professional clients</li> </ul>

Also the fund industry will be affected by FFSA/FAFI, as the current licensing requirement under Art. 19(1bis) CISA, Art. 30a CISO for distributors will be abolished. Distributors will need an entry in the register for investment advisers. Professional investors under FFSA will be considered regulated qualified investors and some private investors, with financial assets exceeding CHF 500'000, that have sufficient knowledge about the risks of investments in the financial sector, may “opt-out” and be considered as “professional clients”<sup>10</sup>.

With regard to prospectus requirements, the FFSA will introduce a uniform set of rules that will be applied to any securities offered publicly. The content and approval of the prospectus are inspired by the EU Prospectus Regulation<sup>11</sup>. In contrast to today's rules, an ex-ante approval of prospectuses will be mandatory under the FFSA, except for collective investment schemes. The verification of these prospectuses will be conducted by a regulatory body which will be licensed by FINMA. Foreign prospectuses can be approved by the body as well. Those issuing for the first time will be required to submit the prospectus 20 calendar

days prior to commencement of the envisaged offering of admission to trading, while other issuers are required to submit at least 10 calendar days prior. Exemptions will depend, among others, on the type of offer or on the admission of trading.

In addition to the prospectus and in line with the EU regulation on PRIIPs<sup>12</sup>, the publication of a key investor information document (KIID) is compulsory if a financial instrument is offered to private clients. KIIDs must provide all information which is relevant for an informed investment decision.

### **Institutional setup for distribution in Switzerland**

A foreign fund authorised to distribute their funds publicly will be able to gain access to big Swiss distribution platforms, thus accessing a broad scope of potential investors. In addition to the requirement of appointing a Swiss representative and a paying agent, an authorisation from FINMA is required<sup>13</sup>.

Once a fund manager takes the decision to approach the Swiss market, the first step is

generally to appoint a Swiss representative. The representative will initially discuss with the fund manager about the Swiss regulations and about aspects which are specific to the type of the fund. A list of Swiss paying agents will be provided for the client to choose from. An on-boarding process follows, which typically takes a few weeks, during which the representative executes due diligence work on the fund, a representation contract is established, and the fund's legal and marketing documents are amended for distribution in Switzerland. This also entails filing of the documents with FINMA and requesting that the fund be authorised for public distribution in one of the Swiss official languages. This is usually not a problem, for example, for a manager from Germany, France or Italy, who already have all the fund documents in their native language, but it may be time consuming for those with documents written in other languages, e.g. managers of UCITS funds from the USA, Asia and the UK, as these financial documents need to be translated.

UCITS and Hong Kong mutual funds have a fast-track approval for distribution to private clients. FINMA has cooperation and information exchange

agreements with the supervisory authorities in 17 countries<sup>14</sup>. Funds domiciled in one of these countries are also eligible to apply for public distribution and access to the big distribution platforms.

### **Choosing a Swiss representative**

Independent firms offering representation services for foreign funds in Switzerland currently fall into two groups:

1. Licensed firms that represent funds distributed to professional and institutional clients only;
2. Licensed firms that represent funds distributed to all types of investors, including private clients.

Representatives that are licensed to represent funds for distribution to all types of investors, including private clients will have a deep knowledge and experience about how to proceed in the best possible way.

The role of the Swiss representative is to ensure that the funds' distribution activities comply with

Swiss laws. Some representatives evolved their services very quickly beyond simple legal representation.

### **In addition to the legal and procedural expertise, Swiss representatives can:**

- Help fund managers who wish to distribute to private clients find the best professional translation service provider;
- Update the funds on regulatory changes and help adapting to them;
- Help gaining access to big Swiss distribution platforms, including the ones from well-established banks;
- Help building relations between funds, Swiss-based distributors and investors;
- Organise cap intro events and conferences to connect funds with investors;
- Act as a global distributor to organise retrocessions for placement agents in Switzerland;
- Help choosing a suitable Swiss legal Counsel when required;
- Assist the fund with cross-border registration in multiple countries within and beyond Europe;
- Publish fund information and documents on

electronic platforms dedicated to Swiss investors;

This makes the Swiss representative an ongoing point of reference, source of business, and long-term partner for a fund's distribution activity in Switzerland.

For any question concerning funds representation and distribution in Switzerland, please feel free to contact Oligo Swiss Fund Services (a regulated Swiss representative for funds addressed to both professional and private Swiss investors) at [info@oligofunds.ch](mailto:info@oligofunds.ch).

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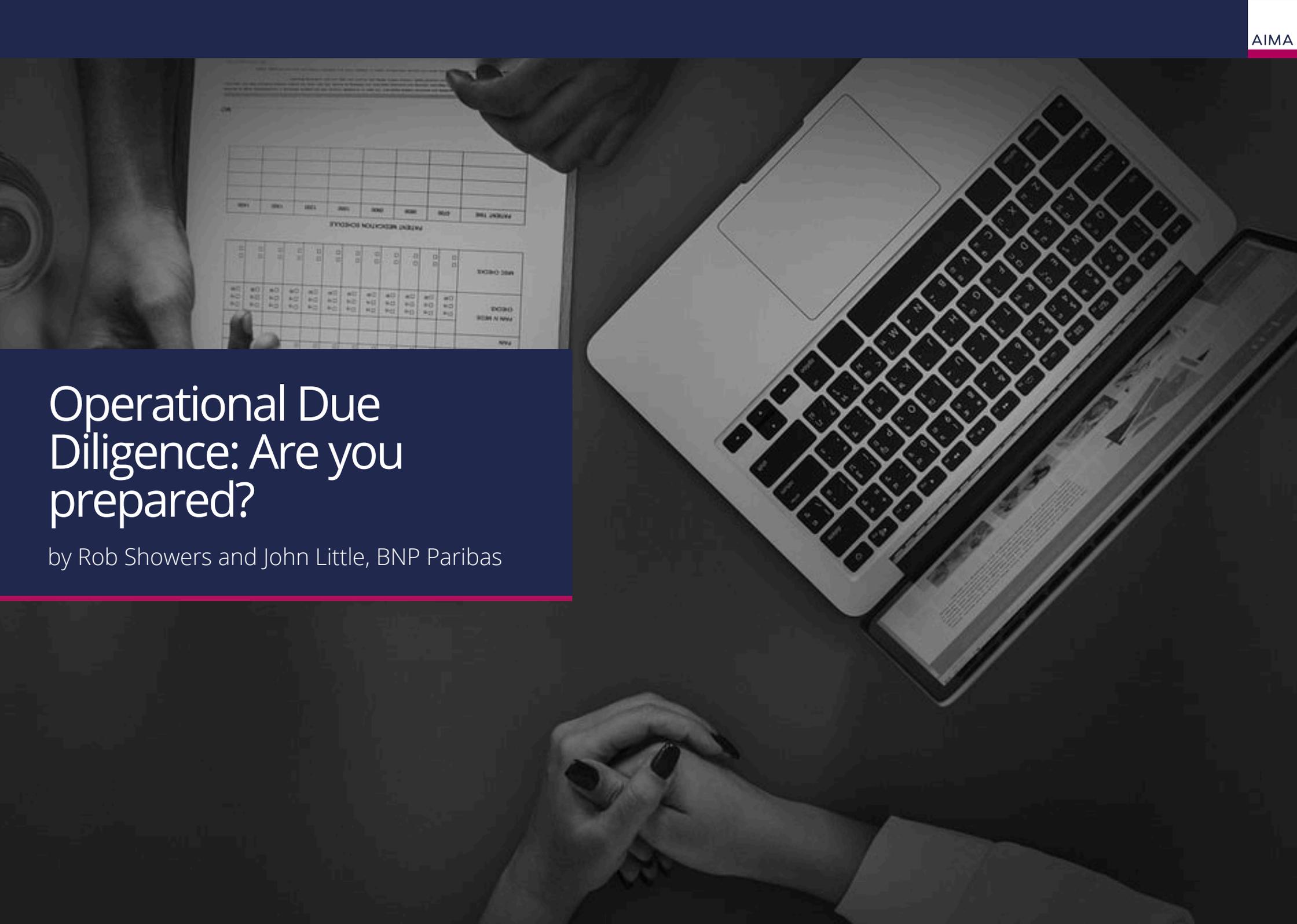
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# Operational Due Diligence: Are you prepared?

by Rob Showers and John Little, BNP Paribas



**by John Little**  
**Director**  
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**by Robert Showers**  
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Even as the global markets continue to show signs of resilience, investors remain steadfast in their quest for granular data, on demand and easily accessible. This has been particularly evident within the alternatives space, where flagship pension funds and other large institutional investors have made increased portfolio clarity and streamlined communications a condition of their ongoing involvement in hedge funds, private credit and related strategies.

Such was the backdrop for the BNP Paribas-sponsored event '*Operational Due Diligence: Are You Prepared?*', held in conjunction with the Alternative Investment Management Association (AIMA) this past June and featuring a panel of senior operational due diligence professionals at investment managers, consultants and wealth advisors.

In her opening remarks, Cathy Beckett, Chief Financial Officer, Hedge Fund Administration, BNP Paribas Financial Services, described how the bank's own asset-management clients are fielding a greater number of requests from investors for more—and increasingly complex—operational due-diligence (ODD) information, including ODD questionnaires and related information. At the same time, increased outsourcing, new modes of communication, as well as the need to fine-tune

valuation practices make this a particularly good time to hear how leading due-diligence experts are working with fund clients to stay above the fray.

