BROWN BROTHERS HARRIMAN

REGULATORY FIELD GUIDE 2022

REVISITING THE PAST,
MANAGING THE PRESENT,
AND EMBRACING THE FUTURE

REVISITING THE PAST, MANAGING THE PRESENT, AND EMBRACING THE FUTURE

Dear Reader,

The regulatory environment across the globe in 2022 is as dynamic as any time in the last decade. As we cautiously inch towards the return of social norms, regulators are looking to recalibrate some of the rules that were put in place before the pandemic, address contemporary topics, and harness a variety of nascent technologies.

Certainty is a scarce commodity in these unpredictable times, and new rules, revisions and changes to timelines are also likely to feature in 2022. Which brings us to the theme of this year's Regulatory Field Guide: revisiting the past, managing the present, and embracing the future. To help abate the uncertainty a little, we have listened to what you have told us is important and bring you this guide to light a path on your regulatory journey for 2022.

Revisiting the Past

After a period of robust debate, reflection, and consultation, this will be a year of execution of regulations revisited and those yet to be concluded. The good news is that some of the regulations following the Global Financial Crisis have stood up well to a multitude of factors including global pandemic related volatility. This means that as regulators revisit the past, they plan to make targeted revisions rather than large scale rewrites to items such as the EU's Capital Market Union, the Alternative Investment Fund Managers Directive, European Long-Term Investment Funds, and certain securities settlement cycles.

Managing the Present

There is also a litany of contemporary issues that have surfaced which regulators must grapple with swiftly. These include workplace culture and diversity, environmental and sustainability practices, as well as complex and rapidly changing areas such as nascent technologies like cryptocurrency, artificial intelligence, machine learning, cybersecurity, cloud storage and ransomware events. This means asset managers and financial institutions should heed the global environmental, social and governance (ESG) agenda, the Securities and Exchange Commission (SEC) 2022 agenda, and ever-increasing anti-money laundering (AML) expectations.

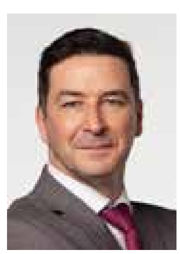
Embracing the Future

The rapid technological shifts that have permeated all aspects of society are fundamentally changing financial services and how it is supervised. Technology has reset customer expectations of how services are delivered, resulting in more data that is transferred more quickly to a wider array of users than ever before and using a multitude of delivery devices and platforms. This increases certain risks and introduces previously unconsidered risks and, as a result, the regulatory perimeter now discernibly reaches beyond previous physical environs and now includes cyberspace, the metaverse, and whatever future digital platform financial services might be conducted upon.

The upcoming agenda also includes a plethora of ESG regulations, as asset managers and their products are viewed through a new and different prism. Non-financial measures of success are now central to how regulators view the totality of activities and practices of regulated entities. This is one of the future topics we will cover in this guide, along with cryptocurrency, and life beyond LIBOR.

BBH's Market Intelligence Group hopes you find the insights in this guide useful as you navigate the regulatory landscape in 2022. We are leveraging our people, our expertise and new technologies to deliver client products and solutions directly related to the challenges and changes outlined within this field guide. We want this to be a conversation starter and our teams are available to discuss any of these topics at your convenience.

Regards,



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On September 7, 2021 State Street Corporation and BBH announced that they have entered into an agreement for State Street to acquire BBH's Investor Services business, including its custody, accounting, fund administration, global markets and technology services. Following the transaction, BBH will continue to independently own and operate its separate Private Banking and Investment Management businesses. The parties are targeting the first quarter of 2022 to complete the acquisition, subject to regulatory approvals and customary closing conditions.

Steering New Money:

Digital Currency to Get its Own Set of Rules

Rules governing crypto, stable coins, and central bank digital currencies look set to shift gears in 2022 as regulators enter the new money fast lane, write John Siena, Tim Bosco and Ingrid Mosquera

As digital currencies continue to dominate the financial headlines, regulators around the world are taking a closer look at how this new money is being used, traded, and developed. Bringing more order to an unruly and somewhat frenetic global market ecosystem hasn't been easy. The absence of legal definitions for any of the myriad of digital currencies, means there is no clear base from which to start writing much-needed regulations.

New rules for digital currencies will fall into three buckets: cryptocurrencies, stablecoins and central bank digital currencies.

Cryptocurrencies: Many people are now familiar with cryptocurrencies such as Bitcoin, Ethereum and Doge coins - three of the largest. They have become almost as popular among young traders as meme stocks[1], despite their huge volatility. Bitcoin, for instance, traded as high as US$67,582 on November 9, 2020, but stood at US$51,519 by December 24, 2021. Cryptocurrencies such as these are primarily a private sector initiative which exists away from the sovereign government issued money frameworks (fiat currencies). They are created on computers by individuals and exist on distributed ledgers, which rely on blockchain technology: their creation is limited to a fixed number.

Stablecoins: These are a form of cryptocurrency generally backed on a 1-to-1 basis by a basket of government-issued fiat currencies such as dollars or euros or other assets. The most popular stable coins include names like Tether and Diem.[2] Unlike cryptocurrencies, there is no limit on how much can be issued. Because of their connection with fiat currencies, stablecoin issuance has boomed from US$5 billion in January 2020 to around US$166 billion in December 2021.[3]

Central Bank Digital Currencies (CBDC): Powered by the technology behind cryptocurrencies, CBDCs represents fiat money that is digitized, using a permission-based blockchain. Unlike fiat currency, CBDCs, much like Bitcoin, have a limit on creation, preventing quantitative easing and debasement, each of which certain commentators suggest have had a detrimental effect on the properties of the traditional fiat money supply. In 2021, the European Central Bank launched a digital euro project[4] and China began a test of a digital yuan.[5] Governments believe these would have the advantages of Bitcoin but also be underpinned by a legal and regulatory framework that would complement, rather than compete with or potentially undermine, global fiat currency ecosystems.

Because computer networks are global, any effort to regulate cryptocurrencies really requires a global approach. In a blog post in December 2021[6], the International Monetary Fund said there exist a variety of risks associated with cryptocurrencies, which it warned "underscore why we now need comprehensive international standards that more fully address risks to the financial system from crypto assets, their associated ecosystem, and their related transactions, while allowing for an enabling environment for useful crypto asset products and applications." Some international agencies, such as the Paris-based Financial Action Task Force, have published guidance[7] to help governments define "virtual assets" and digital currency providers, and proposed rules to prevent money laundering using digital currencies. However, these proposals are not legally binding. They can help shape lawmakers' opinions but no more than that.

Looking to the U.S.

