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When DeFi meets securities laws - A regulatory overview - *PwC Hong Kong*

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Morningstar

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Bill Kelly,
President and CEO of CAIA Association

For more information visit aima.org/media/the-long-short.html

Message from AIMA's CEO

Jack Inglis
CEO, AIMA

I always find the AIMA Journal an excellent bellwether of where the alternative investment industry is focusing its attention at the moment. It provides a peak through the shop window at the work being done by some of the brightest minds in the business.

In Q3 2022, the emphasis is on dissecting the deluge of new regulations and tax proposals currently facing the industry. The US SEC is leading the charge in this regard, although regulators in the UK, the EU and Hong Kong, among others, appear to be equally busy. As articles in this edition explain, not all rule changes are inherently burdensome, and some provide opportunities for fund managers. AIMA, for its part, is working closely with rule-makers in all these jurisdictions on behalf of its members to ensure new rules are fit for purpose.

Speaking of Hong Kong, many column inches have been dedicated recently to discussing to what extent the city-state is risking its position as a premium global financial hub amidst its protracted stringent COVID-19 rules. However, the discussion of a potential 'brain drain' has arguably been a distraction from the government's work to benefit the asset management industry. Journal contributors within correct this oversight.

Elsewhere, financial market commentators appear split on whether a global recession is imminent, or even already underway. Although the latest performance figures from industry data providers show hedge funds posting far superior numbers compared to popular equities indices, they are not immune to macroeconomic forces. It is therefore interesting to note the emphasis of contributors on improving operation efficiency through outsourcing, digitisation and outsourcing as a way to mitigate the challenges of the moment.

Comments on digital assets are notably absent from this edition, reflecting what many industry observers are dubbing the new 'crypto winter', with many asset prices lingering well below 2021 highs. Contributors that do discuss digital assets capture the mood of the moment with a focus on the increased scrutiny by regulators, a theme that has been echoed in the conversations we hear among policymakers globally and our members.

Finally, I would also like to take this opportunity to highlight a new initiative for the AIMA Journal. Given the growing popularity of the Journal, we are receiving an increasing level of interest from AIMA members and non-members to contribute content. In order to best meet this demand and continue to produce the highest quality and diversity of industry thought leadership, we will be making some changes to our production model.

Under this new model, all AIMA (non-Sponsoring Partner) members are entitled to contribute one free article (with the option of an advert) per year with an option to pay for additional content (and/or an advert) in subsequent Journal editions during the year. Non-members also have the option to pay for content (including an advert) per each edition of the journal. AIMA Sponsoring Partners will not be charged and will continue to have the possibility to submit free of charge to each edition of the AIMA journal, subject to any capacity limits that may occur per edition.

Please do contact my colleague Caterina to learn more about this opportunity.

As always, my sincere thanks to all contributors for their insights.

Jack Inglis
CEO, AIMA

Upcoming AIMA conferences

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29 Spetember 2022
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5 October 2022
AIMA European Digital Assets Forum 2022

13 October 2022
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Finding stability in an unpredictable world

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- Firms – should ensure they are meeting their financial sanctions / Anti-Money Laundering (AML) obligations in the light of the ongoing conflict in the Ukraine
- The UK's Financial Conduct Authority (FCA) has a full agenda, which includes regulatory reform post-Brexit, 'green' finance, financial promotions, market abuse, and transaction reporting.
- The US SEC is developing new rules around environmental, social, and governance (ESG), cyber risk management, and crypto assets.

Ukraine Conflict

The past two years have been tumultuous for financial firms and their compliance teams; and the conflict in Ukraine has meant that compliance managers have had a busy start to 2022. Recognising that this is a rapidly evolving situation, we recommend that firms:

- Review their financial crime systems and controls, particularly in relation to financial sanctions. This should include the review of clients and investors against those ever-changing, ever-growing lists of sanctioned persons and institutions.
- Liaise with third party administrators and other vendors, to seek confirmation that they too have taken appropriate steps to implement their sanctions obligations.
- To the extent that assets within those strategies include Russian company-issued equity or debt, review those investments in the light of the sanction measures. Take a forward-looking approach to any potentially new prohibitions that may be imposed.
- Those in the private markets space should assess the exposure of their portfolio companies to Russia and Russian-recognised territories and the Ukraine, taking particular care with supply chains.
- Consider the firm's cybersecurity in the light of these events. The FCA published a Dear CEO letter to banks only recently warning them of the threat of Russian cyberattacks. These warnings should be heeded by all firm types. Business continuity and operational resilience, as well as training for staff should be re-evaluated in the coming weeks.

Meanwhile, regulators in the UK and the US are pressing ahead with their respective agendas in 2022.

The US SEC's focus for 2022

In the US, the Securities and Exchange Commission (SEC) has one of the fullest agendas that it has ever had. Its priorities include:

- **ESG** – The SEC published an ESG exam priority document on 30 March 2022, and stated that ESG will remain an examination priority in 2022, with the regulator getting down into the weeds of firms' ESG programmes. Firms can expect to see, for the first time, ESG and climate risk related enforcement cases in 2022. New rule proposals are also expected soon for disclosure of ESG information and climate risks in public company filings and public statements. Asset management firms should also expect disclosure rules designed for their industry from the SEC in 2022.
- **Private funds** – The SEC has also come out with a new private funds proposed rule, which is a very significant sea change for what the regulator expects from that industry. For insight into the regulator's thinking behind these changes, firms should look at the two risk alerts published in the summer of 2021 and in January 2022. The proposals would require quarterly statement reporting around fees, expenses, and performance. They also prohibit certain activities, to eliminate certain conflicts of interest the regulator has been concerned about.
- **SEC's new marketing rule** – The US SEC's new Marketing Rule (Rule) is the long-awaited modernisation of the rules governing the advertising and cash solicitation practices of SEC-registered investment advisors. The Rule was approved in December 2020 and came into effect in May 2021.

  The final compliance date is the 4 November 2022. Given the changes and potential work that many firms will need to do to comply with these new rules, it is important that registered investment advisors – wherever they are located in the world - are actively taking the relevant steps now to understand the new rule and how it will impact their current marketing materials. Implementation will require considerable planning and work by registered investment advisers. Steps firms need to take include:

  - Review the firm's policies and procedures against the new SEC requirements;
  - Conduct a gap analysis and refresh those policies and procedures to bring them up-to-date;
  - Evaluate all of the firm's marketing materials, as these need to be compliant by the 4 November deadline;
  - Provide training on the new Rule to all staff; and
  - Update the firm's books and records retention to include the new books and records requirements. Firms will also need to prepare to provide further Form ADV disclosures to comply with the new Rule

UK FCA priorities

In the UK, the Financial Conduct Authority's (FCA's) key themes are:

- **UK Future Regulatory Review and international competitiveness** – the regulatory review was initiated back in 2019 as a conscious attempt to reform the architecture of UK regulation in the aftermath of Brexit. The project has progressed to a recent consultation about the respective roles of the government, parliament, and the regulators. The Chancellor recently confirmed that a package of measures will be included in the Queen's speech later in 2022. Over the medium term, potential outcomes of this new structure could include a much-rationalised FCA handbook. A second review, focusing on the UK funds industry, is promising measures that will make the UK a more competitive jurisdiction for fund structures and administrators. The third review, focusing on the wholesale markets, will result in a set of proposals put out to consultation in H2 2022.

- **UK MiFID and AIFMD reforms –** so far, the FCA has made a series of 'quick fix' changes to the way Markets in Financial Instruments Directive (MiFID II) is implemented in the UK, which are similar, but not identical, to changes that the European Union (EU) has recently made. Firms need to be quite agile to ensure they meet the MiFID II obligations in both regimes. UK firms are likely to face a similar situation with the EU's coming Alternative Investment Fund Managers Directive (AIFMD II) reforms.
- **New financial promotions regime –** although the primary focus of the UK Treasury and FCA proposals is on protecting retail investors, there are elements that will have an impact on wholesale firms. For example, there is a proposal for a gateway for regulated firms wanting to approve financial marketing materials from non- regulated firms. There has also recently been a consultation on a review of the rules for the promotion of high-risk investments, including crypto assets. This will include a new category of restricted mass market investments, that will be subject to enhanced risk warnings and a prohibition on financial inducements.
- **Compliance programme considerations –** market abuse remains a high priority for the FCA, just as it has been for some time now. The FCA has warned about how market abuse risks have evolved as a result of the conflict in Ukraine. Transaction reporting is likely to remain another big priority for the FCA over the coming year, as it continues to be underwhelmed by the quality and timeliness of the data being submitted by financial firms. Work by ACA has shown that 97% of transaction reporting and European Markets Infrastructure Regime (EMIR) reporting by firms has errors. Firms may want to undertake an operational review of the processes used to meet these regulatory obligations. Lastly, firms – including private market firms – are engaging with the new climate-related disclosure obligations and will be facing many more over the coming 18 months as the FCA fleshes out its ESG Sourcebook.

Although the past two years have been disruptive for governance, risk, and compliance (GRC) teams because of the COVID-19 pandemic, the next twelve months are set to be no less challenging albeit in new ways. Preparing for the challenges of tomorrow becomes no less intense as we watch the human cost, horrors and uncertainty caused by conflict in Europe, seek to manage growing inflationary pressures and the navigate fluctuations of the post pandemic recovery. GRC professionals are having to manage these external pressures in the context of a hyper competitive job market, a growing regulatory and ESG agenda both sides of the Atlantic, and the expectations of getting more from less.

It's clear that firms can no longer manage the GRC burden on a project-to-project basis, throwing bodies and spreadsheets at a deadline and then moving on. Rather, GRC teams need to think about these changes strategically, and encourage their organisations to do so as well. By taking a more holistic view of the demands that they are being placed under, and employing technology, not only can costs be reduced but the resultant enhanced efficiency provides opportunity to allow the expertise of real people to focus on the high value matters, staff development, retention, and risk mitigation.

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CRS and economic substance developments in the new compliance culture

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A current trend in global regulation is to ensure not only implementation of rules created by supra-national bodies, but also of their application. By way of example, the Financial Action Task Force (**FATF**) or the relevant FATF-style regional bodies assess countries AML regimes globally on an ongoing basis, examining such regimes for both 'technical compliance' (i.e. whether the FATF recommendations have been implemented in local law) and 'effectiveness' (i.e. whether such local laws are being applied and enforced).

The Cayman Islands is recognised by the FATF as compliant or largely compliant with all 40 FATF technical compliance recommendations. Efforts to demonstrate effectiveness of the anti-money laundering regime in enforcing anti-money laundering, counter terrorist and proliferation financing requirements have been positively noted by the FATF. In the context of the FATF review of the Cayman Islands, the jurisdiction has recently seen increased enforcement measures relating to a number of its regulatory laws including the *Tax Information Authority* (International Tax Compliance) (Common Reporting Standard) *Regulations* (As Revised) (the **CRS Regulations**) and the I*nternational Tax Co-operation* (Economic Substance) *Act* (As Revised) (the **ES Act**).

CRS enforcement

Since implementation of the CRS Regulations on 1 January 2016, the Cayman Islands Tax Information Authority (the **TIA**) has obtained specified financial account information from Cayman Islands Financial Institutions (**FIs**) and automatically exchanged that information with over 100 CRS reportable jurisdictions on an annual basis. Among other businesses, all Cayman Islands investment funds fall within the definition of an FI and are required to comply with the CRS Regulations.

The TIA has recently issued enforcement guidelines which build upon the administrative penalty provisions in the CRS Regulations and the CRS guidelines published by the TIA.

What do you need to know?

The enforcement guidelines set out the TIA's procedure for investigating breaches of the CRS Regulations. Firstly, a notice (or warning) of a breach is communicated to the principal point of contact (**PPOC**), the authorised person (**AP**) or the registered office of a Cayman Islands FI. The notice details the reason the TIA believes a breach of the CRS Regulations has occurred and the proposed penalty to be imposed including the requirements to remedy the breach. The enforcement guidelines include a table of indicative administrative penalties for given breaches. For example, the indicative penalty for failure to register as a FI by the relevant deadline is approximately US$45,000. Failure to establish and maintain written policies and procedures could lead to a fine equivalent to approximately US$9,000.

The recipient of the breach notice has 60 days to make written representations in response to the notice. If the TIA nevertheless decides to proceed to impose either the same or a lower penalty, a penalty notice is sent to the PPOC, the AP or the registered office. The recipient has only 60 days to appeal to the Cayman Islands Grand Court against the decision to impose the penalty, its amount or both.