#### **Information evolution**

During the first segment which focused on ODD for hedge funds, participants noted changes in the way ODD teams communicate with fund managers post-crisis. Transparency has continued to rise, with many firms now sending regular updates around their operability status, or including more comprehensive detail if reporting annually. A number of panellists discussed the value of having straightforward yes/no type questionnaires, which they suggested may be more useful for applying information across the entirety of funds under their purview.

In addition to keeping the trust of their investor clients, firms that are communicative are more likely to gain favour with their ODD partners as well. While some funds may be more forthcoming than others, panellists agreed that it is easier for ODD practitioners to work with managers who respond in a timely manner, or proactively get in touch if there are any changes they should know about.

### **Outsourcing insights**

The move towards outsourcing as a cost-saving measure continues to re-define the industry, say experts, mainly for the better. For start-up managers in particular, the ability to outsource nearly any kind of service, from IT to HR or accounting, is a real advantage, one that allows firms to get up and running without a huge footprint or excessive capital requirements. Then again, there are certain functions that are best kept in-house such as CFO or CCO responsibilities—the idea being that if you're not in the same building or are attempting to monitor via email, oversight may be compromised.

While acknowledging the impact of increased competition and thinning margins, managers should never settle for less when seeking outsourced assistance. Thus, it is crucial that a provider has a proven track record, and that the client has internal controls in place to continually monitor services rendered. A firm might have a single IT professional, but it is workable so long as they are working with a trusted partner and have all the necessary contingency plans in place.

### **Staying secure**

Despite the rise in hacking attacks and other nefarious activity, a number of panellists continue to see a disparity in cybersecurity preparedness, with regulatory scrutiny often the prime motivator. For example, rules established by the state of New York in 2017 now require covered financial services companies to maintain adequate cybersecurity programs and policies based on a risk assessment of the firm. However, there's a great deal of dispersion of practice by geography and asset classes. In some cases, controls around customers' personally identifiable information (PII) or other sensitive data often don't exist or have been given

little thought. This has compelled ODD practitioners to highlight the importance of complying with SEC guidelines around encryption, penetration testing, vulnerability testing and the like. Meanwhile, setting controls at the employee-user level can help address potential threats from within by stemming the flow of network information.

### **Workplace policies to the fore**

Of course investors have other concerns besides their annual returns. Questions about conduct, diversity and other cultural components have become a much bigger part of the ODD-client conversation. Accordingly, many in the industry have modified client questionnaires to address a firm's specific HR policies, including whether a harassment policy is in place, how often training is provided, and so forth. Providers may also want to know about any outstanding discrimination claims, similar to inquiries about pending litigation against the firm. Given that many pension funds and other large institutional players maintain a zero-tolerance policy around discrimination or harassment, participants believe such criteria will become even more relevant over the near term.

## ODD and private credit

With the private credit industry in growth mode, AIMA has responded by establishing the Alternative Credit Council, said moderator Michelle Noyes, Head of Americas, AIMA, during her introduction to the event's second panel focused on ODD for private credit funds. This has included new guidance around due diligence, valuation, loan administration and other topics for private credit funds.

Carrying out the due diligence of private credit funds has unique challenges and areas of focus, particularly when compared to hedge funds. For instance, ODD practitioners must regularly review clients' positions to ensure valuations reflect the methodologies that have been specified in their documentation. For their part, managers should adopt a risk-ranked framework, including the use of scenarios to determine if loans will likely perform as expected.

Analyzing private-credit legal documentation also poses a unique challenge from a due-diligence standpoint, given the wide variety of documentation from one private credit manager to

the next. Additionally, panellists pointed to the need for better investor protections, including the ability to replace a GP if the situation warrants.

Yet another priority for ODD leaders is establishing specific infrastructure guidelines on behalf of new managers. To wit, start-ups should have a strong CFO, knowledgeable operations staff, as well as traders who understand the nuances of private credit, given the inherent complexities of the asset class.

Finally, segregation of fund-accounting duties remains front-and-center for fund clients. Though not nearly as widespread as in years past, any PC firm operating without a fully independent administrator will send up an immediate red flag; similarly, on-site valuation committees must include a separate entity to ensure that calculations remain unconflicted. Unlike other fund types, private credit administrators often receive valuation data directly from the manager, who may rely on waterfall calculations rather than doing AML and having fully independent valuation and verification of assets. As such, ODD partners must ensure managers utilize a streamlined system

capable of providing accurate calculations, as opposed to Excel or other manual processes.

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# Securitisation Regulation

by Andrew Bryan and Owen Lysak, Clifford  
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**by Andrew Bryan**  
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The Securitisation Regulation has been in development in one form or another for almost five years and, on 1 January 2019, it will finally begin to apply. Among other things, the Securitisation Regulation will introduce onerous due diligence obligations on "institutional investors", including obligations to check compliance of other parties to the securitisation transaction with their obligations, and refrain from investing if e.g. the sell side does not have appropriate risk retention or disclosure arrangements in place to comply with new Securitisation Regulation rules. There is a serious risk that this will include non-EU AIFMs who market in the EU on a private placement basis under Article 42 of AIFMD.

Historically, in the funds space, the scope of EU regulation relating to securitisation has been fairly clear – and arguably produced quite a sensible result. Broadly speaking, the current securitisation rules under the AIFM regime apply to AIFMs set up in the EU or that have a full AIFMD passport to market in the EU. Where AIFMs register to market on a private placement basis in particular EU Member States under Article 42 of AIFMD, they are not subject to the securitisation rules under Article

17 of AIFMD and the corresponding articles of the AIFM Regulation.

Now, it is looking like the definition of "institutional investor" (the category of people with regulatory obligations to conduct due diligence) in the Securitisation Regulation may change all that. The definition includes "an alternative investment fund manager as defined in point (b) of Article 4(1) of [AIFMD] that manages and/or markets alternative investment funds in the Union". Unhelpfully, the Securitisation Regulation does not include a more general provision restricting its geographic scope, so prima facie a non-EU manager marketing a fund in the EU would be caught, even if it is marketing that fund only in one EU Member State and doing so under a private placement regime.

At first blush, a number of other types of non-EU (or "third country" in the EU jargon) institutional investors would be caught as well. For example, "credit institutions" (essentially, any deposit-taker) also fall within the definition of "institutional investor", regardless of where they are established. Surely the EU is not purporting to police how Old National Bancorp in the US or the National Bank of



**by Owen Lysak**  
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Canada can invest their money? Correct. Although they are deposit-takers, Canadian and US banks will not generally have an EU regulator who could enforce the Securitisation Regulation rules. While it may be slightly clumsy, third country credit institutions are effectively taken out of the rules because there is no regulator to enforce the Securitisation Regulation against them. Not so fund managers registered under Article 42. Having voluntarily submitted to some form of regulation in the EU in order to be allowed to market here, managers with an Article 42 registration have an EU national competent authority charged with ensuring they comply with EU rules. That national competent authority is charged by the Securitisation Regulation with enforcing the due diligence obligations on those managers.

This, of course, would significantly expand the universe of entities required to comply with EU securitisation rules and it is not clear that this expansion was intentional. There are, for example, questions around what sanctions the EU AIFM regulatory regime would apply to an Article 42-registered AIFM to deal with a breach of the Securitisation Regulation. As a result, efforts are

ongoing with regulators and policymakers to clarify this question.

Although it is still possible that guidance might be issued to clarify that Article 42-registered AIFMs are not intended to be caught by the Securitisation Regulation, the application date of 1 January 2019 is fast approaching and most fund managers need to begin making preparations sooner rather than later if they are to be able to comply in a timely fashion. Accordingly, most fund managers with Article 42 registrations appear to be preparing on the basis they will be subject to the due diligence rules under the Securitisation Regulation and preparing accordingly.

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# Beyond Implied Volatility

by Blu Putnam, CME Group

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**By Blu Putnam**  
**Chief Economist**  
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We have observed in studying financial markets that 100-year floods occur quite often, maybe several every decade, so we know simple risk models can be inadequate and misleading. Many financial risk models start with a risk reading taken from the options markets – implied volatility. Implied volatility is a standard deviation-based metric and typically embeds the presumption of a bell-shaped curve. Starting with implied volatility, the risk manager or financial analyst then must work to augment the tails of the probability distribution to increase the odds of extreme events actually happening to align more closely with historical experience. After all, it is the extreme events that can do the most financial damage, so it is critical that the expected probability distribution be augmented beyond a simple standard deviation analysis to properly account for the possibilities.

Our approach and perspective is quite different. We believe that starting points matter. Starting one's risk analysis with implied volatility introduces some hidden biases that may be surprisingly hard to overcome.

To begin with, volatility is a poor measure of risk.

Many analysts like volatility because the historical standard deviation is easy to calculate and fits nicely into basic risk systems and mean-variance portfolio models. The problem is that an investor, or a financial institution for that matter, may have asymmetrical risk preferences, preferring to avoid substantive losses rather than to make large gains. That is, if avoiding large losses is the primary risk, then a symmetrical standard deviation based metric that only looks at the noise level and not the extremes is certainly not appropriate.