The biggest push for new regulations is likely to occur in the U.S., the world's largest capital market and the most important digital currency battleground. This is where regulators are especially keen to start writing regulations about cryptocurrencies to plug holes that allow criminals and terrorists to send money across borders.

A White House paper on preventing corruption[8] said: "The United States will continue to review the risk posed by digital assets, including the ways in which corruption contributes to those risks, and will continue to refine policies and regulations as needed."

While some U.S. government agencies, including the Treasury Department and the Fed, have expressed concern about digital currencies, SEC Chairman Gary Gensler has been the most outspoken on the need for regulation. "The crypto asset market, US$2 trillion plus in size around the globe, needs more investor protection," Gensler told the Wall Street Journal in December 2021.[9] Because crypto has raised money from the public, he said it broadly fits the SEC's remit. Crypto exchanges are holding crypto tokens and trading against their customer base, so they should be regulated like exchanges, he said. One area likely to face tougher regulation is stablecoins, which Gensler recently said were "acting almost like poker chips at the casino right now." Without stronger oversight, he said, "people get hurt."

Regulators have already sought to punish some stablecoins for lack of transparency about the assets they hold. The Commodities Futures Trading Commission fined Tether US$41 million[10] on Oct. 15, 2021 for "misleading statements and omissions of material fact" about its asset holdings. The New York state attorney general also fined Tether US$18.5 million[11] and banned it from trading in New York, saying: "Tether's claims that its virtual currency was fully backed by U.S. dollars at all times was a lie."

Given the controversy around stablecoin asset holdings, regulations requiring more transparent disclosure of what the holdings consist of may be in the offing.

Once U.S. government agencies agree on which agency has jurisdiction over cryptocurrencies, rules requiring Know-Your-Customer and Anti-Money Laundering measures for Bitcoin accounts at exchanges, much like opening a commercial bank account, also are likely to be presented.

Numerous proposals have been suggested requiring identification of counterparties and the ultimate beneficial owners of cryptocurrency accounts. The Biden Administration slipped a measure into the recently passed Infrastructure law that was signed in November requiring tax payments on profits from crypto trading. Many exchanges only require an email address to open a crypto account. That will likely change in time.

Several fund managers have approached the SEC to set up ETFs based on cryptocurrency daily values, according to a Reuters report.[12] So far, the agency has not granted any application, and Gensler is likely to propose dealing with the crypto issue in its entirety rather than a specific decision on ETFs.

Europe Sets High Benchmark

Meanwhile, Europe is considering a different regulatory approach. The European Securities and Monetary Authority said that in 2022 it will focus on several digital initiatives, including a proposed set of regulations termed the Markets in Crypto Assets Regulation (MiCA). This regulation intends to bring these assets within the scope of regulatory protections in Europe. As is the norm with EU policymaking MiCA is comprehensive and demanding. It applies to any crypto-asset which is not already subject to EU regulation and draws in utility tokens, payment tokens, stablecoins and other asset referenced tokens.[13]

The rules are designed to create a true cross border ruleset – despite laws and regulations that may apply at national levels: there is no attempt to harmonize or rationalize these national approaches. The European parliament has stated that the current absence of crypto regulation:

"*… leaves consumers and investors exposed to substantial risks.*"

In addition, the fact that some Member States have put in place bespoke rules at national level for crypto-assets that fall outside current EU regulation, leads to regulatory fragmentation which distorts competition in the Single Market, makes it more difficult for crypto-asset service providers to scale up their activities cross-border, and gives rise to regulatory arbitrage. Lastly, the crypto asset subset of stablecoins can raise additional challenges if it becomes widely adopted by consumers.

MiCA is perhaps the most all-inclusive regulatory policy attempt globally thus far. It includes a wide range of crypto-asset services and activities which come under its purview, including:

- The custody and administration of crypto-assets on behalf of third parties (wallet providers)
- The operation of trading platforms for crypto-assets
- The exchange of crypto-assets for fiat currency that is legal tender
- The exchange of crypto-assets for other crypto-assets
- The execution of orders for crypto-assets on behalf of third parties
- Placement of crypto-assets (initial coin offerings)
- The reception and transmission of orders for crypto-assets on behalf of third parties (brokerage)

U.S. Sets Out "Policy Sprints" for Future Work

In November 2021, Federal regulatory agencies, Federal Reserve System, Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency issued a joint statement summarizing their interagency "policy sprints" focused on crypto-assets and providing a roadmap of future work related to crypto-assets. Similar to a "tech sprint" model, agency staff with various backgrounds and relevant subject matter expertise conducted preliminary analysis on various issues regarding crypto-assets. The joint statement summarizes the work undertaken during the policy sprints and provides a roadmap of future planned work.[14] Many industry participants agree that the size, shape, and timing of their digital asset programs could be dramatically impacted by what come out of this trio in 2022. It could mean that plans ramp up or ramp down considerably. It has made regulatory topics, and not technology or operational topics, among the most important items to watch.

A Crypto Fast-lane, with Speed-Checks

The crypto craze is global, and it doesn't appear to be a short-term fad. As it continues to grow it has become a broader macro-prudential and systemic policy issue that cannot be ignored. Eager to keep pace with the acceleration of digital currencies, regulators are in the fast lane, and it appears that those in major financial centers are keen to provide rules to steer growth. Expect various further regulatory actions throughout 2022.

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[1] A meme stock is a stock that gains popularity among retail investors through social media.

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ESG is Everywhere, But What Next?

Adrian Whelan looks at the top 10 themes in environmental, social and governance investing that could influence rulemaking in 2022

"I miss the River Shannon, And the folks at Skibbereen,The moorlands and the meddle, With their forty shades of green."

- Forty Shades of Green, Johnny Cash, 1959

I live near the foothills of the Dublin Mountains in Ireland, which is referred to as the Emerald Isle due to its vast greenery throughout the Island. It inspired musician Johnny Cash, who travelled across the landscape and wrote the iconic song "Forty Shades of Green". By contrast, the number of investment funds claiming to be green is far greater than 40. While environmental, social and governance (ESG) themes permeate the entire financial industry globally, rule fragmentation and inconsistent definitions mean fund managers run the risk of being accused of greenwashing.

What is true is that ESG is everywhere and staying abreast of the ever-evolving policy landscape on a national, regional, and global basis is far from easy. Luckily, there are 10 consistent themes, which can help us understand the main regulatory focus areas for 2022.

1. ESG Data, Scoring and Ratings Providers

There has been much commentary on the role of ESG data providers and this intense focus is only likely to increase. For the most part, they are unregulated, however they often play a significant role in the ESG strategies of asset managers and banks. They normally have proprietary models for the acquisition and calculation of ESG data which are used to rate underlying companies on various metrics. ESG data providers also purport that their models are based on a large body of objective research which can find links and causation between higher ESG scores and financial performance.