The TIA has already sent breach notices to various entities. Reasons for these include where the TIA believes an entity has not separately registered with the Department of International Tax Cooperation (the **DITC**) on its online Portal (the AEOI Portal) when the TIA believes it should have done so, or where an entity has failed to respond to an information request. We expect more activity in this area over the coming months.

What do you need to do?

Entities should ensure:

- CRS (and FATCA) classifications are correct (especially if the entity has a US Global Intermediary Identification Number or is registered on Cayman Islands Monetary Authority's (**CIMA**) website but does not have an FI number), and the entity has registered on the AEOI Portal where applicable;
- The DITC can contact the PPOC by email (add no-reply@ditc.ky to your safe senders list.);
- CRS written policies and procedures are in place and being implemented;
- Reliable and complete account holder / investor self-certifications have been received at the time of on-boarding;
- Changes in the circumstances of account holders are monitored;
- CRS reporting is accurate and completed in a timely manner; and
- CRS compliance forms are submitted accurately and in a timely manner.

As the TIA increases their enforcement activities and continue to impose significant penalties for non-compliance, whether or not intentional, it is worth considering if your knowledge of the requirements and implementation of your policies and procedures are robust enough to withstand scrutiny. If in doubt it may be worth considering outsourcing of certain functions to service providers with expertise in this area. Although it is not possible to outsource ultimate responsibility for an entity's compliance, you will be able to rest easier if you engage an expert assist to you with the bulk of your CRS compliance obligations.

Economic substance developments

The TIA is also responsible for monitoring compliance with the ES Act. The ES Act is responsive to global OECD Base Erosion and Profit Shifting (**BEPS**) standards regarding geographically mobile activities. Very broadly, 'relevant entities' carrying on 'relevant activities' are required to satisfy certain economic substance (**ES**) tests. Requirements of this type have been implemented on a level playing field basis by all OECD-compliant 'no or only nominal tax' jurisdictions.

In June 2022, the TIA published ES enforcement guidelines. The ES enforcement guidelines provide industry with a degree of certainty with respect to the TIA's approach to enforcement action under the ES regime.

Apart from ensuring effective implementation, enforcement action assists in demonstrating to the international community, in particular, the OECD, that the ES regime in the Cayman Islands is achieving its objectives.

What do you need to know?

Unlike enforcement under CRS, the ES enforcement process does not include a 'breach notice' step, allowing for representations to be made to the TIA. Instead, a 'penalty notice' may be issued. The relevant entity may appeal the penalty to the Grand Court within 30 days after a penalty notice has been issued in relation to a missed reporting, and within 28 days after a penalty notice has been issued in respect of a failure to satisfy the ES test. These are extremely short periods in which to prepare and lodge an appeal to court.

The ES enforcement guidelines provide a set of principles, which are intended to guide the TIA in its exercise of discretion when deciding whether ES requirements have been met, and if not, in determining the penalty to be imposed. Adherence to these principles is expected to produce consistency of enforcement while delivering fair results.

Administrative penalties may be imposed for (i) missed reporting by an entity that is required to satisfy the ES test (this includes continuing daily fines) (ii) failure of the ES test in Year 1, and (iii) failure of the ES test in a subsequent financial year. Importantly, the ES enforcement guidelines provide 'baseline penalties', and the TIA may issue different penalty amounts (within the maximum penalties allowed by the ES Act) to fit the circumstances of each case.

If it comes to the TIA's attention that an entity has misclassified itself, and the deadline for the entity to submit its ES return has passed, the TIA will consider the entity to have missed its reporting requirements under the ES Act and issue a penalty notice to the entity. The entity will then have 30 days from the date of the notice to submit an ES return to the DITC Portal.

If the entity fails to submit an ES return within the deadline, the entity will be deemed to have failed the ES test and will be assessed the maximum applicable penalty under the ES Act.

Where the TIA has determined that there has been a breach, a penalty notice will be issued to the entity's Responsible Person (**RP**). Where there is a missed reporting, the penalty notice will set out certain prescribed information.

What do you need to do?

Entities should ensure:

- ES classifications are correct;
- ES returns have been filed accurately and on time; and
- The contact details of their RP are up-to-date (add no-reply@ditc.ky to your safe senders list).

Conclusion

Since the publication of the enforcement guidelines in March 2022, the TIA has initiated enforcement action under both the CRS and ES regimes. In this regard, we have recently seen notices in respect of CRS and letters of enquiry for ES purposes from the TIA. The guidelines aim to ensure procedural fairness, and should bring greater certainty to the TIA's enforcement processes. This should provide some comfort to entities which are subject to enforcement action. However, entities will reap much greater rewards from being proactive in ensuring compliance with the relevant CRS and ES requirements. To the extent possible, entities should focus efforts on ensuring there is no need for enforcement action to be taken against them in the first place. Understanding their CRS and ES obligations, and putting in place sufficient resources and efficient systems to comply with CRS and ES requirements are good places to start.

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Re-domiciliation of offshore funds to Hong Kong

Fiona Fong
Partner
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In November 2021, Hong Kong introduced legislation to provide for the re-domiciliation of offshore corporate funds to Hong Kong. Deacons worked on the first case, successfully bringing a private Cayman Islands corporate fund to Hong Kong as a re-domiciled open-ended fund company (**OFC**).

According to the Asset and Wealth Management Activities Survey 2021 (**2021 Survey**) issued by the Securities and Futures Commission (**SFC**), as of 31 March 2022, a total of 62 OFCs with 118 OFC sub-funds (including 23 ETFs with a total market capitalisation of HK$13 billion) have been set up.

This article discusses the process and benefits for existing offshore investment funds to re-domicile and register as an OFC in Hong Kong.

Legal regime

The Securities and Futures (Amendment) Ordinance 2021, which came into effect on 1 November 2021, established a new fund re-domiciliation regime whereby existing funds set up in corporate form outside Hong Kong can re-locate their registration to Hong Kong as OFCs. This regime is administered by the SFC.

Process

The process for re-domiciliation can be split into three stages:

Stage 1 (pre-submission preparation), this involves carrying out a feasibility assessment to ensure that:

1. The fund has only one place of incorporation and registration. It cannot be registered in multiple jurisdictions at the same time.

2. The fund is solvent, i.e. the fund will be able to pay its debts in full within 12 months from the date of the fund's re-domiciliation application. Furthermore, there is not any petitions or orders to wind up or liquidate the fund in any place, or any appointments of receiver or liquidator. The fund is not operating under any scheme, order or compromise relating to its insolvency.

3. The constitutive document of the fund and the laws of its place of incorporation do not prohibit the proposed re-domiciliation and the intended de-registration of the fund in its place of incorporation respectively.

4. Approval for the proposed re-domiciliation in accordance with the constitutive document is obtained, which typically requires special resolutions of existing shareholders.

5. Creditors of the fund are notified regarding its proposed re-domiciliation.

6. Consent or approval pursuant to contracts entered into by the fund is obtained or waived in relation to the proposed re-domiciliation and the intended de-registration in the fund's place of incorporation.

7. All key operators of the fund can comply with the eligibility requirements of an OFC.

Stage 2 (application to the SFC – approximately 14 business days), this involves:

1. Applying to the SFC for its approval on the re-domiciliation by submitting to it the requisite forms, fund directors' confirmations, the proposed Instrument of Incorporation for the OFC and fees payable to the SFC, the Companies Registry (**CR**) and the Inland Revenue Department (**IRD**). Amongst others, basic information on the key operators (i.e. the directors, the investment manager and the custodian(s)) needs to be submitted to the SFC.

2. The SFC, upon approval of the application, registering the fund as an OFC and notifying the CR of such registration as soon as reasonably practicable. Thereafter, various certificates are issued to the re-domiciled OFC, including a certificate of registration by the SFC, a certificate of re-domiciliation by the CR, and a business registration certificate by the IRD. The registration of re-domiciled OFC takes effect on the re-domiciliation date, which falls on the issue date of certificate of re-domiciliation.

3. Filing with the SFC the fund's certificate of de-registration issued in its place of incorporation within 60 days after the re-domiciliation date.

   In relation to regulated mutual funds in the Cayman Islands, a certificate of de-registration can be issued by the Registrar of Companies of the Cayman Islands within a matter of days after an application is lodged. A separate application is to be made to the Cayman Islands Monetary Authority (**CIMA**) for cancelling the certificate of registration of the fund as a regulated mutual fund due to a transfer to another jurisdiction. For this purpose, documents to be submitted to CIMA includes the fund's audited accounts in respect of the final financial year that it remains registered with CIMA.

Stage 3 (post-re-domiciliation), this involves:

1. Updating the offering document of the fund to reflect the new OFC structure and to comply with the disclosure requirements under the Securities and Futures Ordinance, the Code on Open-Ended Fund Companies (**OFC Code**) and the Securities and Futures (Open-ended Fund Companies) Rules; and issuing the revised offering document to shareholders.

2. Filing a copy of the offering document with the SFC as soon as reasonably practicable following its issuance.

Benefits

The move to Hong Kong is attractive to fund managers with existing offshore investment funds as there are many benefits associated with the use of OFC in Hong Kong. In particular, such benefits include:

1. Cost savings

The OFC is considered as a very cost-effective solution due to the low incorporation and maintenance fees. The re-domiciliation regime provides legal and tax certainty to overseas corporate funds which migrate to Hong Kong as OFCs.

Hong Kong stamp duty will not be triggered by the re-domiciliation of a fund to Hong Kong as there is no change in the legal personality of the fund, and therefore no transfer of assets between legal entities or change of beneficial ownership of the underlying assets of the fund.

2. OFC grant scheme

One of the major initiatives provided by the Hong Kong Government for the incorporation of OFC or re-domiciliation of an overseas corporate fund to Hong Kong is the OFC grant scheme. The grant scheme accepts applications from 10 May 2021 until 9 May 2024. According to the 2021 Survey, the total number of registered OFCs has more than quadrupled since the introduction of the OFC grant scheme.

Hong Kong-based asset managers can apply for a grant which covers up to 70% of the incorporation costs for new OFCs (or the expenses incurred by overseas corporate funds in moving to Hong Kong and registering as OFCs), subject to a cap of HK$1 million per OFC.

Under the grant scheme, a manager can establish up to three OFCs. Each OFC and its sub-funds created at the time of incorporation count as one use of the grant. Managers need to apply to the SFC under the grant scheme within three months from the date of incorporation of the OFC or the re-domiciliation date (as the case may be). The SFC processes grant scheme applications on a first-come-first-served basis.

Eligible expenses under the OFC grant scheme are expenses paid to Hong Kong-based service providers relating to the incorporation of an OFC or the re-domiciliation to Hong Kong of a non-Hong Kong corporate fund. Examples of such expenses include fees relating to legal services, audit, tax and accounting services, corporate services and regulatory compliance services.

The Government reserves the right to claw back the grant if an OFC commences winding-up or applies for termination of registration within two years from the date of the OFC's incorporation or re-domiciliation.

3. Existing corporate identity

A fund retains its corporate identity after becoming a re-domiciled OFC in Hong Kong. Furthermore, the fund preserves the continuity of its track record. A re-domiciled OFC is not required to re-enter into contracts with its key service providers such as, the investment management agreement, the fund administration agreement and the custody agreement.

4. Convenience

Another main advantage to setting up an OFC relates to its convenience and speed.

The SFC adopts a "one-stop process" whereby applicants submit all application documents and associated fees to the SFC, and the SFC forwards the relevant paperwork to the CR to incorporate or register the OFCs. Currently, private OFCs are typically registered by the SFC within 7 to 14 business days.

5. Market access opportunities

Hong Kong is a preferred fund domicile for many fund managers and investors due to its proximity to Mainland China. Further, Hong Kong possesses a strong community of investors and professional service providers and also an active market for initial public offerings.

Key operators of an OFC

Directors

An OFC must have at least two directors who are natural persons, aged 18 or above and not an undischarged bankrupt (unless with leave of the court). At least one of the directors must be an independent director, who is not a director or employee of the custodian. The proposed appointee must have appropriate experience and expertise and be of good repute.

Custodians

Eligible custodians include banks, trustee companies, SFC licensed corporations or registered institutions for type 1 (dealing in securities) regulated activity meeting the eligibility criteria under the OFC Code. Overseas prime brokers are also eligible to act as custodians for private OFCs so long as they meet certain requirements under the SFC's Code on Unit Trusts and Mutual Funds. Multiple custodians and sub-custodians are also permitted.

Managers

An investment manager of private OFCs is required to hold a licence with the SFC for type 9 (asset management) regulated activity; meet the relevant "fit and proper" requirements; and comply with the SFC's Fund Manager Code of Conduct and other conduct requirements.