Another challenge is that implied volatilities are typically calculated from straightforward options pricing models that embed the heroic assumption that prices move up or down with continuous trading – that is, price breaks or price gaps are assumed never to occur. If market participants fear the possibility of price breaks, options prices will reflect this risk with a higher calculated implied volatility. But it will not be easily apparent that the implied volatility is reflecting price gap risk instead of an upward shift in the volatility regime. And, price gap risk is not the same risk as volatility regime shift risk. Depending on one's financial exposures, one of these risks could be much more

important than the other. For those managing options portfolios, for example, the risk of an abrupt price break can do considerable damage to delta hedging strategies, while a volatility regime

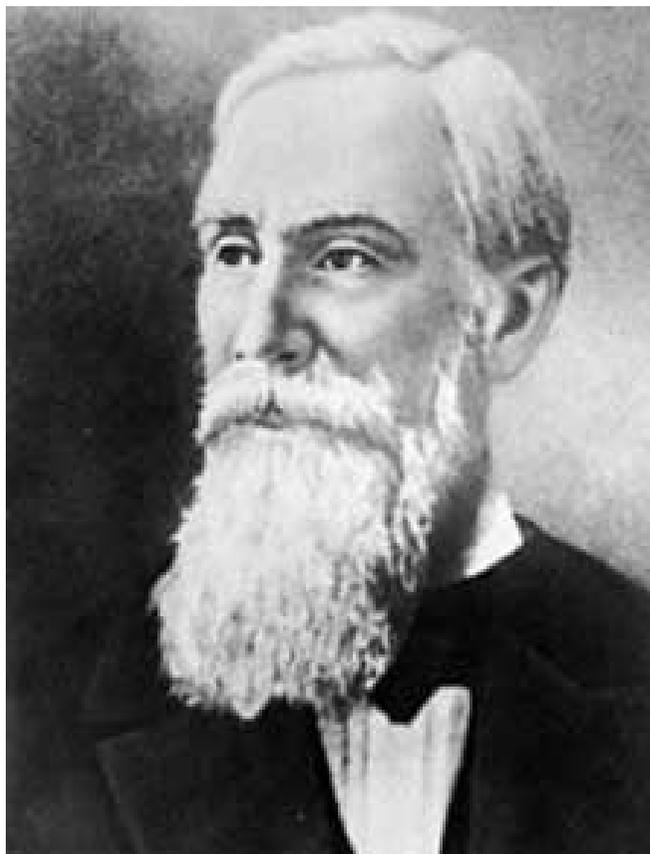


Figure 1: Pafnuty Chebyshev (from Wikipedia)

shift represents a different risk, commonly known as “vega” risk. What one needs to create is a comprehensive view of the whole risk probability distribution providing a robust perception of risks, allowing for decidedly different risk scenarios, and not being biased toward bell-shaped curves.

To build a risk probability distribution that is not necessarily bell-shaped or even of a single mode and can capture the extremes in a robust manner, we prefer to start from a very different point of view. We start with the Bayesian prior of a very unusual distribution – in our case, a bi-modal distribution that might reflect a type of binary or two-scenario risk often associated with event risk. Then, we examine market data to see if the risks are actually more bell-shaped. While the implied volatility is one of the market metrics we examine, it does not necessarily have the primary influence it does when it is the starting point for the risk analysis.

Put another way, if we start from a prior of an extreme and unusual distribution, we know that it can exist and we have not assumed it away. Starting from a standard deviation approach, such

as implied volatility, may inadvertently make it very hard to estimate when extreme and highly dangerous risk distributions are present. The math behind this observation is quite old and goes back to the Russian mathematician, Pafnuty Lvovich Chebyshev (1821 – 1894). What most people take away from Chebyshev’s Inequality Theorem is that if you know only the standard deviation you have a very good idea of the typical ranges in which values will fall the vast majority of the time. What we take away from the Inequality Theorem is that if you only know the standard deviation, you know absolutely nothing about the extremes of the distribution where the most dangerous risks reside.

The motivation for our research was the observation that in financial markets, especially since 2016, we have and will be seeing important episodes of event risk associated with elections – UK Brexit Referendum of June 2016, U.S. Presidential election of November 2016, French and UK elections in 2017, Brazilian elections of October 2018, U.S. Congressional elections of November 2018, etc. This led us to a study of how markets cope with two strikingly different scenarios

– a type of event risk. When there are two possible scenarios, then pre-event, the market is going to price the probability-weighted outcome, or the middle ground. So, post-event, when the outcome becomes known, the market immediately moves away from the middle ground to the “winning” scenario – a price break. For example, with Brexit, the “Leave” vote generated a sharp downward move in the British pound (vs USD), while a “Remain” vote would have presumably generated a sharp almost instantaneous rally in the pound – either way, the pound was no longer going to trade

in the middle. Even if they are relatively rare, if one’s risk system cannot create the possibility of a bi-modal probability distribution, then price break risk and tail risk may be greatly underestimated.

From a practical perspective, starting with the prior of an abnormal, bi-modal risk probability distribution requires some creativity that might put off some risk managers. The challenge is that expected risk-return probability distributions cannot be directly observed. What we are able to do is to estimate some of their characteristics from looking at market behavior – prices, volumes, futures versus options, intra-day activity, etc.

While our research is still at the early stages, we have found a few metrics that are especially enlightening relative to the shape of the probability distribution. Our three primary metrics are: (1) the evolving pattern of put option trading volume relative to call option volume, (2) intra-day market activity, especially high/low spreads, and (3) implied volatility from options prices relative to historical volatility pattern shifts.

Studying put/call volume patterns helps us understand if one side of the market is more at the center of the current debate than the other side. For example, immediately after former Federal Reserve (Fed) Chair Ben Bernanke threw his famous “Taper Tantrum” in May 2013, he set off a debate about if and when the Fed would withdraw quantitative easing (QE) and raise interest rates. Put volume on Treasury note and bond prices soared relative to call volume as an indicator that a two-scenario situation had developed. While there is a buyer and a seller for every trade; one side thought prices would fall (yields rise) and volatility might rise very soon (buyer of puts), while the other side thought the process of exiting QE would take a long time (seller of puts).

Intra-day market dynamics help us appreciate risk in a different way. The observed high price to low price intra-day trading spread is informative in helping us assess the degree to which fat-tails might be present. Mathematically, work by Mark B. Garmin and others back in the 1970s and 1980s has shown that if one assumes a normal distribution then there is a straightforward way to estimate the standard deviation of daily returns

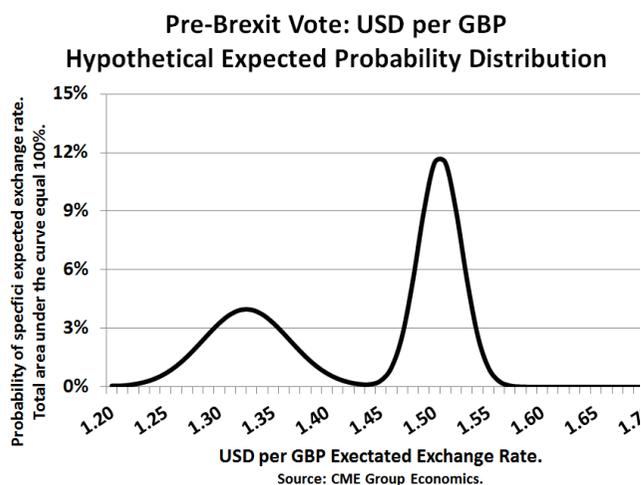


Figure 2: UK Brexit Referendum

from the intra-day high-to-low spread. Put another way, if the relationship between intra-day dynamics and the day-to-day standard deviation diverge in a significant manner, then this is strong evidence that the risk probability distribution is not normally distributed.

To ascertain the risk of price breaks we track the evolving pattern of implied volatility relative to historical volatility. While it is usual for implied volatility to exceed recent historical standard deviations, a shift in the pattern toward a much higher implied volatility may indicate that expectations for the potential of a sharp price break are building in the market. And, if a price break occurs, we often see a quick decline in the implied volatility representing a shift back to a single-mode bell-shaped distribution.

We use a probability mixture technique that is distribution independent to combine our metrics and what we find is that most of the time, bell-shaped curves are appropriate descriptions of the probability distributions. Our method does, however, occasionally generate some especially tall distributions (i.e., high kurtosis), which we classify

as “complacent” and worthy of special study to see if the market may be underestimating risks. We also see on occasion some very flat distributions, not unlike the Wall Street maxim about the equity markets “climbing a wall of worry.” And, finally, on rare occasions our metrics actually support the idea of a two-scenario, event risk, bi-modal distribution. The most likely source of event risk and bi-modal distributions are highly polarized elections, when the candidates are far apart and the vote is closely contested. We classify these event risks as “known date, unknown outcome”. We also see event risk around “unknown date, unknown outcome”, which has shown up when the US-induced trade war evolves into a tit-for-tat tariff retaliation episode. This type of event risk, for example, hit soybeans, quite hard during 2018. Policy decisions taken at scheduled meeting, like a Fed interest rate decision or an OPEC oil production decision fall into the “known date, unknown outcome” category, but they almost always are associated with bell-shaped probability distributions, because the policy makers go out of their way to telegraph the decision ahead of time, reflected in the fact that our metrics pick up no unusual risks.

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# The future is cloud, choose the right model for your firm

by Kulvinder Gill, Eze Castle Integration

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**By Kulvinder Gill**

**Associate Director, International Marketing**

Eze Castle Integration



### **A Cloudy Horizon**

Migrating to the cloud is increasingly on the mind of IT managers as investment businesses demand greater agility, efficiency and adopt pay-as-you-go spending styles. This model poses the opportunity for firms to move away from the hassles of building infrastructure on-site to host applications and data. With capabilities to support front, middle and back-office functions, the cloud computing model includes everything an investment firm needs to operate seamlessly - from business applications and client relationship management systems, to data management solutions and accounting systems.

This model is most commonly provided by a third-party provider. Although, the decision of which cloud to migrate to lies with the firm, so it is important to understand the difference between the cloud deployment models, namely private, public and hybrid cloud.