As such, they play a key role in asset managers' risk management and return goals. However, the divergent designs of their proprietary models (which create different outputs), make it difficult for regulators and investors to compare investments for ESG qualities as using different models will inevitably produce different results.

Regulators are therefore earnestly looking to classify ESG data providers to increase the transparency of the models used to produce ESG scores. On February 3, 2022, the European Securities and Markets Authority opened an industry consultation where it called for evidence on market characteristics for ESG ratings providers.[1] Almost two months earlier, in November 2021, the International Organization of Securities Commissions released a report on ESG data providers.[2] In addition, the triangulation of the EU Taxonomy, the Sustainable Finance Disclosure Regulation (SFDR)[3] and Corporate Sustainability Reporting Directive (which will require many EU organisations to report against ESG metrics) looks to reframe the ESG data model and ensure consistent and comparable methods of weighing and measuring ESG criteria.

2. Global Taxonomies and Standards

Regulatory-driven ESG taxonomies are important classification systems and help bridge the gap between the absence of globally agreed sustainability standards and a uniform method for calculating and comparing ESG characteristics of different investments on a relative basis. They establish an objective list of environmentally sustainable economic activities, enabling regulators and investors to benchmark investments using the same standards and principles of ESG measurement.

The concept of ESG taxonomy has branched out from Europe[4] to include the U.K., Singapore and China. While national and regional versions grow, global convergence on ESG taxonomies is necessary to avoid confusion and provide regulators and investors with assurance of consistency. This will allow them to make meaningful comparisons to enable sustainable integration across global capital markets. The debate on whether gas and nuclear should be included within the EU Taxonomy, highlights the difficulty in reaching agreement on certain taxonomy criteria. Nevertheless, the concept of taxonomies as classification systems will remain a hot topic globally for the foreseeable future.

Taxonomies are not the only show in town for classifying ESG investments. The establishment of the International Sustainability Standards Board (ISSB), announced at the 26th United Nations Climate Change Conference (COP 26) in Glasgow in November 2021, aims to bring an element of harmony to global ESG reporting standards. ISSB will look to set consistent and mandatory accounting standards for entities in 140 countries worldwide.

> "ESG is everywhere, but divergent standards present challenges for cross-border asset managers, many of whom prefer to operate consistent business models on a global basis."

This is an ambitious way of dealing with fragmentation in the way that these entities are currently weighted, including initiatives such as the Task Force for Climate-related Financial Disclosures (TCFD), the Sustainability Accounting Standards Board (SASB), the United Nations Principles for Responsible Investing (UNPRI) and the Global Reporting Initiative (GRI), the Carbon Disclosure Project and the Climate Disclosure Standards Board.

3. Policy Fragmentation

ESG is everywhere, but divergent standards present challenges for cross-border asset managers, many of whom prefer to operate consistent business models on a global basis. Without a single global regulator making the rules, fragmentation is inevitable.

This fragmentation can be burdensome for asset managers operating globally, as non-identical rules from country to country require them to alter their operational processes and compliance policies and procedures. The greater the divergence, the greater the risk, costs, and complexity. Fragmentation is thus the single most dynamic and challenging area of policy for global asset managers in 2022.

That said, supranational bodies such as the Financial Stability Board (FSB) and the International Organization Securities Commission (IOSCO) are collaborating on a global basis to frame guidelines and principles.

4. Proxy Voting and Stewardship

One of the greatest debates in the sphere of ESG investing is about identifying the most effective mechanism for driving tangible and effective change through security ownership. There are three primary schools of thought:

1. **Divestment** in the securities of a company which fails to meet certain ESG characteristics to advance financial, ethical, or political objectives.
2. **Engagement** in the form of dialogue between investors and companies where the investor aims to positively influence the corporate behaviors and strategy of the company to foster sustainable returns over the long-term.
3. **Proxy Voting** or "active ownership" to exercise voting rights on company management/ shareholder resolutions, as well as submitting resolutions, to formally express approval (or disapproval) on relevant matters which might advance.

While each method of driving change at investable companies forms part of the ESG rulemaking roll out we are witnessing, a recent tilt has seen much greater regulatory focus on proxy voting practices. The EU has already implemented its revised Shareholder Rights Directive to increase transparency between issuers and their shareholders and encourage investors to engage in shareholder voting activities and events. The U.K.'s Stewardship Code also sets very high standards of transparency for asset owners and managers on their proxy voting elections and policies and procedures that underpin their proxy voting activities.

In the U.S., the Securities and Exchange Commission (SEC) has proposed changes to its proxy voting advice rules. The changes seek to address investor concerns that existing rules hinder both the timeliness and independence of proxy voting advice from third party firms and subject those firms to undue litigation risks and compliance costs. How asset managers vote on ESG issues is increasingly seen as a test of their ESG credentials.

5. Don't Forget the G in ESG Investing

While much of the focus on ESG investing has been on environmental sustainability (the "E") and social themes (the "S"), there is a disproportionate lack of focus on the G, or corporate governance. Corporate governance may be defined as the manner, principles, and process by which an organization is directed and managed and is therefore perhaps the most important strategic aspect of driving sustainability change in the corporate sphere.

Poor corporate governance practices have stood at the core of some of the biggest corporate scandals.[5] They can lead to reputational damage and financial risk by being inattentive to the most important drivers and forces affecting a business model. The general shift towards sustainability itself is one of the biggest business drivers across all industries and if the governance of the firm doesn't address this fact that could be indicative of mismanagement itself.

6. Ethics, Conduct and Accountability

A firm being judged on ESG should have robust and effective policies for anti-money laundering, cybersecurity, conflicts of interest, insider trading, whistle blowers, and political contributions. There are several interspersed regulations around the globe which home in on ethics, conduct and senior leader accountability.

However, sometimes law and regulation are the lowest bars to clear. In recent years, regulators have cited culture as a key lead indicator of well-run firms. Many of the enforcement actions prosecuted by global regulators have "poor culture" and the absence of ethics or senior leader accountability at their core.

In addition to the firm itself, their senior staff could be held personally accountable for not just their own personal actions but of those under their command.

In the U.S., at the heart of the fiduciary duty is the SEC's Regulation Best Interest, a new rule that aims to provide clarity for consumers across the financial services industry by imposing a higher standard of care rules for asset managers.[6] The assessment of value in the U.K. which now also permeates the European landscape enshrines the concept too. While the concept of individuality accountability regimes has flourished, the U.K.'s Senior Manager & Certification regime (SM&CR), and the Central Bank of Ireland's Senior Executive Accountability Regime (SEAR) stand out. In addition, similar regimes have been rolled out globally including the Monetary Authority of Singapore's Individual Accountability & Conduct Guidelines (IACG) and Hong Kong's Manager in Charge regime.