Investors

Information about an OFC's shareholders is not required to be provided to the CR. An OFC's shareholders' register is not public information and is maintained by the OFC itself. However, the SFC and other government bodies can inspect the register and the SFC has the power to request shareholder information from the investment manager, as is the case in respect of offshore funds managed by SFC-licensed investment managers.

First re-domiciliation case

As highlighted in the 2021 Survey, the SFC recently registered the first private Cayman Islands corporate fund as a re-domiciled private OFC in Hong Kong in April 2022. Deacons acted for the investment manager in this case and is proud to have assisted with this landmark development in Hong Kong.

Conclusion

As the Hong Kong Government continues to provide initiatives to benefit the asset management industry, coupled with the above benefits brought by the re-domiciliation regime in Hong Kong, we expect that there will be an increasing trend of investment managers adopting Hong Kong-domiciled fund structures.

Chinese regulator publishes the draft China SCC

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The Cyberspace Administration of China published the long-awaited standard contract for cross-border data transfer on 30 June for public comment.

The Cyberspace Administration of China (CAC) published the long-awaited standard contract for cross-border data transfer on 30 June for public comment, which supplements the requirements under China's Personal Information Protection Law (PIPL) that came into effect since 1 November 2021. Among others, data exporters are required to assess the impact of data protection laws and policies of the destination jurisdiction on the enforceability of the standard contract.

Cross-border data transfer regime under Chinese law

Pursuant to PIPL, personal information processors (ie equivalent to data controllers under GDPR) may transfer personal information out of mainland China by satisfying one of the following different routes, including: (i) clearing a security assessment organised by the CAC (this is also the only option applicable to operators of critical information infrastructure (**CIIO**) and personal information processors that process personal information exceeding the volume threshold determined by the CAC); (ii) obtaining a personal information protection certification from a professional institution designated by the CAC (**Certification**); or (iii) entering into a standard format data transfer agreement with the overseas recipient (**Standard Contract**).

Standard Contract

The Standard Contract route is similar to the provision of standard contractual clauses (**SCC**) under EU's General Data Protection Regulation (**GDPR**) and is often referred to as the China version SCC for simplicity.

The CAC published the Draft Provisions on the Standard Contract for Personal Information Cross-border Transfer (in Chinese language, **Draft Provisions**) on 30 June, including the draft form Standard Contract, and sought public comment until 29 July 2022. It is anticipated that the Standard Contract will be finalised soon following the consultation. The Draft Provisions, same as the PIPL, have not provided a transitional period mechanism for adopting the Standard Contract. As such it is recommended to get ready to implement the relevant compliance actions as early as practical.

Key takeaways from the draft provisions include the following.

- Under the PIPL, the Draft Provisions and two other draft regulations (not finalised), if the data exporter is a CIIO, or processes personal information of more than one million individuals, or has transferred personal information of more than 100,000 individuals or sensitive personal information of more than 10,000 individuals out of mainland China in a set period of time, it must complete the security assessment organised by the CAC (essentially an approval) before cross-border data transfer. In other words, signing the standard contract alone will not be sufficient for such data exporters to transfer personal information out of mainland China.

- For other data exporters, the standard contract applies to both intra-group transfers and transfers to external third parties.

- Most clauses of the draft standard contract are restatements of the PIPL's requirements on the responsibilities and liabilities of the data exporters and data recipients.

- The draft standard contract provides some flexibility for the signing parties. For example, although the governing law is mandated to be Chinese law, the parties may choose a foreign arbitral venue to resolve disputes arising in connection with the Standard Contract, as long as the venue is located in a New York Convention signatory. The parties may also agree on supplemental clauses as long as they do not contradict with the mandatory provisions of the Standard Contract.

- In addition to signing the standard contract, the data exporter is required to perform a personal information protection impact assessment prior to the transfer, which should cover several aspects including an assessment of the impact of data protection laws and policies of the destination jurisdiction on the enforceability of the standard contract. For those who are familiar with the EU GDPR, this is very similar to the transfer risk assessment, a requirement in GDPR context after the Schrems II ruling, and may turn out to be a practical challenge for many market players.

- The executed standard contract along with the personal information protection impact assessment report shall be filed with provincial counterparts of the CAC within 10 working days from the effective date. The copy of the executed standard contract should also be provided to the data subjects upon request. Based on the current draft form, the standard contract is a standalone contract from the commercial contract between the parties, which means the commercial contract is not required to be filed with the local CAC.

- It remains unclear whether and how the standard contract applies where the data exporter is an entrusted party (i.e. equivalent to data processor under the GDPR) and the allocation of responsibilities and liabilities between such data exporter and the relevant overseas recipient.

Certification: An alternative to the standard contract

China's national standard authority recently published the Specification for the Security Certification of Cross-Border Processing of Personal Information (in Chinese language, **Specification**), which relates to the Certification route paralleled to the standard contract. This Specification is a non-binding technical document aiming to provide practical guidance on obtaining the Certification and introduces stricter compliance requirements than the PIPL. The key provisions therein include the following.

- The Specification applies to the cross-border transfer of personal information among affiliates/ subsidiaries within a multinational group, and overseas processing subject to the extra-territorial effect of the PIPL. In other words, the certification approach may not be applicable for China-based entities which transfer personal information to non-affiliated parties located outside of mainland China.

- The group company applying for the certification must adhere to the principle that personal information being processed outside of mainland China shall be protected in a manner that is equivalent to the standard provided under China data protection laws and regulations, including but not limited to the PIPL.

- The certification will be granted on several conditions: (i) the existence of a binding agreement between the data exporter and the data recipient; (ii) the appointment of an officer and designated body for personal information protection by both the data exporter and the data recipient; (iii) compliance with a set of unified rules on cross-border data processing by both the data exporter and the data recipient; (iv) completion of the personal information protection impact assessment prior to the cross-border transfer; and (v) compliance with data subject rights. The overseas recipient must undertake to be subject to Chinese personal information protection laws and regulations and the supervision of the Certification institution, including responding to inquiries and routine inspections.

The Specification does not provide the application and approval procedures for the certification, the valid period of such Certification or which professional institutions are authorised to grant the certification.

Implications and next steps

Comparatively the standard contract may seem more straightforward and applies to wider scope data transfers than the certification. Despite that the Draft Provisions and the standard contract are still pending finalisation and key issues relating to the Certification (as mentioned above) also await further clarification, we recommend weighing the pros and cons of the two approaches and decide which one better suits your needs, taking into account the relevant obligations, your current data practice and business needs, as well as the compliance costs. In the meanwhile, we recommend starting the relevant preparation, such as mapping out your current cross-border data transfer flows and performing the personal information protection impact assessment, which is required under both options.

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Asset management digitalisation: Is the dam about to break?

Said Fihri
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What happened to asset managements' digital revolution? For some years now, there has been promised transformation in the funds sector — a round of digital upheaval that would reconfigure the industry for good. But while some digital initiatives have moved forward, that 'big bang' moment has proved elusive. Above all, this is still an industry that develops products and then tries to sell them to its customers; for many asset managers, the concept of customer centricity remains out of reach.

Perhaps there should be no surprise at such slow progress. Asset management, after all, is an industry that is highly dependent on the intermediaries that sit between product producers and the investor. These vested interests have powerful reasons not to welcome the digital transformation that takes asset managers closer to their customers.

Self-disruption, in any case, can be difficult to do. Incumbents with legacy systems — and legacy ways of thinking — find it hard to transform. That has been the experience of many industries. New entrants able to develop digital-first businesses from scratch naturally get there more quickly.

For all that, however, it would be a mistake to see digitalisation delayed as digitalisation denied. Change is coming to the sector and time appears to be running out for the incumbents to adapt. This may be evolution rather than revolution, but the laggards will likely still be left behind.

Here come the robots

Take the rise of robo-advice, where the idea of automated and programmatic fund selection is resonating ever more strongly with a growing pool of investors. Robo-advisors are now looking after assets under management worth billions of pounds. Worldwide, the robo-advisory market is now expected to grow at a rate of almost 40% a year, over the next five years. [1]

No wonder. In a marketplace where high-cost, actively-managed fund strategies have continued to disappoint — with both asset managers and intermediaries taking their cut — the low fees charged by robo-advice services are appealing. Moreover, a new generation of investors feels comfortable transacting digitally — robo-advice is just another service accessed through a smartphone app.

COVID-19 also accelerated the shift to robo-advice. Even those investors able and willing to pay for face-to-face financial advice were denied access to these services. Every part of the market became more familiar with managing their lives digitally.

Digital engagement at last

More broadly, both asset managers and fund distributors — even the incumbents — have invested substantial sums in their digital propositions. The web-based interfaces through which investors research and place their trades are more user-friendly than before. Online fund platforms have become the default route to market for investors in many European markets and offer access to a growing range of assets in addition to collective investment vehicles — from direct equities to digital currencies.

This is what many customers want. Fewer investors, even in the high-net-wealth bracket, are impressed by plush offices and lavish hospitality and they no longer want to travel to meetings to talk through their options in person with an adviser. Younger investors, in particular, are shunning direct contact, at least in a conventional sense, and some are engaging via social media. [2]

The effect, slowly but surely, is expected to bring asset managers closer to their customers. Indeed, fund platforms offer a means for managers to build more direct relationships with their customers.

With that more direct relationship comes the opportunity to get to know customers more intimately than ever before, which can enable asset managers to design products tailored around the needs of individual customers, rather than pursuing growth through an endless round of new fund launches.

Blockchain helps transform distribution

Elsewhere, the building blocks are already in place for a new model of fund distribution. There are no technical or regulatory barriers standing in the way of the use of distributed ledger technology for distribution and the potential benefits of this shift are multiple.

Blockchain-enabled distribution can offer increased transaction speed, reduced reconciliation requirements, lower costs and swifter collaboration between each member of the value chain, whether asset managers are dealing directly with investors or via distributors.

1 Global Robo Advisory Market Expected to Rise at a CAGR of 39.9% and Surpass US$59,344.5 Million during the Forecast Period from 2021 to 2028 [228-Pages] | Confirmed by Research Dive, GlobalNewswire, March 2022
2 Op-ed: Advisors must meet the digital demands of young, Mike Boese in CNBC, April 2021.

In fact, the potential for disintermediation is clear. By removing the paper-based administrative burden from the distribution process, where asset managers need support from intermediaries, blockchain solutions can help bring down the cost of customer acquisition and make it easier to deal with retail investors at volume.

Again, the opportunity is for asset managers to move closer to their customers, particularly as this model of distribution enables a far more seamless exchange of data.

Data can help drive operational efficiency

Asset managers shouldn't overlook the advantages of digitalisation in their back- and middle-office operations. This aspect of asset management remains mired in legacy process, with a complex web of in-house and outsourced services providing administrative support to fund distribution. Now, however, new digital solutions offering greater transparency and control are springing up.

There is more to come. One problem for asset managers is the disparate array of processes and systems through which the industry operates. The absence of a common framework for the industry can drive inefficiency and cost. Blockchain, however, provides the potential to develop such a framework.

In other words, across the sector, transformation is now underway. And while the question of when the trickle will become a torrent is difficult to answer, the process of change has begun. Asset managers recognise the grip that intermediaries have on the marketplace, but they also see the potential of digital transformation to loosen that grip — both in the way they work with intermediaries and in how they develop more direct relationships with investors.

Time may be running out to embrace that change. New entrants to the industry will bring disruption of their own. Such competitors may come from a technology background — for example, the tech giants have been moving at pace into payments. Or they may come from elsewhere in the financial industry. Tech-enabled innovators in areas such as digital currency trading, for instance, have an opportunity to move into more traditional asset classes.

Either way, competition is coming. Those asset managers that remain passive in their approach to transformation in this fast-moving marketplace should embrace change to keep up.

Constant change can enable continuous opportunity

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Emerging Managers: Tips for remaining resilient & attracting investors

Lawrence Obertelli
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Cowen

Lawrence Obertelli, Director, Prime Brokerage Sales at Cowen, discusses key findings of a joint research-based report with AIMA which highlights the increased resilience and operational efficiency gained by the global emerging hedge fund manager community as a result of the lessons learned from operating during the pandemic. Based on the results of the survey and on insight from the investor community, Lawrence Obertelli provides tips for fund managers wishing to navigate the current economic challenges and attract investors during this turbulent time.