### **Private Cloud: For Guaranteed High-Performance**

The private cloud has been the go-to option for financial and investment firms that require

enterprise-calibre IT infrastructure. It provides the highest levels of performance, security, and resiliency for enterprise business functionality. Furthermore, this model enables you to exercise greater control over network traffic, in terms of security, quality of service, and availability.

In most cases, that private cloud is professionally managed by a service provider solely focused on monitoring, managing, and maintaining that infrastructure to meet business requirements and compliance directives. Enabling firms to benefit from seasoned, industry-experienced professionals who live and breathe financial IT.

### **Public Cloud: For Open and Affordable Infrastructure**

For many firms, so-called public cloud infrastructures offer compelling opportunities and advantages. For example, Microsoft's Office 365 public cloud is one of the most popular public cloud options, offering users complete access to its flagship productivity applications (e.g., Microsoft Word, Excel, etc.), Microsoft Exchange, mobile device access, storage, and other services.

The flexibility and ease of deployment are persuasive drivers for many smaller and younger firms, and, the initial costs appear to be lower for certain feature sets (although an analysis of the total cost of ownership indicates that advantage is less clear-cut).

### **Hybrid Cloud: For Best of All Worlds**

Investment firms today are not obliged to take an “either/or” approach to their IT infrastructures. With a hybrid cloud approach that combines many of the most compelling features of public and private clouds, firms can leverage a uniquely flexible platform that meets a broad range of needs.

### **So, which is the cloud right for your firm?**

The decision regarding your IT infrastructure has significant implications on the ability of your investment firm to gain and maintain a competitive advantage. As you weigh your options – private, public or hybrid – it can be beneficial to consider some of the following aspects of cloud architectures and weigh their importance as unique to your individual firm.

### **Support**

Technology is not infallible, so it’s imperative for firms to entrust their IT management to a provider well-versed when it comes to technology service and support. Many financial firms find it’s essential to be able to rely on named individuals who can be present physically if needed, as well as understand your business workflow.

Public cloud providers (Microsoft, Amazon, and Google), do not have specific knowledge of your investment business and the features and applications your firm relies on. Also, given their massive structures and reach among customers, it’s unlikely you’ll receive high-touch support. This is where private and hybrid cloud offered by vertically-specific MSPs deliver an advantage. These providers know and appreciate your business model and investment goals, understand the applications and technology requirements you need to power your operations, and ultimately are in the best position to address your short and long-term needs. More flexibility and established relationships with clients enable these cloud providers to be proactive in closing any known vulnerabilities and ensuring all aspects of the

infrastructure are properly, and efficiency upgraded.

### **Availability and Uptime**

Availability is a chief consideration for any investment firm. Especially, when crucial elements, or, the entirety of your IT infrastructure are hosted elsewhere, you need guaranteed uptime. Thus, cloud providers are expected to clearly define the contracted levels of uptime they guarantee to provide, in service level agreements.

Many public cloud providers tend to guarantee up to 99.9% availability. While this appears enough, some private clouds can offer 99.99% uptime guarantee based on their infrastructure redundancy – and the added nine makes a significant difference. With a hybrid approach, your firm can tap into multiple clouds and data centres, leveraging the necessary levels of availability your firm requires. And, each cloud’s infrastructure is designed with redundant resources, network connections, storage, and other vital components to offer a level of resiliency and durability, even in the face of faults and unplanned downtime.

## Compliance

Insider threats are often the greatest risk exposure for investment firms, which explains why they are faced with intense and growing scrutiny from compliance regulators and auditors. Often, a firm's greatest IP and assets are in product plans, strategic initiatives, and confidential employee and customer records. Unfortunately, public clouds have been known to struggle in demonstrating the access controls that are needed to protect this growing share of mission-critical data.

Private Cloud MSPs typically offer any number of tools ideal for compliance purposes, such as file auditing and access controls. With these applications, your organisation can analyse, secure, manage and migrate volumes of structured and unstructured data such as spreadsheets, presentations, audio and video files, emails and text. Thus, a private/hybrid cloud environment puts you in a better position to ensure proper data security, governance and compliance.

## Security

While your public cloud provider may provide world-class security for its services, your firm is still

on the hook for certifying all aspects of information security. So, there are still countless vulnerabilities and exposures that public cloud often fails to address. On the other hand, advancing security features such as multi-factor authentication, targeted attack protection and managed phishing simulations are gaining traction among private/hybrid cloud users who benefit from extensive managed security services offered by their providers.

Another benefit to working with a private cloud provider, either exclusively or as part of a hybrid solution, is that many MSPs also offer cybersecurity training and security plan developing services to complement the protections afforded in their private cloud environment. Public cloud providers may have online resources, but rarely offer these types of complementary security services to their clients.

## Cost

At first glance, public clouds can appear to be a cost-effective alternative to private or hybrid clouds. But firms should look for the number behind upfront expenses for an accurate estimate

of total cost. For example, your per user/per month private/hybrid cloud fee is likely to include many additional features (such as added layers of security and compliance applications, etc.) that are typically offered ad hoc on a public cloud environment. This means your apples-to-apples cost comparison is not accurate.

Cutting corners in any area of technology, but particularly on support and maintenance, can carry a significantly higher long-term cost for firms. In many ways, the hybrid cloud is a happy medium between public and private options, providing more flexibility and access to public cloud features and functionality, as well as support, security and monitoring of the environment by an experienced private cloud provider – at a more reasonable monthly price point. Firms are advised to perform a proper TCO analysis as part of evaluation and decision-making stages.

## Conclusion

For alternative investment firms, the ultimate strategic IT decision has long revolved around the question of whether to embrace the control and professional management of a private cloud vs. the

open, affordable public cloud. However, new hybrid cloud infrastructures mean that firms are not obliged to make an either/or commitment.

By partnering with an experienced, industry service provider, savvy investment firms are increasingly adopting cloud services with features most relevant to them. It is imperative that a decision is made after weighing the importance of email and business applications, industry-vertical support, levels of service, availability/uptime guaranteed, security practices and training offered, regulatory compliance, and overall control.

When considering the different cloud models, firms should also assess applications hosted, connectivity to financial and industry counterparties (e.g. brokers, dark liquidity pools, etc.) and any proximity requirements to data centres supported by a public or private cloud providers, in addition to the factors explored in this article.

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Asset managers see opportunities and challenges on the path to long-term success, that include focusing on the customer, technology and geo-political implications

by Al Fichera, KPMG





**By Al Fichera**  
**Global Head, Alternative Investments**  
KPMG in the US

While buoyant markets have given the world's alternative asset firms reason for optimism in the near term, senior executives are alert to the unfolding challenges and their organization's ability to respond. Asset managers acknowledge that current, calm waters could grow rougher as a result of customer behavior and technology change, or turn choppy due to geo-political or cyber-security threats. They are considering their firm's capabilities to recognize, respond and, in some cases, rethink their proven approaches, whether internally or externally supported.

These insights are among the major themes that emerged from KPMG's 2018 Global CEO Outlook, in which we surveyed 1,300 CEOs from leading enterprises. Once again this year, an integral component of this effort included capturing the perspectives of a cross-section of asset management executives. As a result, 88 leaders from the sector participated, representing firms with revenues from \$500 million to \$10 billion in 11 countries.

Such an extensive survey population brings into

sharp focus the key issues of executives within our industry niche, and make useful comparisons with other sectors. With many commonalities emerging across industries, the title for this year's report, 'Growing pains,' is very relevant for both the broader community of global CEOs, and specifically to the alternative investment sector.

### Anticipating more modest growth

Looking at the big picture, our study revealed how CEOs are confident about the future of their industry and firm, however with more modest rates of growth than in the past. Specifically, 92 percent of asset managers are confident in their company growth over the next three years, and 80 percent are confident in industry growth. However, half of

**Asset management CEOs who are confident about growth prospects for the following over the next 3 years**



Source: 2018 Global CEO Outlook, KPMG International

asset management leaders anticipate topline revenue growth of less than two percent, and 44 percent expect revenue growth between two and five percent.

#### Asset management outlook for topline revenue growth over the next 3 years



Source: 2018 Global CEO Outlook, KPMG International

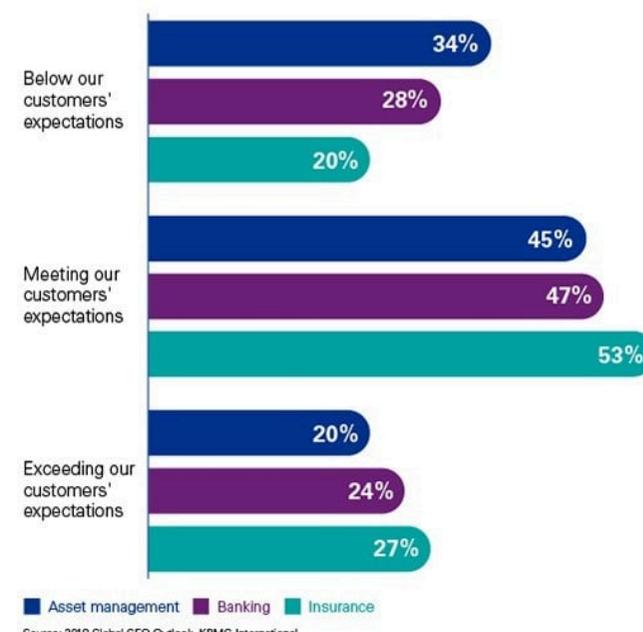
Perhaps a result of these muted growth projections, 57 percent of asset managers expect to increase their headcount by less than five percent over the three-year timespan. They are also looking at new markets to extract fresh growth, since 66 percent of asset managers state that emerging markets will be their priority - versus 32 percent who will focus on developed markets - especially in Latin America and Eastern Europe.