7. ESG Labelling

One aspect of the ESG ecosystem that continues to grow is "labels". Part of the EU's Sustainable Finance Action Plan is the development of an EU Ecolabel for financial products. There have also been national labelling exercises such as the French government's SRI label (Label ISR de L'Etat Francias), Belgium's trade body Febelfin and Luxembourg's privately-led Luxflag. In framing its forthcoming Sustainability Disclosure Requirements, the U.K.'s Financial Conduct Authority has also included investment labels to further define funds' specific characteristics.

Adherence to certain global frameworks and standards are also used generally as "labels" of quality assurance so funds aligned with the TCFD, the UN Principles for Responsible Investment and SASB and the Global ESG Benchmark for Real Assets (GRESB) are also often seen as quality marks for sustainability. In addition, with the SFDR and its categorization of funds in articles 6, 8 and 9, the market has also begun to label funds with these designations as an indication of their commitment to sustainability standards.

These labels might be useful tools to designate and identify the ESG credentials of an asset manager and its funds. However, it is important that they don't remove the traditional investment and risk management rigor essential in capital allocation. Labels might serve a purpose, but they only serve as another signal of an asset manager's or funds' ESG credentials.

8. Diversity, Equity, and Inclusion

Diversity, equity, and inclusion (DE&I) has become an increasingly important ESG theme, with a myriad of measures put in place to rectify inequality. Regulators are increasingly vocal in suggesting that it can help in the reduction of risk by combatting so called "groupthink", which can often lead to sub-optimal decision making.

Yet, despite the marketing approaches employed by many asset managers on the topic, there may be some way to go in making DE&I de rigueur in actual policies. A European Banking Authority (EBA) report published in February 2020 found that 40% of banks had not yet adopted a diversity policy and two-thirds of boards were composed only of men. In July 2020, the Central Bank of Ireland published a thematic review which showed similar sobering statistics on board composition.

Regulators globally are keen to address this. In March 2020, U.K. FCA CEO Nikhil Rathi stated that diversity will be crucial in the FCA's supervisory considerations. In France, the obligation for company boards to have at least 40% female members was extended from listed companies to companies with at least 250 employees and sanctions were strengthened. In the U.S., the SEC has approved rules to improve diversity on company boards and its Asset Management Advisory Committee (AMAC) has presented recommendations to address the very evident absence of gender and racial diversity within the U.S. asset management industry.

DE&I will increase in focus among regulators and investors throughout 2022.

9. Point of Sale Rules: Suitability and ESG Appetite assessments

Another interesting point about ESG is not just how it will impact portfolio compositions and investor appetite, but it also has a discernible effect on the traditional investment advisory and distribution model. Regulators are directing this area too. Through certain revisions to the EU Markets in Financial Instruments Directive (MiFID) requirements, investment advisors and portfolio managers will soon be required to incorporate clients' ESG preferences into their product suitability assessments.

Additionally, the EU SFDR demands detailed disclosure requirements for both principal adverse impacts sustainability statements, additional disclosure requirements for Article 8 (those funds that promote E or S characteristics but do not have them as the overarching objective) and Article 9 funds (those funds that specifically have sustainable goals as their objective as well as the addition of certain mandatory disclosure templates for funds). It is also important commercially to avoid negative regulatory scrutiny and that all salespeople in the chain of distribution are at least conversant on the ESG criteria and credentials of the funds they are selling.

Likewise, in the U.S., the concept of ESG integration and fiduciary duties as well as the implementation of the SEC's Regulation Best Interest now means that where a fund purports to be ESG, the registered investment advisor needs to be able to articulate the mechanisms used to justify this designation. The spectre of both mis-selling and greenwashing loom large if advisors cannot provide investors comfort that the fund truly does stand up to its ESG promises. The funds sales and distribution game just got a whole lot more complex globally.

10. ESG Disclosure

Across all major financial jurisdictions, regulators in different markets are introducing new ESG disclosure rules compelling funds and asset managers to disclose information on their ESG footprint within annual reports and mandatory regulatory reporting. However, in the absence of a universally agreed upon global standard for reporting, it can be unclear which rules to follow when reporting, once more raising the challenge of rule fragmentation.

The International Organization of Securities Commissions (IOSCO) has weighed in on the topic. The global regulator stresses the need for investors to have comparable ESG data, based off certain universally agreed reporting standards. The establishment of the ISSB to develop global standards based primarily off disclosure standards of the TCFD could ultimately form a global baseline of sustainability disclosure.

Regulators in individual jurisdictions are also moving on disclosure. The EU leads the disclosure space race with its SFDR, but in the U.S., SEC Chairman Gary Gensler has said he wants mandatory disclosure on climate risks. The U.K. is also a fast follower with the publication of a triumvirate of ESG disclosure related documents in late 2021:

- Greening Finance: A Roadmap to Sustainable Investing
- FCA Discussion Paper 21/4 Sustainability Disclosure Requirements (SDR) and investment labels
- FCA Policy Statement 21/24: Enhancing climate-related disclosures by asset managers, life insurers and FCA-regulated pension providers

While staying abreast of the ever-evolving ESG policy landscape on a national, regional, and global basis presents a challenge to asset managers, they can be guided by these universal themes that will influence rulemaking in 2022. Given the strides of regulators to collaborate further on global standards for ESG disclosure, reporting and measurement one thing looks clear: thematically convergence on ESG rulemaking is gathering pace and asset managers can hope for more consistent shades of green when it comes to ESG rulemaking.