The recently-published AIMA and Cowen report entitled 'Emerging Stronger: The Next Generation Manager Survey 2022' was informed by two surveys carried out in Q4 2021 and Q1 2022: one of emerging managers running up to US$500 million in assets under management (AUM), and another of the investors that allocate to them. The key findings make for interesting reading, revealing a community of hedge fund managers who have actively taken steps to cut costs in order to run lean, robust organisations. It also highlighted an investor community willing to invest in firms that are less than three years old.

The research also revealed:

- The average breakeven has fallen by 25% from its 2017 level of US$86 million in 2017 to US$64 million.
- Two-thirds of investors will consider allocating to hedge funds with less than US$100 million AUM.
- The average time to close on new investments for emerging managers is taking 6.3 months on average and even less, 5.6 months, for managers of sub-US$100 million funds.

Top tips to survive and thrive

Given the impending economic turmoil, what can fund managers learn from recent challenging times in order to remain resilient? And importantly, what steps can they take to increase their chances of securing investment? Based on the survey findings, listed on page 30 are some top-line tips for how best to survive and thrive.

1. **Have a plan and regularly review it.** Our survey found that 61.5% of investors would block an investment if the manager had a poor business plan with unrealistic targets. So make sure you have a sound business plan. The plan will need updating regularly along the way and it is important that the changes are realistic, address the constantly evolving market conditions and remain in line with your overall strategy.

2. **Have a clearly defined strategy.** Our joint research with AIMA highlighted that investors' strategy preferences tend to be matched with managers, with long-short equity and multi strategy taking up a total of 62%. Standing out from the crowd with niche strategies seems to be a less common approach these days and isn't widely sought after by investors. Avoid style-drift, as 69.2% of investors would consider this a barrier to investing.

3. **Embrace platforms.** Regulatory hosting and structuring platforms enable firms to manage themselves at a fraction of the cost required to operate these functions fully in-house. Our joint feedback sessions with AIMA revealed the increasing adoption of such platforms with managers – and acceptance by investors. This is a trend that looks set to continue.

4. **Be a networker.** Our survey revealed that investors' number one source of new managers was their personal network. This was stated by around 35% of investors and highlights the importance of taking time to meet and build relationships with potential investors.

5. **Partner with a prime broker with cap intro services -** The second most popular source for investors (23%) was prime brokerage capital introduction. This highlights the added value that a prime broker can offer. At Cowen, for example, we have a carefully selected network of differentiated investors and provide value through targeted introductions. As the majority of our team have allocator backgrounds, we can provide a high level of insight and guidance to fund managers seeking investment, and we employ rigorous analytical processes which increase the likelihood of a match.

6. **Think carefully about your fees.** Our survey found that management fees were closely clustered, with only a small proportion of fund managers charging fees - either higher or lower - outside this cluster. The highest management fees were typically in the APAC region (1.41%), with the lowest fees in the UK (1.37%). Performance fees mirrored these regional differences, with APAC topping the chart with average performance fees of 16.6% and the UK at the lowest end with 15.8%. There seems to be a firm consensus of management fees being around 1-1.5% and performance fees of 15-17%.

7. **Take a 'lower AUM for longer' approach.** Our survey revealed that 50% of managers sub US$100m are over 5 years old, compared to 38.9% in 2017. This highlights that challenges in scaling up have increased. To address this, ensure you get as much working capital as possible into the business and make it go as far as possible.

8. **Keep costs to a minimum.** In response to challenges in scaling-up AUM, look at ways to reduce costs. Managers at our survey-feedback session referred to reducing travel costs and reviewing the office space required, with some choosing to relocate out of inner cities. Some have adopted hybrid and remote working, which have all become more mainstream as a result of the pandemic.

   Outsourced solutions and platforms - which the feedback sessions highlighted are already being used by a large number of hedge funds – are increasingly being expanded in remit to include additional areas of the business, including core functions.

Emerging managers who operate lean, robust and well-planned organisations can have a bright future ahead.

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New research quantifies benefits of outsourcing

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As private equity continues to attract institutional capital, funds are outsourcing to their trusted partners to overcome resource and technology pain points.

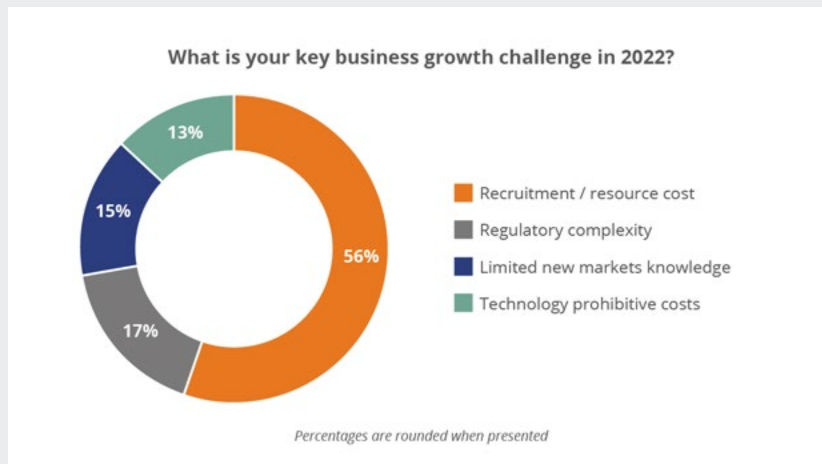
According to Preqin's Global Alternatives Report 2022, assets under management by private markets funds are set to climb to over US$23 trillion by the end of 2026 - with private equity (PE) and venture capital accounting for almost half of that sum.

Accordingly, many PE firms are looking for growth opportunities through diversification of their investment strategies and/or expansion into international markets. But this comes with an additional set of operational pressures.

Here we explore the biggest growth challenges facing PE firms in 2022 and reveal new research which quantifies the costs and resource benefits of using an outsourced third-party partner to alleviate these resource constraints and achieve greater efficiency.

Filling talent gaps

A recent LinkedIn poll by Apex Group revealed that the biggest growth challenge for PE firms in 2022 was recruitment and resource cost (56%). This was followed by managing regulatory complexity (17%), then having limited new markets knowledge (15%) and lastly, technology prohibitive costs (13%).



Trying to maintain and build a fixed headcount in-house with the right skillset can be challenging and costly in the current environment. This is particularly pertinent given that finding and retaining talent is one of the key success factors to scaling.

Drawing on a third-party service provider that has a global footprint can act as an extension of the fund team, sourcing talent via their global footprint to achieve greater flexibility and efficiency. By outsourcing the heavy lifting of often repetitive or administrative tasks, the funds' employees are freed up to focus on high value projects and core investment objectives.

In addition, seeking growth through expansion into new markets can be a minefield of challenges for firms that don't have the knowledge in place to deal with local regulations and processes. A global partner, with people on the ground, can ensure firms respond quickly to any regulatory requirements and are compliant wherever the next opportunities lie.

Those PE firms that took part in Forrester Consulting's Total Economic Impact™ study saved on average US$3.9 million on internal staff costs over a three-year period by drawing on a service provider's single source solution. This equated to an estimated average saving of four to five full-time staff per fund by working with an independent service provider.

Technology stacks up

When it comes to unlocking value, it is no surprise that PE firms are turning to data solutions, technology providers and third-party experts to leverage the benefits of cutting-edge tools.

As in-house expectations of what can be accomplished with data increase, so too do the expectations of investors. Increasingly, they are calling for full transparency, especially on factors such as risk management and contextual market data. Coinciding with this has been the rise of ESG, further contributing to the complexity of the metrics investors are demanding transparency on.

Technology is becoming central to successful operations, bringing benefits across a range of functional areas, with PE firms finding that poorly integrated legacy technology stacks simply cannot perform many of the functions that their investors are calling for.

The right partner can provide access to the latest industry leading technologies that can be tailored and integrated to specific needs. A recent Apex Group poll of asset managers found 62% view having access to leading technologies as being the most immediate benefit of seeking third-party support.

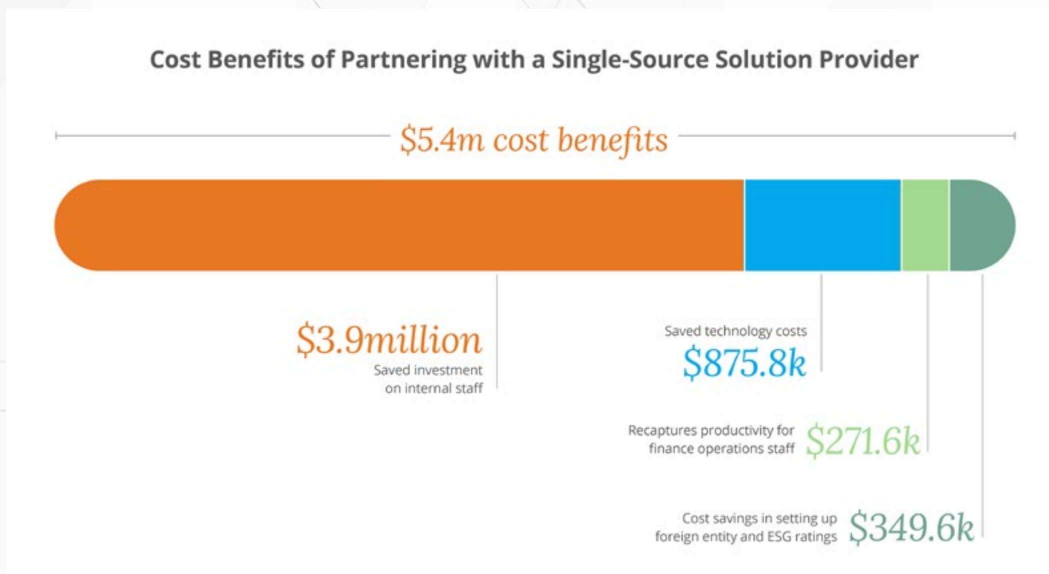
By leveraging integrated technology, a single-source provider can deliver the tools and expertise to help achieve success. Forrester Consulting found that over three years, the PE firms interviewed were able to make savings of around US$876,000 by leveraging on technology. This efficiency not only came through reduced expenses on license fees, but from the implementation and ongoing management of the technology stack as well.

The benefits of partnering with a single-source solution provider

Many private markets managers are now following what hedge fund managers have done for a while by turning to trusted partners for additional business support and guidance, not only for back-office functions, but for front office too.

Whether firms are looking to scale up or down, using a service provider delivers the flexibility of being able to access leading technology, manage resource levels and add necessary skillsets quickly and easily.

The Total Economic Impact™ report by Forrester Consulting has shown that PE firms that have partnered with a single source solution provider can achieve an average return on investment of 105% and total cost benefits of US$5.4m, with a net present value of US$2.75m over a three-year period.



This shows that there are clear and quantifiable benefits of drawing on a dedicated, external financial or operational resource. The right partner can help improve efficiencies, control costs – particularly human capital and technology expenditure – and ease the burden of managing increased regulatory and investor reporting requirements.

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Source: Forester Consulting's Total Economic Impact ™ Study of Apex Group

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Out of the Shadows: With focus on independent NAV validation, how can alternative managers meet growing market and investor demands for transparency and auditability?

Justin Hayes
Senior Product Manager
Linedata Asset Management (UK)

Transparency in fund management has never been more important, and this starts with fund operations. The independent calculation completed to verify the official valuation, or a 'shadow' NAV (net asset value), is a fundamental part of this process.

Whether this requirement is coming from regulators around the globe or increasing investor demands, this independent valuation enables managers to meet the growing market pressure for transparency and auditability.

For alternative fund managers who use fund administrators to value their funds, this includes the validation of their performance fee reporting. In such cases, fund managers often want to perform a shadow NAV on the calculation provided by their administrator in order to validate the TPA's (Third-Party Administrator's) fund valuations and performance fee calculations. Additionally, this also answers the call for better, more detailed investor reporting, with additional granularity around share class and limited partner P&L (Profit and Loss) allocation for side pockets.

The calculation of a shadow NAV can be handled in multiple ways: insourced by the alternative fund itself, via the appointment of a second fund administrator, or outsourced to a services provider. Because of the increased scrutiny, more hedge funds and alternatives managers are looking to find ways to address this—and one of the ways that they are doing so is by bringing on more sophisticated systems within their own operations.

So, amid this sea change, what are the industry drivers impacting the uptake of these solutions? There are a few noteworthy market trends:

- **Post-pandemic realities.** The recent past has not only upended the traditional workforce and processes but also allowed both investors and fund managers to rethink and retool operations with an emphasis on better technology and efficiency. This includes the opportunity to incorporate software with richer capabilities.