#### What's tempering their growth ambitions?

When we examine the underlying reasons for asset managers' subdued views on growth, we see several factors weighing upon them. First, senior leadership in our industry is not immune to concerns about how connected their enterprise is to their customers. In fact, whether we talk with retail-focused funds serving the mass affluent or high net worth segments, or firms catering to institutional clients, there is a consistent preoccupation with their ability to meet present or emerging customer demands.

Our survey highlighted this concern, in that only 45 percent of asset management leaders believe they are meeting customer expectations for a 'personalized' experience and 34 percent feel they are falling below customer expectations. Interestingly, asset managers are significantly less confident in their firm's success in this area when compared to their counterparts in banking and insurance. This may suggest that asset managers realize they need to catch up with their financial services peers in terms of how they are connecting with their customers and offering customer centric products, services and channels.

#### Financial services CEOs' perceptions of their organization's performance in meeting customers' expectations for a 'personalized' experience



Source: 2018 Global CEO Outlook, KPMG International

In addition, while asset managers may have in the past primarily linked customer satisfaction with investment performance, executives in our survey voiced concerns about learning to understand the needs of millennial customers, whether in terms of attracting their attention among competing online content or adapting their sales and distribution models to the next generation. In addition, our

survey found that the top priority among asset managers to support growth over the next three years is to make their products and services available via an online platform provider.

Second, while customer demands are paramount, asset managers are well aware of the potential impact of geo-political factors on their growth. Alongside their colleagues in other industries, asset managers rated the perceived 'return to territorialism,' including the uncertainty around Brexit in Europe and increased trade conflicts worldwide, as being the number one threat to their organization's growth. This attention to geo-political issues has increased significantly since we polled leaders in 2017.

#### Top five risks that pose the greatest threat to organizational growth

Rank #	Asset management
1	Return to territorialism
2	Environmental risk
3	Emerging technology risk
4	Operational risk
5	Reputational/brand risk

Source: 2018 Global CEO Outlook, KPMG International

This finding mirrors the concerns shared by alternative asset management clients who question their ability to continue to deliver top quartile returns in markets made volatile by political tumult. They are also uncertain whether they can expand their portfolios, sales or operations in attractive new markets if protectionist or increased regulatory actions take hold.

Third, while asset managers listed a number of top risks on their radar screens, it's noteworthy that cyber security risk climbed significantly from 2017, achieving a top five ranking among CEOs, whereas the issue barely made the top 10 list last year. While banking and insurance CEOs expressed greater concern with cyber security risks than asset managers - perhaps due to their larger customer exposure and greater public retail profile - asset managers are paying closer attention to the threat. This sentiment is clear when you consider that 58 percent of asset managers say that a strong cyber strategy is now a critical foundational element to engendering trust with key stakeholders.

### Overcoming the growth challenges

Despite the various growth inhibitors described above, we've witnessed bold moves among asset management clients to respond to these challenges. For example, a number of firms are actively forming strategic alliances (32 percent), enhancing or accelerating their organic growth (30 percent) and some (17 percent) are focused on mergers and acquisitions.

Many CEOs indicated that they are clearly embracing digital transformation, notwithstanding the long lead time and investment required. Notably, 98 percent of asset manager CEOs see technology disruption as more of an opportunity than a threat, and 73 percent are personally prepared to lead their organization through radical transformation.

However, 70 percent say the lead times to achieve significant progress on transformation can be overwhelming. A key takeaway is that - despite the fact that 91 percent were looking for significant returns within three years - there was a clear need to manage expectations with their board. Over half the CEOs (56 percent) say their boards and those

charged with governance have unreasonable expectations of such returns.

And, there's no doubt that asset managers are among the leaders in the application of artificial intelligence and predictive analytics to strengthen their portfolio performance. Among our survey respondents, 35 percent say they are now piloting/trialing AI in a small number of processes and 49 percent have begun limited automation of AI for some specific processes. These executives also report that they consider it highly important for their firm to hire emerging technology specialists, data scientists and cyber security experts.

#### Expected benefits from introducing artificial intelligence

Benefit	Asset management Ranked 1, 2, 3
Improve risk management	=1
Reduce operating costs	=1
Improve data governance	2
Improve data analytics capability	3

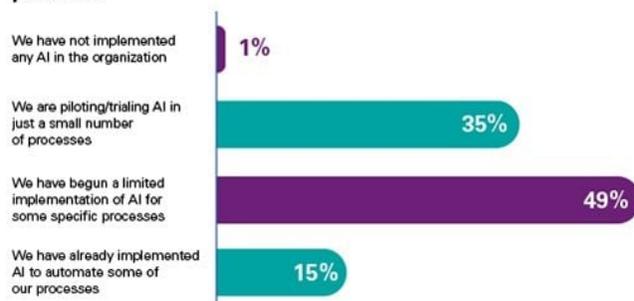
Source: 2018 Global CEO Outlook, KPMG International

However, our 2018 Global CEO Outlook definitely highlights some of the challenges these firms face moving forward. Among them, there is some hesitancy among senior executives to put absolute trust in new data & analytics techniques, over traditional methodologies and models. For example, 53 percent of asset management CEOs say they are less confident about the accuracy of predictive analytics than historic data. In addition, 67 percent of these executives say they have put their own experience or intuition ahead of the insights provided by data analysis models or computer driven models when they contradict. This suggests that leaders feel there is still work to be done to ensure the consistency and reliability of technology-driven methods, before they are ready for mass implementation across their firms' critical operations.

Similarly, a number of CEOs state that, while they believe that building third-party partnerships is critical to improving their business and operational agility, a quarter of respondents note the difficulty of sharing data securely with third parties and the challenges of measuring ROI from third-party partnerships. Fully 60 percent of asset managers recall that they reconsidered a partnership with a third party that could have helped achieve growth since there was not a good fit with their organization's culture and purpose.

Considering the insights from these senior executives, one can't help but be struck by the sheer volume and depth of the issues facing CEOs and how they are focusing their efforts as leaders to engage and solve them. By doing so, innovative alternative asset firm CEOs can overcome the 'growing pains' many have described, to meet or exceed their current modest growth ambitions,

#### Use of artificial intelligence in automating asset management processes



Source: 2018 Global CEO Outlook, KPMG International





# Securities Financing Transaction Regulation (SFTR) – An overview of the key challenges

by Duncan Carpenter, Pirum Systems Limited

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*Although the dust has barely settled from the implementation of MiFID II earlier this year, the regulatory requirements facing EU domiciled firms show no sign of abating. The Securities Finance Transaction Regulation (SFTR) first came into effect on 12 January 2016, however, with multiple EMIR rewrites, MiFID II, Brexit and GDPR stealing the headlines, it has only recently become a focus for much of the market.*



**By Duncan Carpenter**

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The regulation is part of the EU's approach to meet the objectives set out by the Financial Stability Board (FSB) aimed at increasing transparency post the financial crisis. Some of the obligations of SFTR regarding fund disclosures and collateral re-use have already been implemented since SFTR was first enacted. However, one of the main, and arguably most onerous, requirements is still to come. Article 4 requires in-scope market participants to report all SFTs to a registered Trade Repository (TR) on a T+1 basis. The SFTs in scope include repos, prime brokerage margin lending transactions, securities lending, buy/sell backs and commodities lending.

The SFTR reporting obligations apply to any counterparty to an SFT that is established in the EU (including their branches, wherever they are located) or any counterparty established outside the EU transacting SFTs through an EU branch.

Companies that need to report include:

- Investment firms and Credit institutions
- CCPs and CSDs
- UCITS, AIFMs, Insurance companies and Pension funds
- Corporates (NFCs)

To be clear, the reporting requirement applies to the principal counterparts in the trade. So in an agency lending structure, it is the fund rather than the agent lender who has the responsibility to report. It should be noted that for Alternative Investment Managers (AIFMs), it is the fund rather than the management company who is the in-scope counterparty of the transaction to report. Where a fund is in-scope, the responsibility to send the report under the regulation is passed to the AIFM.

Similarly, if a SFT takes place between a financial counterparty (FC) and a non-financial counterparty (NFC) then the FC is potentially obligated to perform delegated reporting on behalf of the NFC if the NFC meets certain criteria relating to their balance sheet, turnover and staffing numbers.

Counterparties can also optionally choose to delegate the reporting exercise to other parties, but from a regulatory perspective the responsibility for the report remains with the in-scope counterparty.

There are a limited number of exemptions such as SFTs with EU member central banks, other Union public bodies managing public debt, or the Bank for International Settlements who do not need to report transactions under the SFTR, although these transactions would potentially need to be reported under MiFID as a result.

### What are the main reporting requirements?

- SFTR is a two-sided reporting requirement, with both collateral provider (borrower) and collateral receiver (lender) required to report their side of the SFT to an approved TR on trade date +1 (T+1).
- All new SFTs, modifications of open SFT's and terminations of existing SFTs must be reported daily.
- As part of the two-sided reporting obligation a Unique Transaction Identifier (UTI) must be included by participants in their reports to the

TRs. This identifier will be used by the TRs to match separately received reports from each counterpart to an SFT.

- Participants must also use Legal Entity Identifiers (LEIs) to identify their counterparts along with many other parties involved in the SFT (e.g. Agent Lenders, CSD participants, CCPs)
- An extensive transaction, collateral, clearing and counterpart dataset needs to be reported which is up to 153 fields, depending on product and report type.
- A high number of matching fields (90+) combined with strict tolerances is likely to result in low matching rates post reporting. ESMA have provided a window of 24 months post implementation date to reconcile certain fields but the initial list is extensive and remains a significant challenge.
- For agency loans with multiple underlying principals, both borrower and lender will need to submit each allocation to a principal as an individually reportable transaction.
- SFTR reporting must also include any collateral linked to the SFTs including the LEI of the counterparty with whom the collateral was

exchanged and the master agreement under which the transaction was agreed.