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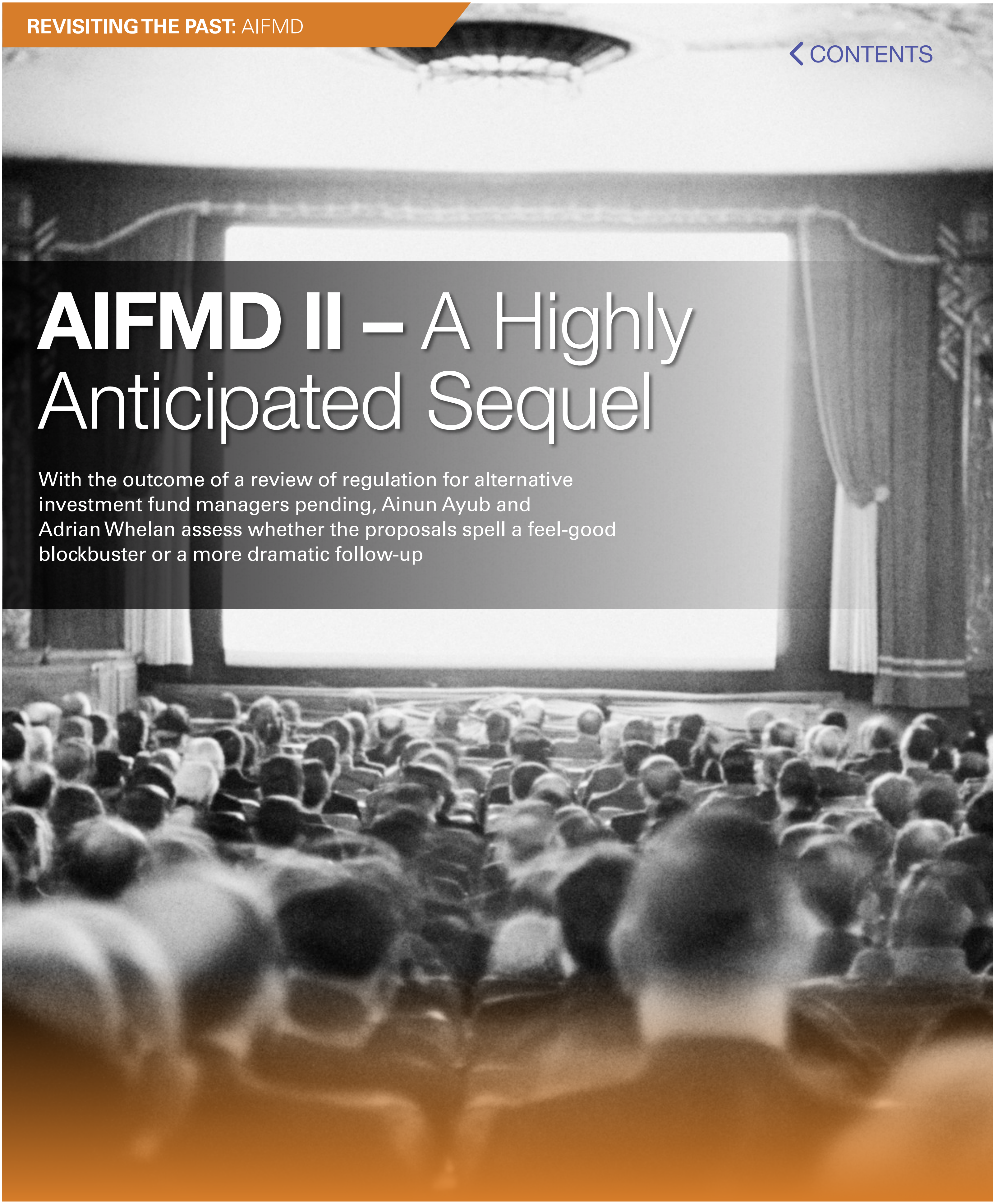

AIFMD II – A Highly Anticipated Sequel

With the outcome of a review of regulation for alternative investment fund managers pending, Ainun Ayub and Adrian Whelan assess whether the proposals spell a feel-good blockbuster or a more dramatic follow-up

"Great success breeds a lot of things, including sequels."

– Dwayne "The Rock" Johnson

In the wake of the Global Financial Crisis and certain momentous events such as the Madoff scandal,[1] European policy makers looked to reshape the EU alternative fund landscape with a heightened investor protection regime. The solution to this apparent under regulation of alternatives was the Alternative Investment Fund Manager Directive (AIFMD).

First introduced in 2011, AIFMD had a turbulent beginning owing to its recast of the entire alternative fund model in Europe, impacting fund distribution particularly for non-EU funds selling into the bloc, delegation models, trade reporting, liability standards, the depositary regime, and remuneration.

However, despite its bumpy start, AIFMD has largely worked as intended and for the most part it has been a policy success if measured by the criteria of making the EU alternatives fund market better governed, reducing adverse investor impacts and increasing the ability to supervise for regulators. AIFMD set a high governance bar for alternative funds in Europe: funds under the regime have grown significantly year on year to now stand at over €7.6 trillion assets under management based on the European Fund and Asset Management Association's (EFAMA) September 2021 Fact Sheet.

AIFMD II: A Feelgood Sequel?

Since AIFMD's inception, the plan was always to review the framework with a view to ensuring it was fit for purpose. Kicking off in January 2019, that process has taken longer than expected, but with the European Commission's proposal publication on November 25, 2021,[2] at long last AIFMD II is finally here (see Figure 1). In this article we look at the major plot points of this much anticipated regulatory sequel. Spoiler alert: the sequel is more of a feel-good film than a horror movie.

Based on an initial review, the proposed revisions are very targeted in nature. This mild revision of the Directive owes to the fact that, for the most part, many stakeholders believe that the AIFMD has worked as intended since its introduction and there is no need to disrupt its functioning with wholesale revisions. In addition, certain areas of the AIFMD proposal contain cross references to the UCITS Directive and seek alignment in key areas such as delegation, liquidity risk management, regulatory reporting, and treatment of depositary/custodians. This is a positive for asset managers who operate under both regimes and is in line with the EU's aspiration for greater supervisory convergence across Member States.

Figure 1: The AIFMD Review Journey So Far

January 2019	June 2020	August 2020	January 2021	November 2021	Throughout 2022
An independent review of the AIFMD conducted by KPMG on behalf of the European Commission	The European Commission publishes its own review into the AIFMD	European Securities and Markets Authority (ESMA) Letter sets out its opinion on areas of amendment to the AIFMD which ought to be considered	A public consultation on the AIFMD is conducted from October 2020 to January 2021 with significant industry feedback submitted	The European Commission publishes its proposals for "AIFMD II," the culmination of years of review	The European Commission's proposals will be debated, subject to scrutiny and change with the European Council and Parliament.

What Happens Next?

The Commission's proposals are merely the opening gambit of the detailed EU trilogue process. They will now move on to the reviewing and debating phase at both national level and by the Council and the European Parliament. Given the revisions are quite targeted and specific rather than broad based, it's expected that agreement on the proposals will be reached quickly, so likely in the second half of 2022. The EU Council is expected to begin its work immediately with an initial reading of the text, followed by more intense negotiations, so industry advocacy on areas of importance initially noted will be crucial.

That would be followed by publication of the final AIFMD II in the EU official journal in early 2023. EU Member States would then be given 24 months to implement the required changes in domestic legislation and regulations. On that timeline and the assumption of no problems or undue delays with adoption of the proposals would mean AIFMD II would apply from late 2024 or at the start of 2025. As always with these highly complex policies, the devil is in the detail. So, while it may seem like a relatively benign timeline for revision, a flurry of action should be expected in early 2022 when the technical details of the proposals will be digested and discussed at industry level.