- **Improve the customer experience.** Managers need to give investors' a better perspective on performance that is closer to real-time, not just a monthly statement, in addition to more granularity. As both fund managers' workforces and end investors' get younger, the emphasis on bespoke and improved client experiences that both Millennials and Gen Z's value cannot be overstated.

- **More detailed, in-depth reporting.** Fund administrators also want to build out more detailed reporting for end investors. Twenty years ago, reporting on an opening and closing balance may have been enough, but in this market, fund managers need to be more responsive to investor needs. That is a reason why fund administrators have taken over that role, to both give them that expertise and provide these really specific reports per investor. This is because each investor will have different performance, and HNWIs (high-net-worth individuals) especially want that granularity. The ability to provide this level of reporting is seen as a competitive advantage and differentiator.

- **Regulatory environment and more.** For some time now, regulations from the US SEC (Securities and Exchange Commission) and Europe's AIFMD (Alternative Investment Fund Managers Directive) have dictated that hedge funds must have third-party independent valuation by the fund administrator. But it is not due to regulators alone, as managers themselves want to ensure the fund administrator is accurate.

So, who can benefit from adopting these solutions? The big winners stand to be alternative managers with portfolio management system software looking to price at share class and limited partner levels. This enables performance fee calculations at both levels and can automate what might have previously been manual tasks, freeing up workforces. Additionally, there is the possibility that these tasks to calculate a shadow NAV will provide greater transparency and information about their investors. This is becoming more relevant as investors increasingly want to have a closer relationship with their managers.

Why now? Market turmoil meet transparency

Certain portfolio management system software may not give the full workflow to the investor level, and some of the valuation and fee calculation will possibly be done offline. This is true, particularly around fees, which can be complex and need to be calculated at the investor level. Investor demands require greater transparency due to the recent history of market turmoil.

Alternative asset managers need to have that information readily available, in addition to being able to address a myriad of other pain points:

- **HNWI expectations**. Fund managers often lack the systems and reporting to provide granularity around performance that is expected by clients, especially for HNWI.

- **Share class/ limited partner (LP) levels**. Alternative funds want to shadow the fund administrator, but this can be cumbersome with daily funds, especially if they need to drill down to share class. Transfer agency systems can enable them to truly shadow the TPA at these levels while maintaining an audit trail that is part of an automated workflow, not a manual process.

- **Manual processes.** Alternative fund managers needing shadow NAV and performance fee calculation also need a fully auditable, automated tool or mirror administration that provides a certain level of comfort. This includes moving away from these error-prone manual processes to automated workflows with audited work. Additionally, there should be no offline calculation of performance fees.

- **Client reporting.** Alternative fund managers need the ability to provide better client reporting—from the investor level to performance fee, all while providing more granularity and full transparency.

- **Performance fees.** Many portfolio management systems do not have investor information, so a transfer agency or investor platform can enable managers to calculate fees at the investor level.

Enter solutions

One way to help firms solve this is by combining solutions such as Linedata's Mshare allocations along with a portfolio management system like Linedata Global Hedge (LGH). Together solutions like these can enable managers to meet growing market and investor requirements for transparency and auditability in their in-house operations.

For example, if a fund shadows its administrator, Mshare allocations provides highly accurate data and valuations without the headache of spreadsheets or other workarounds. It can take the P&L from an administrator's accounting platform and integrate it with a firm's portfolio management system to perform complex side pocket and investor equalisation calculations and series of shares accounting with ease.

Together with Linedata Global Hedge, Mshare can provide an end-to-end solution for alternative funds wishing to perform their own shadow accounting. While portfolio management systems provide the fund level NAV, Mshare can work with LGH or another system.

Additionally, fund managers should look for solutions that, like Mshare, provide share class level and partnership level investor accounting via their allocations module. This can deliver streamlined solutions for hedge fund investors that want daily P&L but would have previously required lengthy, manual spreadsheet competitions. Without it, these can involve onerous amounts of work, be prone to manual errors, and, in the end, only manage a handful of share classes. Mshare can also include performance fee calculation.

True transparency and NAV validation

The value to alternative managers of an in-house system that efficiently produces accurate NAV validation along with the right level of investor reporting became even more apparent as the pandemic developed, when firms' realised what had to be done to advance and streamline these processes. In other words, with regulators and investors exerting more pressure, the time of the spreadsheet has passed because manual processes and lack of transparency are a risk in 2022 and beyond.

These are steps alternative fund managers can take to provide a clear-eyed view of NAV validation and investor level reporting, especially for those looking to price at share class level and partnership level; enable performance fee calculations; and move away from manual processes, all while increasing the level of client reporting.

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- **Enhance transparency** with independent shadow NAV and granular performance fee calculation

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How intelligent automation rewrites the future of fund operations: Five good reasons to revisit your spreadsheet usage

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Despite the tremendous strides in automation in recent years, it's surprising how many asset management firms still have pockets of spreadsheet dependency in their operations. Like many unhealthy habits, it starts innocently enough when someone needs immediate answers, and solving that need through normal IT channels takes too long. Then, before you know it, the organisation is hooked – to the point that spreadsheets become a crucial component of your processing workflow, embedded into the firm's daily deliverables.

The effect on efficiency

The problem is not with spreadsheet software as a tool but its overuse and integration into the daily business process. Moving data outside of core systems and into a spreadsheet introduces a manual step that inherently slows down the data process flow. Moreover, it puts the end-user in the middle of the process rather than the technology, thereby reducing efficiency. Spreadsheet use also creates the potential for data manipulation or "fat finger" mistakes. Errors in data will inevitably create downstream issues that require time to correct, resulting in further lost efficiency.

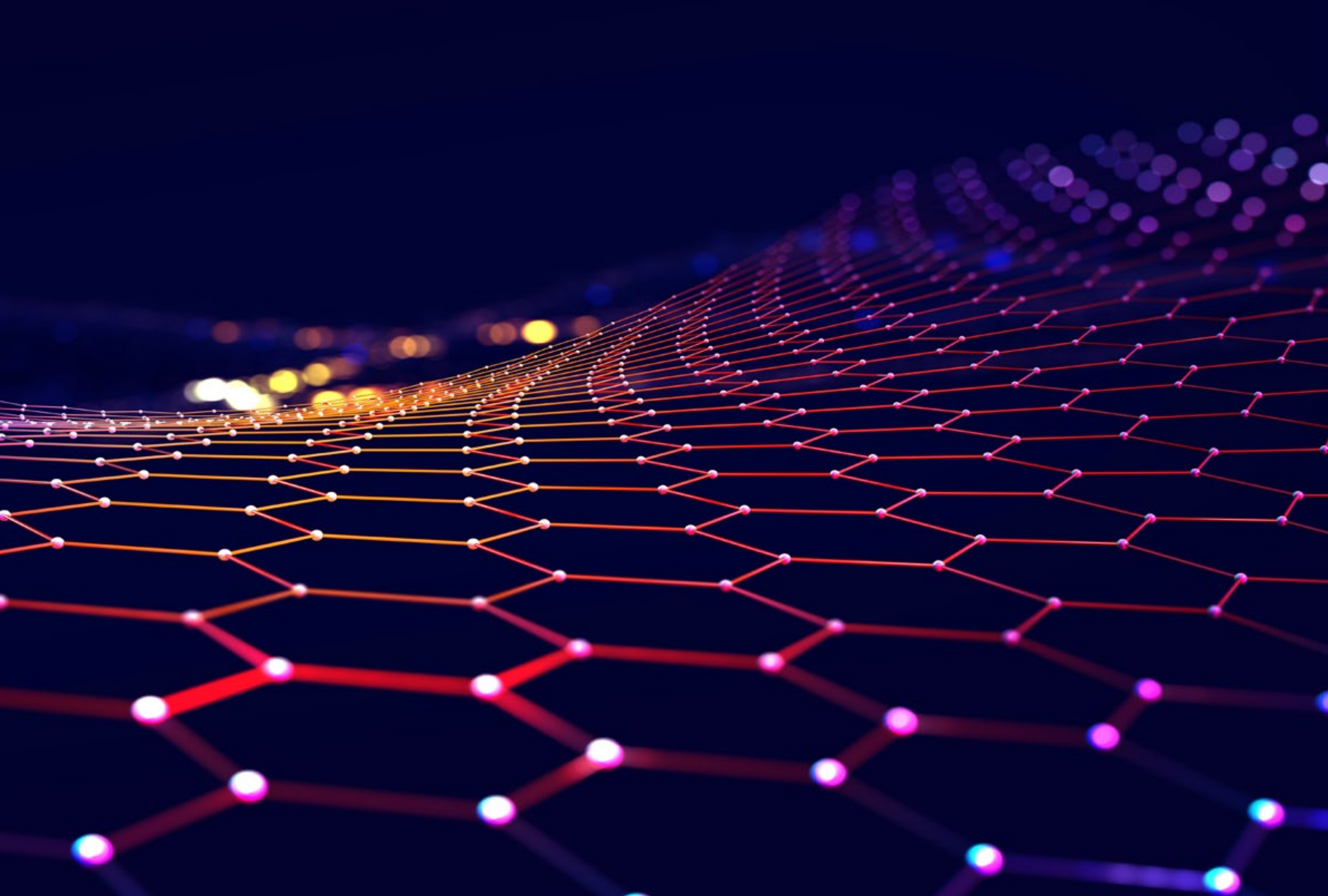
Fortunately, today's advanced automation technologies – including but not limited to artificial intelligence and its variants – have the potential to drive dramatic efficiency gains. Moreover, new tools and processes can also confer flexibility and transparency that eliminates the need – or the temptation – to extract and isolate data from the normal process flow.

Leveraging more modern technology solutions, however, should be combined with rethinking existing processes. Unfortunately, many firms mistakenly believe they can graft artificial intelligence solutions into their existing processes and systems to achieve incremental efficiency. This fix is like putting a turbocharger on your 1982 car. The car will go slightly faster, but you will have the same steering, suspension and interior as before not greatly improving the overall driving experience. Instead, the opportunity to undertake a process reengineering approach that uncovers smarter, leaner processing that fits with new intelligent technologies will produce the most dramatic results.

Five good reasons to revisit your spreadsheet usage

Several benefits will occur from increasing automation, leveraging intelligent tools and eliminating offline processes using desktop software. First, however, let's focus on the top five:

1. **Optimising the data processing workflow.** The most efficient enterprise data processing approach is an automated workflow moving data along its designated process steps. The data is processed by the appropriate service layer and moved to the following processing component. Automation reduces the "wait state" between manual business process steps when using spreadsheet tools.
2. **Maintaining data integrity.** As noted earlier, once data is out of the core processing application into a spreadsheet, the potential for data manipulation can result in an incorrect change of data and inconsistency with the source system. Users may think they can compensate by validating the data as it flows back into the core processing system. However, instead of building programmatic data checks, why not stay within the core processing system where the controls are consistent and data integrity can be maintained?
3. **Preserving historical data accuracy**. A spreadsheet program is not a database. Therefore, moving data into a spreadsheet constrains the ability to keep historical records of changes. Implementing an automated solution to do its work uninterrupted will ensure that changes are accurately recorded across all dependent systems and enable reliable audit trails.
4. **Optimising the value of the data.** The ability to implement artificial intelligence algorithms is key to driving process efficiency. To be effective, AI needs to consume data. However, data manipulated in a spreadsheet is generally not accessible for use in AI programs. Leveraging data directly from a database (and avoiding pulling it offline in a spreadsheet) will enable you to take advantage of AI more effectively and consistently in your operations.
5. **Avoiding "Key Person Risk" with proper change control.** At times there is a need to change the calculations or data from a system, usually due to a business change. If an organisation has multiple spreadsheets running production processes, the enduser who controls each separate spreadsheet needs to be the one who makes changes, which introduces "Key Person Risk" if that individual is unavailable or leaves the organisation. Maintaining data within an automated solution makes centralised changes easier and is not dependent on one person's knowledge.



Take the spreadsheet challenge

The key is to step back and take this challenge for firms concerned that spreadsheets may have become embedded too deeply into their production processing.

1. First, analyse the usage of the spreadsheet program in daily processing and assess the potential inefficiencies that have come from its usage. Start by breaking down the process steps within an operation (many organisations use Value Stream Mapping, a lean-process methodology for documenting the steps in a process[1]).
2. Next, inventory the spreadsheets used within each process step. Then measure accurately the total time required outside of the core processing system to open, maintain, process, back up and move data in and out of the spreadsheet environment.
3. Finally, compare the overall duration of processing a spreadsheet in the business process to processing within the core systems, accounting for artificial intelligence to increase overall processing efficiency.