- Collateral is reported on T+1 or value date +1 (S+1) dependent on the method of collateralisation used.
- Collateral re-use must be reported daily at S+1 by the reporting entity and not the counterpart.
- Participants also need to keep records of any SFT for a minimum of five years following its termination.

The final draft of the Regulatory technical standards was released by the European Securities and Markets Authority (ESMA) on 31 March 2017, and have been under review from the European Commission (EC) for almost fifteen months. The EC officially commented in late July and had advised that the standards will be adopted once some minor changes have been drafted which rather than affecting the substance of the regulation, merely explain which body has the future power to change and adopt standards.

More recently, ESMA has responded indicating it would not make the changes proposed by the EC,

which will likely result in some additional time as the two bodies come to a resolution on these remaining points. Allowing for those discussions and the subsequent adoption and approval process taking around four to five months, we expect the standards to enter into force some time during Q1 2019.

The first phase of reporting will come into effect 12 months after the Level 2 technical standards come into force, which would therefore result in a Q1 2020 go live date. The phased timeline is outlined below and, based on current expectations, this would mean that AIFM and UCITS management companies with funds established within the EU would have a go live date of Q3 2020.

### Challenges

There are numerous challenges in meeting SFTR requirements including UTI generation, the reconciliation demands, enhancing your connectivity to the market, and the task of reporting and sharing information in a timely manner. In addition to this, the exercise of gathering the required data for a single report is a significant challenge in its own right. The securities financing market is complex and disjointed in nature and typically there isn't a single platform or source that holds a comprehensive view of all the data that needs to be reported. This is particularly relevant for AIFs and beneficial owners whereby their full set of data is often only stored on their prime brokers (PBs) or Agent

Lender (AL) systems and not readily available to them to compose the report. This becomes more of an issue when you consider the daily life cycle events which must be captured, processed and reported also with a dependency on receiving timely feeds from their PBs and ALs. Additionally, many of the 153 data fields included on the level 2 regulatory technical standards such as CFI codes, issuer credit ratings and LEI of issuer sit outside the scope of many of these platforms. Therefore, the data gathering exercise must include enrichment from externally sourced reference data and third parties, which adds to the challenge and the cost significantly.

Due to these difficulties, many firms are now looking to expedite the data roundup by leveraging existing industry data pipes and partnering with trusted third-party vendors.

### Prime brokerage margin loans

In comparison to other asset types included in the regulation (stock loans, commodity loans, repos, buy/sell backs) which are reported per transaction, margin lending activity must be reported as an end of day position. Another notable difference is that

Phase	Institution Type	Time lapse from go live
First Phase	Investment Firms and credit institutions	Day One
Second Phase	CCPs and CSDs	+ three months
Third Phase	Insurance, UCITS, AIF, Pension funds	+ six months
Fourth Phase	Non-Financial counterparts (NFCs)	+ nine months

each margin lending relationship between a prime broker and its client will be assigned a single UTI for reporting purposes. This is maintained for the lifetime of the relationship between both counterparts, whereas for other asset types a UTI is required for every reportable transaction. Reporting of the margin lending position will be required whenever there is a net negative cash balance, or a positive short market value at the relationship level.

The margin lending report includes both the details of the margin loan between PB and client in base currency, alongside a breakdown of any credits/debits in the underlying currencies. Details of the portfolio used by the PB to collateralise the margin loan also need to be reported by both PB and client (where in-scope). As PBs do not allocate specific collateral based on the current net exposure with a client this effectively means the full composition of the collateral portfolio needs to be reported whenever there is a margin lending reporting requirement.

## **Conclusion**

As noted, for UCITS or AIF funds the management

company is accountable for reporting. Firms should talk to their PB's and service providers early, both to understand requirements and understand their approach. It should be noted that delegated reporting is permitted and potentially may be offered by PBs for in-scope clients. Third parties will often offer a modular solution whereby you can select a full end-to-end reporting service, or you could receive the prepared reports ready to send on to the chosen repository. It is vital to remember, however, that the regulatory obligation always remains with the counterparty to the trade. SFTR is a seismic challenge for all market participants and, with the deadline on the horizon, you must start preparing now.

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# UCITS performance fees in Ireland: Thematic review

by Christopher Christian, Mark Dillon and Jeff Mackey, Dechert LLP





**by Christopher Christian**  
Dechert LLP

The Central Bank of Ireland (the “Central Bank”) recently issued an industry letter highlighting issues identified during its recent thematic review of the calculation and payment of performance fees by UCITS. The review was carried out in parallel to its consultation on potential amendments to the Central Bank UCITS Regulations (CP 119).

The Central Bank, as part of its thematic review, reviewed a sample of approximately 30% of Irish UCITS funds which charge performance fees. In about 10% of those reviewed, the Central Bank



**by Mark Dillon**  
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identified instances of non-compliance with the Central Bank’s UCITS performance fee guidance (the “Guidance”).

The Central Bank industry letter, together with its accompanying press release, highlighted a number of key supervisory issues relating to the payment of performance fees by UCITS. The Central Bank industry letter is required to be brought to the attention of all members of the board of a UCITS management company (or board of the UCITS in respect of a self-managed investment company) (the “Fund Management Company”) and to the relevant responsible persons within the depositary



**by Jeff Mackey**  
Dechert LLP

of the UCITS (the “Depositaries”) and administrator of the UCITS (the “Administrators”) (together the “Fund Service Providers”). The Central Bank will have regard to the contents of the industry letter as part of future supervisory engagement.

Some of the main issues identified by the Central Bank were:

- In some instances performance fees were not calculated in accordance with the Guidance.
- Inadequate disclosure informing investors that, where performance fees are paid on the basis of achieving a new high net asset value

per share (the “High Water Mark approach”), fees may be accrued as a result of market movements rather than due to the performance of the investment manager.

- Where performance fees are based on the outperformance of an index, it was unclear as to which version of the index was being used in some cases.
- Poor practices were observed at Depositaries in the verification of the calculation of performance fees.
- Poor practices were observed at Administrators in certain areas of the calculation of performance fees.

The Central Bank’s Director General of Financial Conduct, Derville Rowland said: “We are concerned that the Guidance is not being applied in a consistent and comprehensive manner across Industry, which could lead to the overpayment of performance fees by UCITS and their investors.”

*“Investors in regulated funds have a right to expect that they will be charged the right fee and that the firms and individuals overseeing this process are operating to a high standard. The findings of this*

*review highlight the need for individuals within regulated firms to be vigilant, especially as we now move to have our Guidance on performance fees become binding rules. We are requiring all fund management companies whose UCITS charge performance fees to review their existing methodologies and confirm their compliance to the Central Bank, and we will continue to engage with those individual UCITS that were the subject of this review and to monitor fees charged to ensure that the best interests of investors are protected.”*

All Fund Management Companies managing UCITS that charge performance fees are required to confirm to the Central Bank, by 30 November 2018, that they have carried out a review of the existing methodologies in order satisfy themselves that performance fees charged comply with the Guidance. The confirmation will need to confirm whether in the course of the review:

- Any required changes to existing methodologies have been identified;
- Any required changes to prospectus disclosure have been identified;
- Any instances of improper payment of

- performance fee have been identified; and
- Actions are being taken to remedy the above.

In carrying out its review, the Fund Management Company should be cognisant of, and take appropriate action, to address the following:

- The Central Bank has identified cases where performance fees were calculated based on Gross Asset Value (“GAV”) contrary to the Guidance to pay UCITS performance fees based on Net Asset Value (“NAV”). UCITS performance fees must only be calculated based on NAV.
- The Central Bank also identified instances of UCITS calculating performance fees based on the outperformance of a benchmark or index, which did not appear to be relevant in the context of the UCITS policy, as set out in the Guidance. Any UCITS calculating performance fees based on outperforming an index must be able to demonstrate that the index is relevant in the context of the UCITS policy. As part of the review, the Fund Management Company should satisfy itself that the benchmark chosen complies with this

requirement and record in writing the basis for being so satisfied.

- The Central Bank, as outlined above, identified that, where performance fees are paid on the basis of the High Water Mark approach, such fees accruing may be the result of market movements rather than due to the performance of the Investment Manager. The Central Bank identified inadequate disclosure practices in this regard and considers that investors may not be fully aware of the circumstances which led to the payment of the performance fee.
- The Central Bank's review also identified instances where UCITS calculating performance fees on the basis of the High Water Mark approach were not using the initial offer price as the starting price for calculations as set out in the Guidance. Any UCITS calculating a performance fee on the basis of the High Water Mark approach must ensure that the initial offer price is taken as the starting price for calculations.
- The Guidance provides that any underperformance of the index in preceding periods be clawed back before a performance

fee becomes due in subsequent periods.

UCITS have been identified where underperformance of the index is only clawed back for a specified period. The Fund Management Company must satisfy itself that investors were not disadvantaged where clawback was limited to a certain period and amend the UCITS performance fee methodology to comply with the Guidance.