AIFMD II Proposals: The Major Plotlines

The proposals are wide-ranging, but the "Top 10" most important elements are:

1. Delegation Models

AIFMD permits alternative investment fund managers (AIFMs) to delegate certain tasks as long as certain criteria continue to be met. However, in the wake of Brexit there was an intense focus among EU regulators on delegation particularly to non-EU third countries. Despite industry's ongoing insistence that global delegation models provide better investor outcomes and are already robustly supervised, modifications to the existing delegation models were expected. It remained a question of how disruptive the proposed changes would be. After much anxiety and bated breath, the largely positive news is that delegation will continue in much the same manner as it does now. A couple of bells and whistles have been added but overall it's a good news story for global asset managers.

For example, AIFMs may continue to delegate more of the portfolio and risk management functions than they retain. There had been widespread concern that a requirement to retain a majority proportion of activities within EU-based AIFMs would be imposed, but this has not ultimately come to pass. That allows the continued unfettered access to asset manager expertise. A new delegation reporting requirement is now placed upon national regulators who must report to the European Securities and Markets Authority (ESMA) instances where AIFM's delegate more risk and portfolio management activities to third countries than are retained. ESMA must develop the "form, content and procedures" for these notifications and there will be additional work for AIFMs, but it remains far more palatable than additional restrictions to use of third country delegates overall. It is further expected that this new delegation reporting will help ESMA make future decisions on whether further rule making is required particularly if they sense that that "too much" activity is happening beyond their EU regulatory perimeter or if they consider too much reliance on third country expertise to represent a systemic risk.

The issue of delegation dovetails also with the concept of domicile "substance." The proposals require the AIFM to employ or commit to employ two natural persons resident in the EU on a

Indicative AIFMD Trilogue Timeline

January 2022	H2 2022	Q1 2023	Q1 2025
EU Council reading of proposals and industry advocacy will be intense at start of 2022	Proposals expected to be ratified by Council and Parliament	Publication of Directive to EU Official Journal	Likely effective date for AIFMD II

full-time basis. In practical terms, the horse has already bolted on this topic since the two largest EU AIFMD fund centers, namely, Luxembourg and Ireland have already imposed quantitative substance requirements on AIFMs above the AIFMD II proposal. Nevertheless, the clarity and putting regulatory substance on a pan-EU legislative basis is important.

2. Delegation Notifications

So, while there is no imposition of a requirement for an AIFM to retain more risk or portfolio management than it has delegated, there will be a new reporting regime implemented where this is the case. The proposals request national regulators to notify ESMA annually of delegation arrangements where more risk or portfolio management is delegated to non-EU third-country entities than is retained. ESMA is tasked with development of the required standards and procedures for such delegation notifications. These delegation notifications also seem to apply to current delegation arrangements. Therefore, a review of existing delegation arrangements will be required regardless and the detailed Level 2 rules will draw much focus from industry.

Firms can take comfort from the fact that in Ireland and Luxembourg much of the work on delegation has already been carried out. There is also already a body of existing work in both the ESMA Brexit opinion and the recent supervisory work of the Central Bank of Ireland and Commission de Surveillance du Secteur Financier (CSSF). That should hopefully place most AIFMs in the two dominant AIFM domiciles in a relatively good position to deal with these reporting obligations regardless.

The Commission's proposals also require ESMA to provide the European Parliament, the Council, and the Commission with regular reports (at least every two years) analyzing prevailing EU AIFM delegation practices involving entities located in non-EU third countries. This includes the United States and the United Kingdom, both significant providers of required risk and portfolio management services to EU AIFMs. Five years after AIFMD II is effective, the Commission is then required to review the functioning of the new delegation regime with a view to preventing the creation of EU letter-box entities. The proposals also include similar amendments to the UCITS Directive on delegation.

While it's hugely positive that no substantial changes are deemed necessary to the delegation model currently in situ, ESMA's role on supervision of delegation will be further codified. The industry may currently be confident that no fundamental changes to the global AIFMD delegation regime are necessary or will apply into the future. However, it does seem like the new delegation notification regime is a basis for future rulemaking of some kind by ESMA so will remain one to watch for all asset managers globally.

3. Third-Country Marketing

The proposals materially amend the AIFM third-country marketing rules. They state that non-EU third-country alternative investment funds (AIFs) may only be marketed within the EU if their home states are not on the EU list of non-cooperative jurisdictions for tax purposes. This marks a significant deviation from the current reference to the Financial Action Task Force Anti-Money Laundering blacklist.

Also, there may not be much time or pre-warning before a jurisdiction is re-characterized as 'non-cooperative'. The dynamic nature of changes to the EU's list also means increased uncertainty and if a particular third country became ineligible, for example in the middle of a fund raising, this would be very disruptive to an asset manager's distribution strategy.

4. Liquidity risk management

The AIFMD II proposals include specific provisions relating to liquidity risk management. Liquidity management in a fund context refers to a set of processes, strategies, and supporting mechanisms or tools that ensure a fund is able to access cash when it is needed, in particular to pay out redemption requests promptly as they are received. A range of liquidity risk management tools (LMT) exist including redemption fees, swing pricing, redemptions in kind, side pockets, fund suspension and more. Previous recommendations by the European Systemic Risk Board (ESRB) and ESMA, for the harmonization of rules governing liquidity management tools,[3] are not currently explicitly referenced in AIFMD or UCITS. There also currently exists a wide spectrum of divergent practices and supervisory approaches on LMTs across member state regulators.

The proposals provide that an AIFM that manages an open-ended AIF must select at least one appropriate LMT from a list (to be set out by ESMA in a new AIFMD Annex) for possible use in the interest of the AIF's investors – this is in addition to being able to suspend subscriptions and redemptions. The AIFM must also implement detailed policies and procedures for the activation and deactivation of its selected liquidity management tools and the operational and administrative arrangements for their use.

The proposals also allow regulators themselves to step in where they see fit and demand that an AIFM activates or deactivates a relevant LMT. This is a novel approach, and it is also expected that this power be extended to cover non-EU AIFMs – the question of jurisdiction is particularly interesting here. Also, whether regulators will be capable of enforcing the activation of LMTs – which may not be in the fund documentation – remains to be seen. The majority of these LMT proposals will also extend to UCITS and it is proposed that UCITS management companies notify the competent authorities when they activate or deactivate an LMT.