We believe you will find that highly automated processes will consistently outperform a process involving human intervention and data manipulation. Advanced artificial intelligence technologies in conjunction with re-engineering existing business processes make it possible to implement a more efficient end-to-end service model.

1 "What is Value Stream Mapping?" American Society for Quality (ASQ), 2021, https://asq.org/quality-resources/lean/valuestream-mapping

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Is regulatory incubation distinct from regulatory hosting – and does it matter?

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Many providers, when discussing the appointed representative (AR) concept, use the terms 'regulatory hosting' and 'regulatory incubation' as though they are synonymous. However, there is a fundamental difference in value and approach between these two concepts and it's important to understand this before starting down the route of seeking an appropriate principal firm. As we will see, the difference also has wider implications for the future of the industry itself.

'Regulatory hosting', although now a widely used term, only came into use in 2012. It refers very simply to the relationship of a principal Financial Conduct Authority (FCA) authorised firm (a principal) appointing another firm or individual as its AR, subject to approval by the FCA. The AR can then undertake specific regulated activities, using its principal's authorised regulated approvals, but within the further restriction that it can only 'arrange' and 'advise'. No AR can ever manage funds or hold client assets. The principal is responsible to the FCA for the AR's conduct and regulated activities. The 'hosting' term implies a stable relationship with no real growth or development — the AR is literally 'hosted' on an ongoing basis by the principal.

However, the original term for the concept of the AR outside the insurance world was in fact 'regulatory incubation' — this term was coined by Seonaid Mackenzie (founder of Sturgeon Ventures LLP) who chose the name for its wider connotations of 'incubation' versus 'hosting'. The term 'incubation' implies growth and development within a protected environment. The approach here is that the AR, once appointed and FCA-approved, does not merely make use of the principal's scope of approved activities with associated monitoring but is also actively prepared for the time when it becomes, if it so chooses and is approved, a directly authorised entity. In this incubatory approach, the principal will seek to ensure that the AR's practices and approaches are readied for the post-authorisation challenge of direct authorisation, in terms of compliance, risk, bookkeeping, record keeping and internal monitoring of staff activities.

This approach enables the AR both to (i) rely on the principal's support and guidance and (ii) identify and resolve issues and requirements before it comes under direct FCA supervision itself. The principal also works with the incubating AR to ensure the key requirements for achieving direct authorisation, such as business plans, management accounts, clear websites and bios, and a strong compliance framework are all in place. The regulatory requirement that all data collected by the AR is the principal's—to be held by the principal or accessible on demand—becomes a benefit, in enabling the principal to provide top-to-bottom understanding, monitoring and support — so avoiding issues before they arise. Then, when the incubated AR is finally authorised, it is ready for its new regulatory

responsibilities, with its risk of being fined (or worse) for errors or failures much reduced. With a reputable principal, either simple "regulatory hosting" or the more supportive and nurturing approach of "regulatory incubation" will both enable a new AR to access the market without the time-consuming and substantial financial, staffing, compliance, and bookkeeping demands of obtaining a full FCA authorisation.

The AR model reduces the time to market access significantly since the FCA's requirements for approval of an AR are much simpler and thus approval is quicker than for any full authorisation — there may be a difference of many months. From an ongoing angle, being an AR is also significantly cheaper than being a directly authorised firm, with all the associated capital, compliance and risk-related requirements and FCA fees. Both approaches also enable the AR to access the in-house compliance and risk support of the hosting principal, thereby allowing the new firm to concentrate on developing its business.

However, the "regulatory incubation" route not only allows the AR to access all these positives but also supports it through its journey to independence. It's also important to consider the FCA's shifting stance to much stronger monitoring of the principal-AR relationship and related oversight and control of the ARs. The FCA increasingly wants proof that the principal firm has a full understanding of — and control over — the AR's activities. With the incubation relationship, this is better demonstrated, since the two firms' relationship will be much closer. Post-Greensill, the FCA is even more focussed on evidence of proper governance and risk frameworks. The incubation model — although perhaps initially less appealing in its greater demands on the AR's controllers — fits far better with the FCA's requirements, than the simple hosting model.

When considering which route to take, the controllers of the potential AR, therefore, need to determine at the beginning if there is any likelihood of the AR needing to be directly authorised in the future. Whether in the shorter or longer term, if such authorisation is potentially needed, the regulatory incubation route offers stronger support. It supports 'career progression' compared to simply enabling a 9-to-5 job.

It is of course perfectly possible for an AR to achieve direct authorisation without strong support or guidance from its principal, but that would be much more challenging — and time consuming. Finding a strong principal offering genuine regulatory incubation enables the AR to concentrate on its business while using the principal's expertise and guidance to develop the strong structure that will enable the firm to grow, flourish and ultimately gain authorisation (without needing to reinvent the wheel of how to do it well).

At this point, it's of course worth considering whether the AR concept is still the most appropriate route to take at all — especially in the context of the regulatory incubation of an investment management business. In such a scenario, the client company of the regulatory incubator "principal" (such client company, the 'clientco') either seconds its individual portfolio managers to the incubatory principal or provides them as consultants, and those individuals are then registered with the FCA as certified staff of the principal. A branding name can then be used by the principal to distinguish the specific mandate. In such cases, there may be no need for an AR providing regulated services such as investment advice, and the clientco may instead simply contract with the principal to provide unregulated "middle office" support.

Alternatively, the client may be an AR marketing fund interests or providing advice on the investment business, either of which is of course a regulated activity. As and when the clientco determines to seek FCA authorisation in its own right, it then, whether or not an AR, has the branding, infrastructure, and track record in place (either in its firm name, as an AR, or through the individuals who have been acting as portfolio managers within the principal) to move seamlessly to applying for that approval. Furthermore, some principals, in addition to their FCA authorisation, are registered with the US Securities and Exchange Commission (SEC) enabling them to take US investors into their funds without limit.

Assuming, however, that the AR route remains the preferred approach, it is inevitably the case that proper regulatory incubation is likely to cost more than mere "hosting", during the period that the firm is an AR. But, as the saying goes, you get what you pay for. And ultimately, the long-term cost savings are clear — less risk of liability, a strong compliance and risk basis, and a team of well-trained individuals to take the firm to the next level.

Finally, new ARs should consider the regulatory coverage they need from the principal, depending on whether the principal is a MiFID firm or an AIFM. Costs tend to be lower with a MiFID principal, and Sturgeon Ventures partners with investment managers outside the UK (for example in the Cayman Islands) who can perform the role of alternative investment manager cost effectively and outside the jurisdictional reach of the AIFMD.

Finally, if we look beyond the AR's perspective to the wider industry view, we can see that regulatory incubation and hosting have helped to bolster the UK's position post-Brexit — by supporting innovative projects, enabling a nimble turnaround in structuring to market, and giving new funds stronger oversight from principals — compared to simply applying for direct authorisation from the start. The 'incubation' approach, provided effectively, helps to ensure the long-term survival of this useful model, as the regulators' focus continues to sharpen. Principals can thus help ensure the longer-term survival of this AR model by improving their controls, enhancing their own governance and risk management, and ensuring their ARs are properly monitored and supported — properly incubated, not just hosted, as they go forward. In an industry where risk and compliance are ever more key, incubation is clearly the model that best protects both the AR, the principal and the future of the model itself.

When DeFi meets securities laws - A regulatory overview

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What is DeFi?

Decentralised finance (**DeFi**) is an umbrella term that encompasses a range of financial services provided on public blockchains.

In this article, we will provide an overview of some of the DeFi assets/strategies from the viewpoint of regulations, and whether managing, dealing in, or advising on, a portfolio of such assets would amount to regulated activity in Hong Kong (thereby requiring a licence from the Securities and Futures Commission (**SFC**)).

Regulatory framework

Trading, managing of, or advising on, DeFi assets would fall within the local regulatory perimeter, if such DeFi assets constitute securities as defined in Schedule 1 of the Securities and Futures Ordinance (**SFO**).

Section 114(1) of the SFO provides that no person is allowed to "carry on a business in a regulated activity" without being licensed by the SFC. The relevant categories of "regulated activities" that would trigger a licensing requirement are listed in Schedule 5 to the SFO as follows:

- Type 1 – Dealing in securities
- Type 4 – Advising on securities
- Type 9 – Managing a portfolio of securities or futures contracts

Under Schedule 1 of the SFO, the term securities is defined to include the followings:

"shares, stocks, debentures, loan stocks, rights, options or interests in respect of shares, interests in any collective investment schemes...interests, rights of property, whether in the form of an instrument or otherwise, commonly known as securities."

In SFC's statement on initial coin offerings in September 2017, it was stated that digital tokens that amount to virtual commodities would not be securities under the SFO, including situations:

- Where the tokens were strictly 'utilitarian' in nature – only provide use rights on digital platforms; or
- Where token holders expected to make a return on their investment by reselling on cryptocurrency exchanges.

However, certain tokens may have terms and features that may render them securities. For example, if:

- holders were given rights similar to holding 'shares';
- holders were given rights similar to holding 'debentures'; or
- the project was managed collectively by the token issuer to invest in projects with an aim to enable token holders to participate in a share of the returns provided by the project (such that it became a "collective investment scheme" (**CIS**)).

A virtual asset (VA) may also be caught by the definition of a structured product, which is also considered a security.

With these concepts in mind, we will examine the more common types of DeFi assets/activities that are currently the most relevant to VA Funds below.

VA lending

Lending in the realm of DeFi allows VA holders to earn interest on their holdings. A lender is usually paid an attractive annual percentage yield (**APY**) in return for providing a loan, which resembles closely loans in traditional financial markets. However, it is unlikely that participating in VA lending will be caught by any definition of regulated activities involving securities.

VA loans themselves should not amount to securities unless:

- The loans become centrally managed and administered with a view to providing returns or profits to participants; or
- The loans become unitised or 'minted' into other assets that are also freely transferable for value.

Staking

VA holders earn a percentage-rate reward by staking – locking up a VA for a certain period of time. The rewards are usually paid in native tokens and governance tokens of DAOs by participating in a proof-of-stake consensus mechanism without a centralised body. This would appear to be similar to a term deposit arrangement at a bank, where the principal amount being staked does not change, and a regular interest component is paid. The only difference would be that tokens being staked may be withdrawn immediately, although in some cases, an un-staking period may be imposed during which time, tokens being 'unstaked' also earn no interest. As such, it would seem unlikely that staking itself gives rise to any security implications – especially where the token being staked is, itself, not considered a security.

Liquidity mining

The majority of decentralised exchanges (**DEXs**) use an automated market maker protocol (**AMM**). AMM-based DEXs resolve liquidity issues by incentivising liquidity providers to channel funds into liquidity pools. In this process, liquidity providers deposit their VA assets into liquidity pools. In return, liquidity providers are rewarded newly minted LP tokens (**LP Tokens**). When the liquidity pool facilitates a transaction, LP Tokens holders will be entitled to receive a fractional trading fee in respect of that transaction.

The analysis as to whether liquidity mining activities can be broken down into several levels. At its most basic, the act of liquidity mining itself should not give rise to any security-type implications. However, when LP Tokens are introduced into the picture – the outcome becomes less clear.

First, the act of providing VA tokens in pairs to liquidity pools is a mere contractual arrangement, similar to a loan. As discussed above, it should not amount to securities.

Secondly, liquidity providers contribute token pairs into liquidity pools in return for profits distributed to them on a pro-rata basis, and there is the prospect of capital gains as well as losses. However, the fact that liquidity protocols act as AMMs and that liquidity contributed is not managed by any centralised entity distinguishes the liquidity mining arrangement from a typical CIS. Therefore, the transaction is unlikely to be one that involves a security.

Finally, LP Tokens provide rights that are akin to the payment of interest or dividends. They are similar to shares as they represent mathematical proof that a party has provided assets to a pool and hold the key to claiming those assets back. LP Tokens may be 'structured products', given that they are instruments under which the return is determined by reference to:

- Changes in the price of the underlying contributed tokens
- The occurrence or non-occurrence of any specified event(s) affecting the price of the underlying contributed tokens

As LP Tokens are generally available to retail investors, they would be structured products that are also considered securities.

Where LP Tokens are also capable of being freely transferred or exchanged, the argument for these being securities becomes even more compelling. Given the above, it would be prudent for managers to approach liquidity mining activity with a bit more caution as there could very well be securities involved in the process, especially when one considers the involvement of LP Tokens.