- Where performance fees are based on the outperformance of an index, the Central Bank found cases where it was unclear as to which version of the index was being used. The Central Bank requires that the prospectus clearly disclose the version of the index being used. For example, UCITS may consider disclosing the ticker code relating to the index in order to identify it.
- The Central Bank observed poor practices at Administrators in certain areas of the calculation of UCITS performance fees including:
  - Performance fees paid on invoiced amount issued by the investment manager without full reconciliation to the Administrator calculation; and

- Fund Administrators using pre-designed manual calculation tools created by investment managers of the UCITS without any independent validation of the methodology.
- The Central Bank requires that the Fund Management Company reviews the calculation procedures adopted by Administrators to ensure that the calculation of performance fees is applied in a consistent and independent manner.
- The Central Bank observed poor practices at Depositories in the verification of the calculation of UCITS performance fees (the "verification process"), including:
  - The verification process only being applied to a sample of UCITS performance fee calculations;
  - The verification process carried out post payment of the performance fee; and
  - The verification process only carried out where a performance fee is due for payment.

Where the Fund Management Company identifies any issues as outlined in the industry letter or any other instances of non-compliance with the Guidance, the Central Bank must be notified of the steps being taken by the relevant Fund Management Company to rectify the situation including any adverse impact on the UCITS and its investors.

The Central Bank will also commence supervisory engagement with the individual UCITS that were the subject of the Central Bank's thematic review.

### **Conclusion**

Given the scope of the review which Fund Management Companies are now tasked with conducting and the deadline of responding to the Central Bank by no later than 30 November 2018, Fund Management Companies should begin conducting the necessary reviews as soon as possible.

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# The right strategy, at the right price

by Ken Owens, PwC



*The alternative funds industry is changing fast. Investors are hyper-sensitive to value for money, and keenly aware of paying only for alpha, not for beta. They are also increasingly tuned into overall outcomes as opposed to simply raw performance, and are demanding better and customised strategies. All of this, they want at fee levels that many in the alternative investments industry would not have considered a decade ago.*



**By Ken Owens**  
**Partner, Asset Management**  
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This has significant distribution implications for alternative fund managers, as they adapt to keep pace with these growing demands, examining all aspects of their business and marketing models and making changes where they can.

### **The right strategy, at the right price**

In a recent collaboration between PwC and the Alternative Investment Management Association (AIMA), we examine the two-speed nature of the alternative funds industry and investigate, through a survey and interviews, how alternative fund managers are processing it. The survey was carried out among alternative fund managers in Europe, North America and Asia, many with extensive distribution networks. PwC also interviewed managers at a number of firms on a one-to-one basis to uncover specific detail about their sales practices.

This article explores some of the findings of our survey while sharing some key observations and insights gleaned from interviews with managers on their viewpoints on the industry.

### **The outcome is everything**

According to the alternative fund managers surveyed, investors see performance as paramount. The difference with the past is that, from the investors' perspective, performance is measured through a broader set of outcomes rather than absolute returns. Outcomes in this context being the delivery of solutions to specific investor needs, as opposed to a more simply defined product, drilling past pure performance to look at how that performance fits with investors' requirements. Whatever the aim, the key for alternative fund managers seeking further allocations is to identify individual needs of clients and then build in the flexibility and skill sets to meet these needs.

To keep their products relevant and meet the growing expectations of their investors, managers proactively monitor investor profiles. Pension plans, endowment, funds of funds and high net worth (HNW) investors are the biggest allocators globally to alternatives. But there are material regional differences.

### **Face-to-face access prized above all else**

The need to customise their offerings is driving managers' marketing behaviours. As capital is driven to fewer and larger alternative fund managers, other managers know they must articulate their value proposition with vigour and clarity to compete. It is not enough to have a niche strategy and peer-beating performance if those virtues are not reaching the right investors.

Alternative strategies have always depended to a degree on face-to-face communication and firms are prepared to invest considerable sums to get in front of prospective investors. As a large asset manager attests: "It's all about people. Digital distribution doesn't work for alternatives." The slow adoption of technology by many alternative investment firms for distribution purposes contrasts strongly with the adoption by alternative firms of technology for enhancing investment strategies. While the uptake of digital distribution will gradually expand, alternative fund managers indicate there are barriers to this expansion. Chief among them is regulation, closely followed by a lack of in-house expertise to operate platforms and also a lack of willingness on the part of some existing

investors to engage and transact via a digital platform.

### **Buyers hold whip hand on fees**

With global equities rising more or less consistently since early 2009, not all investors are willing to pay elevated fees for undifferentiated returns that have been available through passive tracker funds. Accordingly, in the current buyers' market, investors can exert considerable pressure on fees. The 2+20 fee structure for hedge funds is rapidly disappearing, with 1+10 more common, and even lower for large tickets or early bird investors.

But the fee adjustment is not completely over: just over a fifth of respondents say they will lower fees, either to attract new investors or retain existing ones. A large fund of hedge funds manager says it has lowered fees for its key "strategic partnerships" in order to retain assets, and plans to lower fees selectively to attract new investors.

Many alternative fund managers have reduced their fees over the course of the equity bull run and some may feel they have cut their margins to the bone. In addition, their operating costs are

rising as many invest in new technology and as competition rises for quantifiable investment skill. So, fees are not likely to move much further in the near term. More than three-quarters of respondents are not planning to lower their fees.

### **Politics unlikely to disrupt buying patterns**

The exit of the UK from the EU, due to take place in March 2019, has the potential to impact the alternative fund management industry the world over. Although a transitional period during which little will change until the end of 2020 is being negotiated, managers have already started to plan for change. Still, unless a 'no-deal' scenario materialises, investors and managers will be operating in the same environment for the next two and a half years.

It is too early to speculate on how the UK and EU will develop from the point of view of ease of cross-border distribution of funds.

But it is likely that the EU will most likely become marginally more restrictive in the way non-EU funds will be able to be marketed in the EU (it is already very difficult today), mainly by lowering barriers within the single market. The UK may

become more liberal as was witnessed, for example, by the UK regulatory authorities extending a temporary permission regime to EU firms to ensure the smooth operations of those entities under any potential scenario.

The biggest potential impact on the way EU markets will be accessed by non-EU firms will revolve around any changes to the rules on delegation of portfolio management. Currently, a great number of non-EU firms rely on the ability of their affiliates established in the EU to outsource portfolio management services to entities located outside the EU. If this regime continues without major disruption, difficulties with access to the EU market can be significantly mitigated. Brexit has started a debate on whether and how delegation rules ought to be changed, but significant change is unlikely to materialise in the near future – it is more of a medium-term prospect.

Finally, the industry is still processing the impact of the recently-enacted comprehensive US tax reform. This US tax reform will impact financial markets broadly and may have impacts on specific alternative investment strategies. Some strategies may see a marginal uplift to returns, and some may

be able to offer more tax-efficient opportunities to investors.

### **Conclusion**

The way alternative products are distributed has changed little since the products first appeared on investors' radar. But the world around alternative fund managers is changing fast: investors want a lot more from their alternative funds and demand lower fees at the same time. Many investors are also looking for more accessible alternatives via mutual fund structures, such as UCITS. Meanwhile, geopolitics is a perennial disruptor to distribution channels.

Alternative fund managers are responding but, in some cases, too slowly. Compared with their sophisticated investment strategies, the distribution activities of many alternative fund managers seem relatively clunky. The direct contact paradigm is a slow and expensive means of communications, which is decidedly dated.

Shorn of technology options and the accompanying economies of scale, costs for alternative managers are likely to rise in line with assets, making it hard to increase margins. And yet

assets managed by alternative funds keep rising, so they must be doing something right.

Far be it for us to suggest there should be wholesale change in the industry. We do not. But we do think that with more capital being allocated to fewer managers, only the savviest – those who understand that performance, strategy, consistency, and reputation must come as a package – will adapt and attract the size of flows that will allow them to compete going forward.

Please download a copy of the full report [here](#).

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# Understanding investor liquidity in hedge funds

by Tom Kehoe, AIMA

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## Ten years since the last global liquidity crash which catalysed the financial crisis of 2008, commentators are beginning to talk up the next one.

Following an unprecedented \$15 trillion in QE manifested globally through a series of monetary easing actions, central banks have begun to adjust monetary policy. The resultant tightening bias has

by Tom Kehoe

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led to a series of interest rate hikes being implemented by central banks this year (notably in the US, and the UK). Further, geo-political concerns, including protectionist policies of the Trump administration and Brexit, are creating currency tremors and inflationary pressures. All these factors combined have led to a substantial contraction in global liquidity, seen in the steep declines being experienced across some emerging markets already this year.

For fiduciaries, accurate intelligence and information are crucial. It is possible that we are entering a new season in our capital markets, and that the long bull-run since may be ending. To address this uncertainty and a climate of cumulative disruption, AIMA and the CAIA Association have released the fourth instalment in our series of trustee education: '[\*Efficient Flows: understanding liquidity in alternative investment funds\*](#)'.

The paper examines four facets of liquidity and how to conceptualise them across a varied alternative investment fund universe. The paper appraises the different liquidity types to the

different levels provided by a range of alternative investment funds. Apart from the efficient management of capital, liquidity concerns the alignment of manager and investor interests, who need confidence that they are being offered the greatest liquidity available without affecting the ability to grow capital. For managers, who must accommodate the needs of their investors, liquidity arrangements must also be tailored to their strategies.

### Investor Liquidity for Hedge Funds

During the 2008 financial crisis, the liquidity that some hedge funds had been able to offer investors under normal market conditions was not available. Unable to meet a wave of redemption orders, many hedge funds imposed gates or separated illiquid or hard-to-value assets into side pockets. Such contractual arrangements are not harmful, but investors need to understand them before committing capital.

Hedge fund strategies span the entirety of the liquidity spectrum in all its dimensions. Investors, therefore, need to understand the liquidity of assets in which managers invest on their behalf,

the liquidity requirements for strategies pursued by managers, the funding liquidity of such strategies as well as the liquidity provided to investors by the fund vehicles themselves.