ESMA will work on detailed technical standards - a process that will be watched with great interest as it adds a layer of complexity operationally and around the timing of such events. By their nature LMTs are used in times of great market stress, with funds quite reluctant to pull the trigger on them and they are in practice a last resort. The fact that a regulator may now formally instruct the activation or deactivation of LMTs is unprecedented and significantly curbs an asset manager's autonomy and discretion. It is likely to be an area of robust industry debate when ESMA releases the detailed proposals. It does mark a more interventionist stance by ESMA on a topic it has long considered to be crucial to wider systemic risk consideration, so perhaps is not as unexpected as many suggest.

5. Loan Origination Funds

Loan origination is another area where the Commission suggests diverging national regulatory approaches have undermined the growth of the market, result in regulatory arbitrage and provide uneven levels of investor protection across the EU. The proposed loan origination changes therefore sit in the supervisory convergence and harmonization agenda that underpins many of the ESMA AIFMD proposals. What is also true is that loan origination has become a far larger market within the EU primarily due to certain bank retrenchment from lending, particularly to start ups and EU small and medium enterprise (SME) segments.

ESMA gave an opinion on the key principles for a European framework for loan origination funds in 2016, which largely mirrored the loan fund regime implemented in Ireland and where certain requirements are already applicable to Luxembourg AIFMs managing loan-originating funds. These proposals move this on a level playing field and look to strike a balance between preservation of financial stability and growth and development of the EU loan AIFs market. The most notable changes to the framework include:

- *Closed Ended*
  Loan-origination AIFs (L-AIF) must be closed ended if the notional value of their loans originated exceed 60% of their net asset value (NAV).
- *Lending to other Financial Institutions*
  A lending concentration limit of 20% of the AIF's capital applies if the borrower is a financial institution under Solvency II (which directs the amount of capital insurers must hold to reduce the risk of insolvency), or a collective investment undertaking such as a UCITS or another AIF, but significantly not to other borrower types.
- *Risk Retention*
  Intended to "avoid the moral hazard" of originated loans being immediately sold off on the secondary market. So, a loan-AIF must retain on an ongoing basis 5% of the notional value of loans originated and subsequently sold off to the secondary market.
- *Conflict of Interests*
  AIFMs and their staff should not receive loans from L-AIFs that they manage. Similarly, the AIF's depositary and its staff or the AIFM's delegate and its staff should be prohibited from receiving loans from the associated AIFs.
- *Lending Policies and Procedures*
  AIFMs managing L-AIFs must implement effective policies, procedures, and processes for granting loans, which must include elements such as credit risk, and administer and monitor their credit portfolios. These policies, procedures and processes must be periodically reviewed.
- *New reporting requirements*
  AIFMs will also be required to report to investors the portfolio composition of originated loans.

6. Depositary Considerations

The current AIFMD requirement is that a depositary should reside in the same Member State as the appointing EU AIF. The Commission notes that in smaller, more concentrated markets, where there are fewer service providers, this requirement leads to a lack of competition, increased costs for fund managers and less efficient fund structures, impacting on investor returns. The introduction of a depositary passport was considered but was not deemed feasible without EU harmonization of securities and insolvency laws.

So rather than introducing a depositary passport, the proposals contain an interim measure permitting depositary services to be sourced cross-border, pending further review. Related to this, depositaries must cooperate, not only with their home state competent authorities but also with the competent authorities of the AIF's and its AIFM's home states. For depositaries in non-EU jurisdictions, the depositary should not be established in a high-risk third country pursuant to Article 9(2) of the AML Directive.

The Commission notes that, under current AIFMD rules, depositaries are sometimes prevented from performing their duties where the fund's assets are held by a Central Securities Depository (CSD) as CSDs are currently not considered delegates of the depositary. The proposals however seek to bring CSDs into the chain of custody and CSDs under AIFMD will be deemed to be delegates of the depositary where they are providing custody services, aligning with existing UCITS rules. This revision is seen as leveling the playing field among custodians and ensuring depositaries have access to all the information required to perform their asset safekeeping and oversight duties.

7. New Regulatory Reporting

AIFMD II suggests increased regulatory-reporting obligations for all types of AIFM. The Commission appears keen to increase the amount of data it receives, proposing that "limitations" are deleted from the data that competent authorities receive from AIFMs on their AIFs. In practice, this means that references will be to "the instruments traded" rather than "the main instruments traded."

Further changes are also in the pipeline regarding Annex IV reporting, as the Commission has mandated ESMA to develop level 2 standards to replace the current Annex IV supervisory reporting template. The general expansion of the scope of AIFMD reporting, inclusive of transaction level, liquidity, leverage, loan origination, direct and indirect fees, delegation models and servicing of securitization special purpose vehicles, just shows the direction of travel where regulators want to use data and analytics to supervise to a greater degree than ever before.

8. ESMA's Wider Remit

Another important consideration is the Commission's proposals to expand ESMA's remit once more to have more direct supervisory authority. There has been an ongoing shift towards increased ESMA powers with a view to ensuring regulatory harmonization, which detracts somewhat from national regulator competency. ESMA is also charged with developing a significant amount of the Level 2 technical details on a range of AIFMD issues. The authority has in the past used its mandate on the regulatory technical standards as an opportunity to expand the scope and specificity beyond the principles outlined in the Commission's original proposals. This has been the case in relation to several Brexit-related initiatives but also in terms of liquidity-risk management, delegation, and substance and certain Markets in Financial Instruments Directive (MiFID) revisions. The industry therefore will be watching for the AIFMD II technical details as they become available.

9. UCITS Impact

What's good for the goose is good for the gander when it comes to delegation regulation it seems. And there are several AIFMD II themes that carry over into proposed changes to the UCITS regime also. This is very much in line with the general supervisory alignment agenda that ESMA is campaigning for and reflects the fact that a great number of asset managers and fund management companies operate within both regimes anyway.

10. Fees and Charges Disclosure

The proposals call for increased disclosure of all fees and charges which apply to an AIF and that will be borne by the AIFM and its affiliates. This includes quarterly reporting on all direct and indirect fees and charges. Across the board regulators are becoming increasingly focused on fee transparency and value for money. Unsurprisingly, this also makes its way into the AIFMD II proposals.

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[1] American fraudster and financier Bernie Madoff ran the largest Ponzi scheme in history.

[2] https://www2.deloitte.com/lu/en/pages/aifmd/articles/aifmd-ii-out-now-european-commission-published-draft-amend-aifmd.html

[3] https://www.esma.europa.eu/sites/default/files/library/esma34-39-1119-report_on_the_esrb_recommendation_on_liquidity_risks_in_funds.pdf

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Delayed, But Not Cancelled: Some Welcome Regulatory Breathers

Key deferrals of regulatory implementations in Europe have afforded asset managers some welcome respite, but much preparatory work remains for each

"Delay is preferable to error"

–Thomas Jefferson

With the upheaval caused by the global pandemic, one of the greatest challenges has been scheduling events. Everyone has been impacted by cancellations, rearrangements, or deferrals to one degree or another. Best laid plans have been disrupted at late notice or sometimes with no notice at all. Vacation travel, meals in a restaurant and house calls to family and friends are some of the activities that have been subject to change at short notice. Some regulators have faced a similar fate and have had to delay their own plans.