Synthetic assets

Synthetic assets in DeFi, (also known as **synths**), are conceived as 'tokenised' versions of securities in the traditional financial world. These blockchain-based VA derivatives generate their value from the underlying assets which they are simulating, such as stocks or interest rates, and are represented by digital tokens. The holders of synths do not have any rights or obligations which are assigned to the underlying listed equity. Trading in synths does not directly affect the price of real-world counterparts either, as there is no actual buy or sale of the real securities involved.

Synths are likely to be structured products as defined under the SFO, under which the return is determined by reference to either:

- Changes in the price of the underlying securities which they mirror
- The occurrence or non-occurrence of any specified event(s) (for example, macroeconomic, industry or sector specific),

depending on the type of oracle being used. We do not take the view that the interjection of oracles between the synth and the underlying real world security which they mirror removes the derivative nature of the synth (although it should be noted that the regulators of other jurisdictions have taken a different approach. In Singapore, for example, synths are not considered 'capital markets products' precisely because of the interjection of oracles into the pricing process).

As these structured products are not restricted to "professional investors" and are intended for access by the retail public, this would make them fall within the definition of a security under the SFO. To this end, it should be noted that in 2021, the Italian Consob, the UK FCA, the German BaFin and the Hong Kong SFC have all issued warnings about 'tokenised shares' potentially being securities.

DAOs

DAOs are collectively owned and managed by their members. The smart contract between token holders defines the rules of the DAO and governs the organisation's treasury. Once the smart contract is live on the Ethereum blockchain, the rules can only be changed by vote.

To the extent DAOs are created for profit making purposes and have elements of a pooling of funds for the purpose of deployment to achieve these objectives, they share some common features with a CIS. However, it is clear that there is no management of this property by a third party for or on behalf of the participants in the DAO, and that the participants in a DAO do have day-to-day control over management decisions. As such, it would be difficult to characterise a DAO as a CIS under the SFO.

Nevertheless, it would still be open to classify the tokens of a DAO as securities, particularly if:

- They provided for regular payments which are akin to payments of dividend
- They provided for voting rights
- Their value (or price) depends on, or fluctuates with, the commercial success of the DAO

In the US, at least, the SEC has concluded that tokens issued by The DAO in July 2017 amounted to securities based on an analysis similar to the above.

As each DAO may be formed for different purposes, one would need to consider their specific characteristics on a case-by-case basis to understand the nature of the tokens they are issuing.

Conclusion

DeFi is a rapidly evolving space that has attracted increasing scrutiny from regulators. Given the recent moves by the SFC and HKMA (in their joint announcement issued on 28 January 2022) to close the loop on VA advisory and VA dealing activities (by intermediaries), and the upcoming VA Service Provider exchange regime, our view is that there is a clear trend towards the establishment of a comprehensive regime that will capture all VA related activities, regardless of whether they are securities or not. It is likely, therefore, that by then, there would be less need to differentiate VA (and DeFi assets in particular) based on whether they are securities or not.

Obtaining B Corp certification: People, planet and profit

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Aspect Capital became one of the first European alternative investment managers to achieve B Corp certification earlier this year.

In this article we expand on what B Corp certification means and how it can be obtained, explain why companies might seek certification and examine some factors others, particularly in the investment management industry, may wish to consider before doing so.

What is a B Corp?

Certified B Corporations, or B Corps, are a new kind of business that seek to balance purpose and profit. They are legally required to consider the impact of their decisions on their workers, customers, suppliers, community, and the environment.

B Lab is the non-profit network behind the movement. Founded in 2006, B Lab set-out to create a different kind of economy: a global economy that uses business as a force for good; one where corporations lead the way towards a new, stakeholder-driven model. B Lab became known for certifying B Corporations, a new type of corporation, that are purpose-driven and benefit all stakeholders, not just shareholders.

The B Corp movement has at its heart the concept of 'stakeholder capitalism', with certified B Corps committing to the so-called 'triple bottom line' of people, planet and profit, unlike the traditional corporation that gives priority only to financial profitability.

Why would a business seek to become certified?

B Corp accreditation represents independent validation that a business is being run thoughtfully and sustainably, with due consideration for employees, suppliers, investors and the planet. Just as importantly, it also provides a roadmap for Corporate Social Responsibility (CSR) initiatives, enabling firms to be at the forefront of industry best practice and continue to meet the ever-evolving expectations of investors and current and future employees, who increasingly expect firms to demonstrate their wider impact.

What does the certification process involve?

Certification as a B Corp is a rigorous process designed to identify companies that meet high standards of social and environmental performance, accountability, and transparency. The process starts with completion of the 'B Impact Assessment', which comprises of over 220 questions about the business, spanning five 'impact areas': Governance, Workers, Community, Environment and Customers.

Each response in the B Impact Assessment is assigned a score, and companies who achieve a final, verified score above 80 are eligible to become certified B Corps, so this initial assessment is crucial in helping to determine whether a company is already on track to achieve that or, if not, which areas they should focus on.

Thereafter the process is about evaluating and verifying the responses provided, in conjunction with a dedicated B Corp analyst. Companies are required to evidence the answers they have provided to the B Impact Assessment, via documentation, written follow-up questions and/or a final verification interview, with scores being adjusted up and down accordingly.

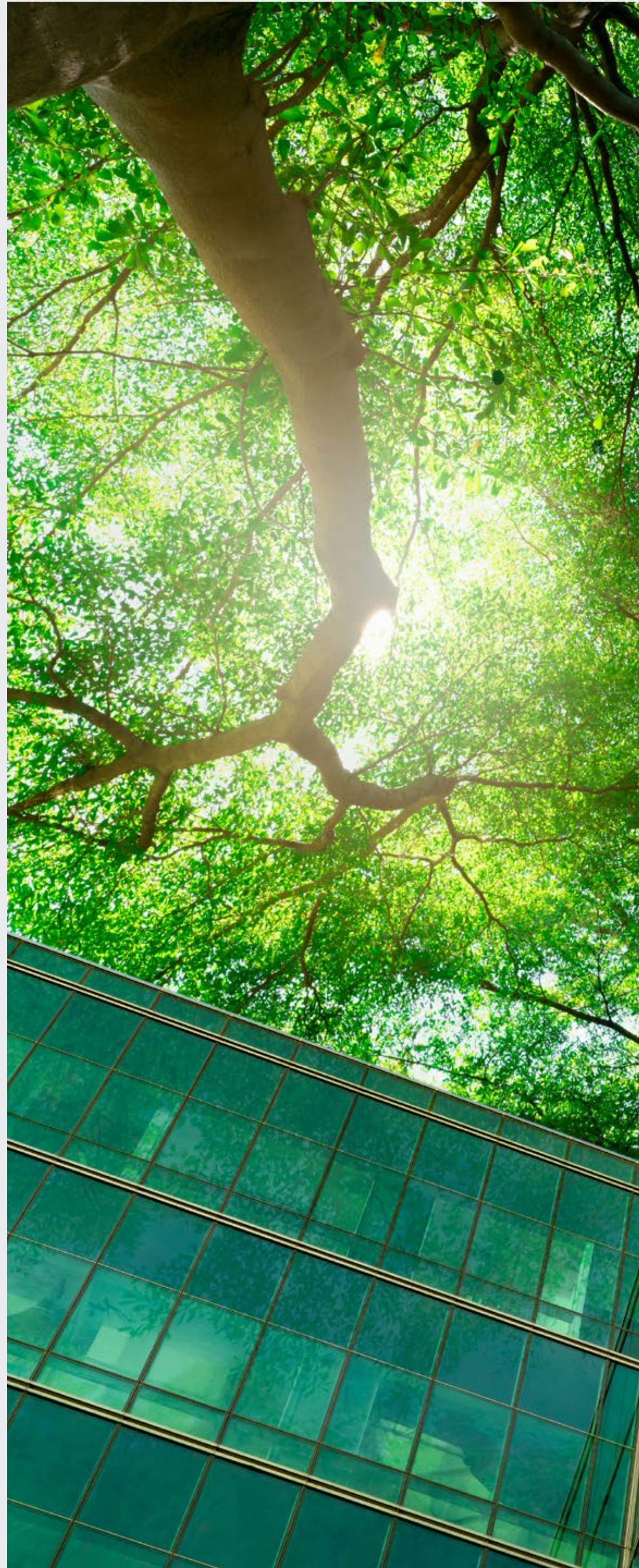
One particularly important requirement, which will contribute materially to a company's overall score, is the so-called 'legal requirement', whereby a prospective B Corp is required to enshrine in its constitutional documentation a commitment to remain legally accountable to all of its stakeholders.

The precise requirement will vary depending on the legal structure and jurisdiction of a company; for, Aspect, a private limited company incorporated in England, this involved a change to the articles of association, requiring the approval of a majority of shareholders.

Once a firm has achieved a verified score of over 80 in the B Impact Assessment, there are a several final background checks before becoming officially certified.

As an example, the process took around 18 months from start to finish for Aspect: initially completing the impact assessment in January 2021 and receiving certification in June 2022. The length of time it takes is reflective of the growing popularity of the B Corp movement, with the B Lab team being inundated with applications over recent years.

This is certainly a positive sign that the movement is gaining traction and recognition, with the number of certified B Corps in the UK alone growing from less than 400 at the start of 2020 to over 700 today. Globally, over 5,000 companies across 83 countries are now certified B Corps.



What factors might other investment managers wish to consider before applying?

The scale of the undertaking for a firm to become a certified B Corp will depend on a number of factors, but in no case should it be taken lightly.

The most significant factor will be the extent to which a company is already operating in accordance with the highest standards of social and environmental performance, accountability, and transparency. In Aspect's case, we achieved an initial score in excess of 80 in the B Impact Assessment, and this was not subject to material adjustment during the verification process. We did not, therefore, have to make significant changes to the way the business operates in order to achieve certification. Firms starting from a lower base can expect a more demanding and resource-intensive process, however, the beauty of the process is that it allows firms to clearly identify the areas in which there is room for improvement and facilitates specific goal setting and tracking against those objectives. Another relevant factor to consider is the industry in which a company operates, with the B Impact Assessment being tailored depending on a firm's industry classification. For an investment manager, the scope for meaningful impact in certain areas will clearly be reduced.

There is a significant focus on environmental, social and governance (ESG) integration and related topics such as impact investing as part of the questioning, which may prove more challenging for some in the industry. At Aspect, we aim to incorporate ESG factors into our investment decisions where appropriate to do so, and continuously seek to minimise our impact on the financial markets in which we operate; but given the nature of our investment strategies and the asset classes we trade, we found there was somewhat limited scope to score points in these areas as part of the B Impact Assessment.

Linked to this, we hope to continue collaborating with B Lab to provide insight into how businesses like ours and the wider finance industry operate, with a view to ensuring that the things our sophisticated, international client base value – such as a repeatable investment process, robust risk management and transparency – are recognised as part of the B Impact Assessment.

Salaried member case digest: A positive result for the industry but by no means the end of the story

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The first case relating to the UK's salaried member rules (ITTOIA 2005 s.863A-863G) was released on 29 June 2022, reference TC/2019/09328. It represents the opening test of the legislation in the UK courts and will have important implications for UK asset managers structured as a limited liability partnership (LLP). Similar to the mixed membership rules that were introduced alongside the salaried member rules in 2014, the first case relates to an alternative investment manager, demonstrating HMRC's continued focus on the industry.

Legislation

The salaried member rules operate by recharacterising a member of an LLP as an employee for UK tax purposes, where three conditions (A to C) are met:

- Condition A – The individual is reasonably expected to receive remuneration that is at least 80% "disguised salary"
- Condition B – The individual does not have significant influence over the affairs of the partnership as a whole
- Condition C – The individual does not have capital >25% of their disguised salary.

If all three conditions are met then the partner will be classed as an employee imposing PAYE obligations on compensation, including the requirement for the LLP to pay the employer's NIC at a rate of 13.8% (15.05% from April 2022). The rules are intended to apply to those members of LLPs who are more like employees than partners in a traditional partnership.

Background

The appellant in the case is one of Europe's best-known alternative asset managers. Since 2009 it has adopted an LLP structure through which to operate its UK investment management functions, and notably decided to close its funds to outside investors in 2015. The case covers five tax years from 2014/15 to 2018/19, over which time approximately one-third of the appellant's workforce in the UK were partners in an LLP, split between three broad categories:

- 1/5 infrastructure members, which included an executive committee (ExCo)
- 3/5 portfolio managers / discretionary traders (collectively the 'PMs')
- 1/5 of other front office members

The compensation of individual partners is comprised of three main components: priority distributions, discretionary allocations, and income point allocations.