In the period after the 2008 financial crisis, many hedge fund managers reacted positively to investors' demands for more control over fund liquidity and custody arrangements, and for more detailed information regarding their investments. Managers and investors began working together to create bespoke liquidity conditions for specific hedge funds and/or groups of investors, which then match the liquidity profiles of the invested instruments.

When structured appropriately, gates allow managers to offer redeeming investors reasonable levels of liquidity without taking on inappropriate asset-liability mismatches that could lead to instability for the fund and its investors. Accordingly, funds have restructured their investment vehicles to match the liquidity of their strategies and established investor-level gates to ensure fund managers are not forced to liquidate their portfolio to meet redemptions. Illiquid funds

use these more than those following more liquid investment strategies, with niche strategy funds deploying more fund level gates.

Liquid hedge funds are now adapting fund liquidity profiles that narrow the gap between themselves and traditional long-only investment fund offerings, which generally offer greater fund liquidity terms. Indeed, many of these funds now provide monthly liquidity options, and industry rule-makers enforce particular requirements of certain structures. UCITS funds, a form of regulated hedge fund structure offered in European markets, must offer bi-weekly liquidity as a minimum. Funds compliant with the Investment Company Act of 1940 ('40 Act funds') regulations must also offer regular liquidity, with redemptions being paid within seven days.

Some hedge fund strategies like investments in distressed securities are most often long-term and illiquid, and infrequent redemption periods are common. For managers that pursue these strategies, it is essential to have a large pool of committed capital so that liquidity does not become a problem. For these strategies, frequent liquidity windows, such as on a quarterly or semi-

annual basis, work against the nature of the strategy and the fund's investors. However, many illiquid funds are now launching new share classes with more favourable investor liquidity terms, such as soft lock-ups.

Many hedge funds are now open to the idea of managed accounts and the concept of providing associated levels of transparency. Such accounts are individually customised to meet an investor's specific goals for the security, return and liquidity of its investment(s). Having such an arrangement gives the investor the scope to set the hedge fund manager a specific investment mandate offering improved liquidity, transparency and investor control. Most arrangements allow for the fund's underlying positions to be viewed on a live basis with daily reporting. They also allow clients to segregate their investments in vehicles separate from the manager's main hedge fund, meaning investors retain control over their assets, usually with the ability to redeem much more frequently than the main fund. With this structure, the investor is much better positioned to assess the actual liquidity of the fund with fewer levels of liquidity to consider.

According to Credit Suisse\*, demand among institutional investors for managed accounts reached a seven-year high in 2018, with 58% of investors in a recent survey indicating that they currently invest in managed accounts, and a further 29% saying that they plan to increase their allocations.

When setting compensation levels, there are many factors to consider. As investors become more experienced regarding the types of portfolio solutions that they want, the investor liquidity on offer should be a key consideration when setting the appropriate fee structure to pay their investment manager.

In a further sign of investors and hedge fund managers aligning their interests, some of the industry's largest investors in hedge funds acknowledge that when hedge funds offer greater levels of liquidity they should be compensated accordingly. Albeit this is an emerging trend, it's unlikely that any compensation being agreed between the hedge fund manager and investor will be ultimately settled by what level of liquidity is on offer to the client.

In short, liquidity is about the efficient management of capital: releasing it when it can be released and holding it when doing so will lead to greater returns. Investors should be confident that their managers are offering them the most liquidity possible without jeopardising their ability to protect and grow that capital. Asset managers, meanwhile, must account for the liquidity needs of their investors, while at the same time ensuring that their funds' liquidity arrangements are tailored to their strategies. We trust this latest paper will be considered a valued source for trustees and other fiduciaries wishing to learn more about this important area of finance.

\* Mass Appeal, Bespoke Approach: A Tailored View of Managed Accounts, Credit Suisse (2018)

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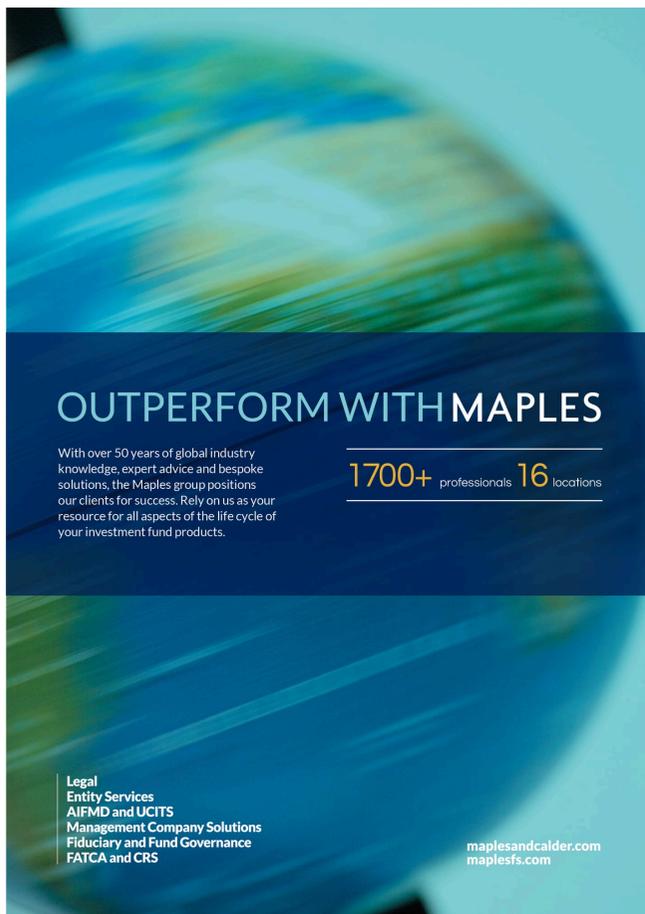
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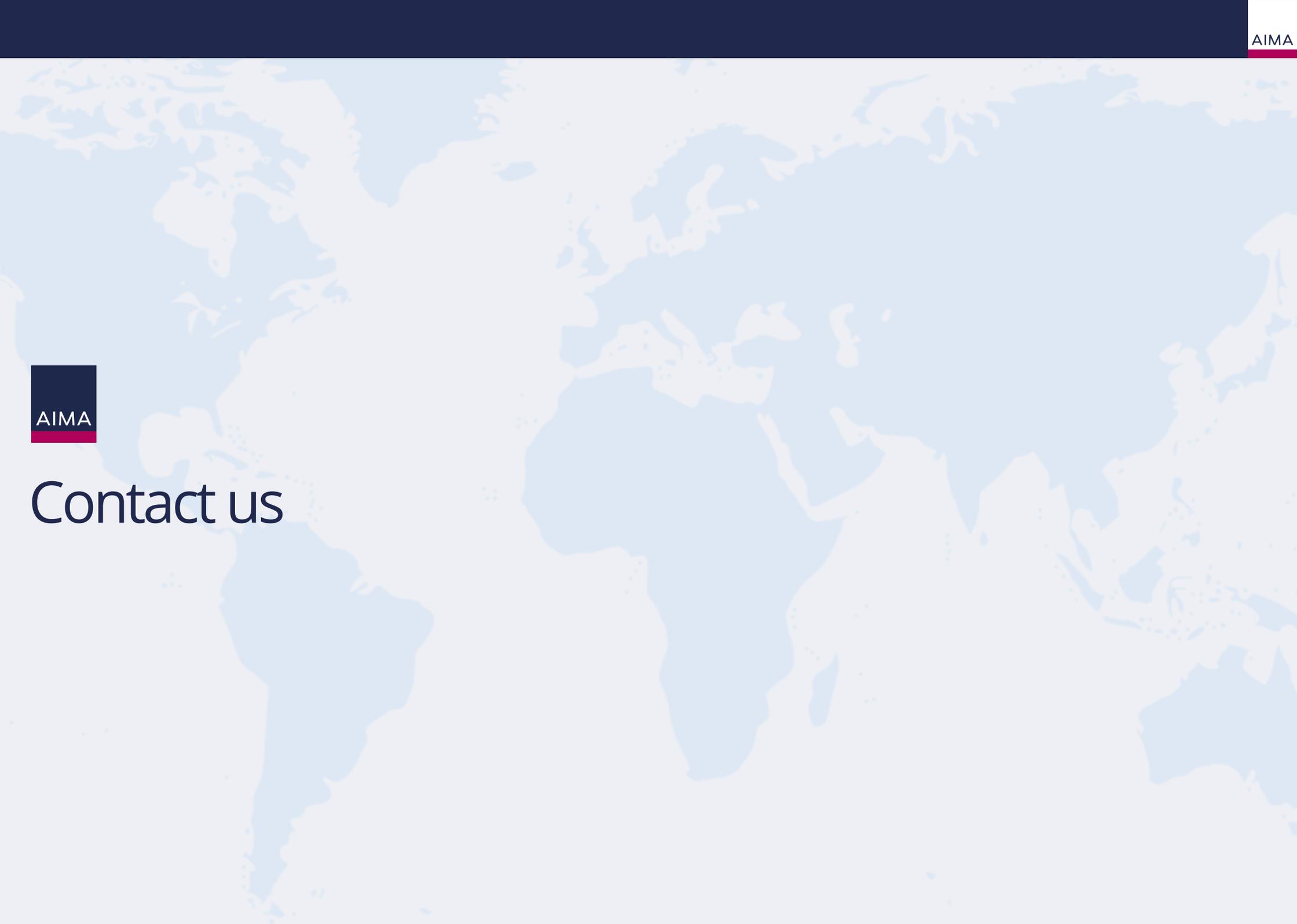
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