HMRC's view was that only the original four partners on the ExCo should be classified as partners for tax purposes (based on the fact that they had significant influence, therefore, failing Condition B), but all the other individual partners met all three conditions. The appellant appealed, asking that the First Tier Tax Tribunal (FTT) consider both Conditions A and B for the remaining partners (noting that it was common ground that the application of Condition C was not in question).

Condition A

The case focused on discretionary allocations. These were decided by a global remuneration committee, which was expected to work out the anticipated accounting profit and then reward members on the basis of their individual performance. For PMs, this was determined by a percentage of the profit made on capital allocations. This was a process of judgment rather than the application of a formula and an individual's profits could increase even though the overall profits of the LLP might reduce.

HMRC submitted that the discretionary allocations were not a share of overall profits and the imposition of a cap, by reference to the profits of the LLP, was not sufficient to establish that the allocations were variable by reference to the profits of the LLP. Whilst there was a clear link to the individual performance of the member, there was no clear link to the profits of the LLP.

The appellant submitted that the amounts were variable by reference to the overall profits of the partnership, and in particular the absence of profits or the presence of a loss, as if the profits were insufficient, then the discretionary allocations were abated or reduced to nil. Even though each partner was 'siloed' in that each partner was rewarded for their performance, poor performance from other partners could affect the overall profitability of the LLP and so could affect the amount awarded to each 'siloed' partner. Furthermore, the appellant submitted that there was no need for the discretionary allocations to track the profits of the LLP from year to year, it was sufficient that the amount was affected by the profitability of the LLP.

The learned Judge agreed with the appellant that there was no need for the discretionary allocations of an individual to track the level of profits of the partnership, hence an individual's allocation could go up even if the firm's profits decreased and vice versa. However, he did not agree that it was sufficient to establish the requisite link that if there were fewer profits available, the quantum of the allocations might abate. Rather, he decided that the element of variation derived not from the profits of the LLP, but rather from the performance of the individuals.

In terms of a literal interpretation of the legislation, this is a surprising decision, as the discretionary allocations were clearly variable by reference to the overall amount of the profits or losses of the LLP. If those overall profits were reduced, then the amount varied. The learned Judge seems to have adopted a highly purposive interpretation based on his view that the purpose of the salaried member rules was to treat as outside the rules, only those who were closely akin to the members of a traditional partnership. This purposive approach worked against the appellant on Condition A but worked in their favour on Condition B.

Condition B

HMRC submitted that the question of significant influence was to be resolved by looking to see who, having regard to the mutual rights and duties of the LLP and its members, wielded *'managerial clout'*. This was directed at what might be described as the constitutional aspects of the various relationships, and other aspects, such as the amount of capital allocations under a PM's discretion were irrelevant.

The appellant submitted that to breach Condition B an individual member did not have to wield significant influence over all the affairs of the partnership, but rather it could relate to just one aspect of the partnership, such as investment activity or back-office activity. Particularly in the case of PMs, an individual partner with a capital allocation of US$100 million or above would wield such influence.

The learned Judge, who referred to his own experience of being a member of a law firm, accepted the appellant's analysis. He saw no justification in limiting significant influence to managerial influence. He saw the broad purpose of this rule as being to distinguish between members playing the role of a partner in a traditional partnership and those who are playing the role of employees. In a memorable phrase, he said the role of a partner was to "find, mind and grind", so get the work, supervise the work and undertake the work. The concept of 'significant influence' went well beyond managerial influence and into other aspects of a partner's activities in a traditional partnership. He also accepted that influence in this sense could also be just over one aspect of the LLP's business. His view was the evidence showed the PMs (with a capital allocation of $100m or more) took key investment decisions on a daily basis and could, both as a class and as individuals, potentially exercise influence over the LLP by reason of this investment activity.

However, (with the exception of the original four members of the ExCo) he did not come to the same conclusion for the infrastructure or other front office members, admitting that evidentially he was struggling to understand precisely what these individuals actually did in the context of the partnership. The lack of evidence and/or familiarity with the inner workings of an asset manager appears to have led to this decision, suggesting there is ample scope for the point to be revisited.

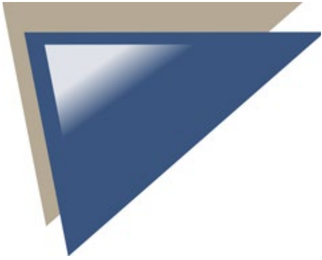
Again, given the wording of the legislation, which does seem directed at constitutional power rather than economic influence or involvement in the business of the partnership, the learned Judge appears to have adopted a strongly purposive interpretation. The counter-argument to this rather broad approach is that parliament in providing the test at Conditions A-C has directed how the legislation is to apply with some considerable degree of precision and so those rules should be applied according to their terms.

Impact on asset managers

Single-strategy asset managers (or those with a single profit pool to share) have historically been able to rely more heavily on Condition A being breached, and the decision in the case is unlikely to change this position. Additionally, it is likely to build confidence in those managers around also breaching Condition B for certain members, also perhaps hoping to apply some of the principles established in the case beyond PMs. Likewise, multi-strategy managers will welcome the finding on Condition B but are likely to be disappointed with the decision on Condition A.

Nonetheless, there seems little doubt that the decision will be appealed, and so further guidance can be expected from the courts as the case works its way through the appeals process. In short, whilst the outcome is positive in some aspects, it is perhaps just the latest chapter in an increasingly long and frustrating story.

Caution should be observed in reading too much into the conclusions thus far, particularly as FTT decisions are only binding on the parties in a particular case. Interpretation of the rules needs to be considered on a case-by-case basis and decisions are fact specific. A high degree of uncertainty around the application of the legislation still exists, however, what is clear is HMRC's willingness to litigate and its continued focus on the industry. Best practice for taxpayers is to evidence compliance annually and reassess the rules for each partner at the beginning of the tax year, or more regularly if required (e.g. new launches, joiners, leavers, etc.). Contemporaneous documentation is extremely valuable and should be maintained. Now is clearly a good time for asset managers to both review their position and the evidence supporting it.



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HMRC guidance boosts the case for credit fund QAHCs

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Introduction/Background

The UK Qualifying Asset Holding Company (QAHC) is a new tax advantaged regime for UK resident companies that was introduced into UK law by the Finance Act 2022 with effect from 1st April 2022 . It is the result of an enormous amount of lobbying by various industry bodies in the fund management sector, including AIMA and the ACC, together with a huge amount of consultation and effort on the part of HMRC and HMT. The QAHC is designed to be an intermediary holding company to own fund assets in the private equity, private credit and real estate sectors. At present, most of these types of intermediary companies are established in Luxembourg or Ireland (at least in terms of funds managed by UK or EU based fund managers). Accordingly, the QAHC rules are designed to compete with their Luxembourg and Irish counterparts so far as possible.

Time will tell whether the QAHC can compete effectively with its EU competitors but one of the main concerns in deciding whether to use a QAHC is to ensure that it can and will continue to meet the qualifying conditions necessary to access the regime's crucial UK tax benefits. Leaving aside the relatively complex ownership condition that a QAHC must meet (which is not addressed in this article) it is also imperative that the QAHC carries on an "investment" rather than a "trading" activity in order to meet the activity condition (or at least that any trading activity is merely ancillary to the main investment activity). The distinction/dividing line between an investment and a trading activity has always been somewhat grey in terms of the activities of funds owning financial assets and the initial guidance put out by HMRC on this point relating to QAHCs did little to shed additional light on the issue. In particular, while most in the industry would normally expect typical loan origination funds to carry on an investment activity, some uncertainty existed in this regard due to the quasi-banking nature of the activity and the fact that fees are often generated in connection with the activity. Accordingly, representatives of industry bodies focused on the credit fund space, including AIMA and the ACC, requested further guidance to be issued by HMRC to try to clarify their views on this topic and as a result additional helpful guidance was issued in early June this year.

The new guidance

The guidance can be found in the HMRC Manuals at IFM40260. In particular, the new guidance sets out further commentary and some specific illustrative examples as to how the key activity test will be applied to certain facts, including loan origination activity (and in particular whether it is an allowable investment activity or a prohibited trading activity). One of the key points to note coming out of the examples is that it is crucial that the intention of the QAHC is to hold debt (whether originated itself or acquired from a third party) for the medium to long term and therefore it will be important for contemporaneous evidence of that intention to be available. For example, company board minutes outlining the intention of the QAHC in terms of the intended holding period of the debt would be an extremely useful record of the intention of the QAHC, especially in circumstances where unexpected opportunities or circumstances force an earlier sale or redemption of the debt. Also, evidence in the form of promotional literature or statements setting out the intended holding period in the strategy section of an Offering Memorandum to investors would be helpful. Unfortunately, but perhaps not surprisingly, there are no bright lines as to what constitutes the medium to long term but the examples indicate that it is likely to mean holding periods of several years and certainly not weeks or months.

Another key point that emerges from the guidance and the examples is that fees received in conjunction with loan origination activity (such as origination, participation, documentation or consent fees) may form part of the investment return alongside portfolio investment income without causing the activity to become a trading activity. In addition, the activity of loan origination will not of itself be considered to be a trading activity or an indication that the company is trading. However, if the QAHC engages in activity such as arranging loans for the benefit of ownership by others or receives significant syndication fees that could lead to a conclusion that the activity is a trading activity. In practice therefore, if such activity might be a part of what the QAHC does, it would be important to evidence at the outset that the intention of the company is that any such fee income or arranging/ syndication activity would only be a small incidental part of the overall investment strategy of the QAHC.

The new guidance does reference that a very high turnover of assets/holding assets in the short term is indicative of a trading activity. However, there is a helpful example that notes that where a bundle of assets are acquired but where not all are intended to be retained, the fact that some unwanted assets are sold in the short term should not prejudice the status of the company assuming the intention is to hold the retained assets for the medium to long term.

Distressed debt strategies

As noted above, the new guidance gives comfort that credit/debt funds that originate or acquire loans with the intention of owning them for the medium to long term should be capable of satisfying the activity condition. However, what about strategies involving the acquisition and sale of distressed debt that are more focused on generating gains rather than income yield? A specific example in the guidance seeks to address this and indicates that provided the initial intention is to hold the debt for the medium to long term it can still satisfy the activity test even if opportunities are taken to sell down the debt from time to time or participate in a debt restructuring or even insolvency activity prior to the final maturity of the debt. However, where the company intends to lead a restructuring or insolvency process prior to the final maturity of the debt this could lead to the conclusion that the activity is a trading activity. That will not necessarily be the case but if, for example, the company was receiving substantial fees for taking the lead in the process that would likely be fatal. In addition, constantly renewing the book of distressed assets with a view to short term realisation held may be indicative of a trading activity.

There is however additional clarification in the new guidance which seeks to illustrate that where debt is converted into equity as a result of a restructuring of the borrower company's debt, this can still constitute an investment activity provided the company continues to hold the equity (or has the intention to do so) for the medium to long term.

Conclusions on QAHC viability for credit funds

Prior to the issuance of the new HMRC guidance, a degree of doubt lingered around whether typical loan origination activity might be treated as a trading activity by HMRC, particularly where fee income was received by the fund in conjunction with that activity. While each case must be considered on a fact specific basis, loan origination funds which intend to hold originated debt for a number of years and properly evidence that intention should qualify under the activity test for QAHCs.

In our view, there is now a strong case for considering the use of a QAHC in conjunction with an EU focused credit fund or loan origination fund in preference to the traditional Luxembourg subsidiary, particularly where unlisted UK debt is to be a significant part of the fund portfolio. If the fund is managed from the UK, it is easier to create substance in the QAHC in the UK and there would be no need to travel abroad or hold overseas board meetings. Neither is the QAHC within the scope of the new ATAD 3 "unshell" Directive which could conceivably deny certain Luxembourg based fund subsidiaries the treaty reliefs that they depend upon to achieve tax neutrality for investors. In addition, with respect to UK debt, there is no need to seek treaty benefits to receive interest payments on a gross basis and that will be a great relief for anyone who has had recent experience of the large delays and administrative headaches which now seem to be inherent in seeking a UK double tax treaty passport from HMRC.

The position in relation to distressed or active fund strategies will clearly require more careful consideration but may still be capable of constituting an investment activity in specific circumstances.

In summary, the new HMRC guidance has resulted in a timely boost to the case for the QAHC and we are now seeing a heightened interest in the potential use of the QAHC in an EU credit or loan origination fund context.

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- **Q4 Edition 132**
  Deadline for submission 5pm UK time Monday 24th October | Publication Monday 28th November

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