Regardless of the reasons there have been some key deferrals of regulatory implementations in Europe which have afforded asset managers some welcome respite, at least for the time being. However, it's important to remember that these have merely been deferred not canceled and as such there remains much preparatory work for each even if asset managers now have a little more time to get ready.

Let's look at these three crucial regulatory delays in turn:

1. Packaged Retail and Insurance-based Investment Products Regulation (PRIIPs)

On November 23, 2021, the European Parliament voted to formally delay certain requirements for Packaged Retail Investment and Insurance Products (PRIIPs) and UCITS. The changes confirmed that funds already producing a UCITS Key Investor Information Document (KIID) will now have until December 31, 2022 to produce a PRIIPs Key Information Document (KID), and also confirming that a UCITS KIID is no longer required as long as a PRIIPs KID is produced.

The progress of the latest PRIIPs revisions were much anticipated particularly because they were going to include UCITS funds in their latest roll out. The original plan was that UCITS would begin to provide PRIIPs key information documents (KIDs), a template investor disclosure document, from July 1 2022, following the end of a previously agreed exemption period.

However, on November 23, 2021 the European Parliament voted to extend the deadline once more, this time from the intended date of July 1, 2022 until December 31, 2022. This "quick fix" amendment has avoided the requirements for trilogue meetings between the EU parliament, EU Commission and EU Council. At the same time, it was confirmed that a UCITS KIID is no longer required so long as a PRIIPs KID is produced to avoid duplicative and confusing information being given to an investor.

The extension was universally welcomed by asset managers owing primarily to the inevitable upheaval which would have resulted from having to transition thousands of existing UCITS KIIDs to the new PRIIPs KID version.

In voting through the further delay, there was once more much commentary about the evident deficiencies of the PRIIPs and MEPs tabled an amendment to the regulation that would allow asset managers to continue to provide professional investors with a UCITS KIID (in the format they do currently) if they wished. The PRIIPs KID has proven to be unpopular with investors and asset managers alike due to primarily the inclusion of future performance scenarios and concerns around the calculation of fund costs particularly transaction costs.

Finally, the European Commission has already begun a wider review of the PRIIPs regulation as part of its Retail Investment Strategy which itself is a cornerstone of the wider Capital Markets Union initiative. This reviews findings are due to be published in Q2 of 2022. If the EU's goal is to increase retail investor access and understanding of mutual funds, then the PRIIPs KID debate becomes extremely important. The goal should be creation of a template disclosure document that is useful and easily understood by investors, as the current UCITS KIID is.

2. Central Securities Depository Regulation: Settlement Discipline Mandatory Buy In

The Central Securities Depositories Regulation (CSDR) is one of the key regulations adopted in the aftermath of the 2008 Global Financial Crisis and focused on ensuring more efficient settlement of securities in Europe. For some asset managers, it was largely seen as a custodial issue but that's only partially true. CSDR's iterative roll out has been in train since 2014 However, the last and most contentious part is the Settlement Discipline Regime (SDR). SDR includes the provision of mandatory buy-ins and cash penalties for failed transactions.

The industry has long advocated for dropping the mandatory buy in (MBI) requirement, or at least deferring it so that it could be reconsidered as drafted in the legislation. The industry argued that MBI's disruptive impact would lead to higher trading costs and spreads and heightened liquidity risks, which were born out in certain segments of the bond markets in the early stages of the Covid crisis. Following extensive engagement between the industry and public authorities, an agreement was reached in trilogue in November 2021 among the EU co-legislators that MBI should be delayed beyond February 1, 2022. ESMA followed up in December by publishing a recommendation to supervisory authorities not to prioritize MBI (despite taking effect under the legislation): some national supervisors responded with announcements confirming as much.

MBI is expected to be reviewed by the Commission before mid-2022: the industry hopes that any changes – if MBI is retained in some other form – would take effect with sufficient time for the industry to prepare.

3. Sustainable Finance Disclosure Regulation

No discussion on European or indeed global regulation would be complete without mentioning the Sustainable Finance Disclosure Regulation (SFDR). Initially introduced on March 10, 2021, SFDR's goal is to make disclosure of financial products' performance on ESG issues compulsory for EU asset managers, to help EU's broader ambition to meet its emissions reduction targets. Its implementation is a hugely complex undertaking, and we have already seen a delay to the application of the regulatory technical standards (RTS) to July 1, 2022, also not its first deferral. Then in late November, the European Commission confirmed that, due to the "length and technical detail" of the directive, it would delay the application of the RTS six months until January 1, 2023.

The SFDR 'level two' obligations require funds to report on 18 mandatory principle adverse impacts statements (PAIS) as well as other voluntary areas of disclosure. While this delay is broadly welcomed, asset managers should know that they still provide disclosures under SFDR, and they are expected to comply with its requirements on a best-efforts basis until then. Asset managers continue to scramble to find solutions to gather all the necessary data to adhere to the very prescriptive and detailed disclosures contained in SFDR and the other ancillary ESG regulations which are cropping up across the global capital markets.

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[1] PRIIPS statement Nov2021 final.pdf (efama.org)

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LIBOR Leftovers

Financial institutions have had a lot on their plates in bidding farewell to the most popular interest rate benchmark. Sinead McIntosh assesses industry progress in moving away from LIBOR to alternative risk-free rates and the extent to which it will consume the regulatory agenda in 2022

December 31, 2021 bid a near final farewell to the London Interbank Offered Rate (LIBOR), the most popular reference rate for an array of financial products. Regulators called time on its use for new contracts, with only nine of the existing 35 permutations of LIBOR continuing and those solely for use in legacy contracts yet to be transitioned. This has involved a lot of work for many, from derivatives and loans to debt issuance where consent solicitation has frequently been required.

Launched by the British Bankers' Association in 1986, initially for three currencies and as a benchmark for pricing floating rate corporate loans, LIBOR grew to become one of the most important financial constructs in the global economy, with more than US$350 trillion in financial contracts being tied to it. That doesn't include the tens of billions of dollars of residential. mortgages and consumer loans around the world referencing LIBOR.

Following widening cracks in the authenticity of LIBOR, including incidences of rate manipulation, false reporting, and a decline in liquidity in the interbank funding market, global reforms relating to benchmark rates were undertaken and in March 2021 the U.K. Financial Conduct Authority, and Intercontinental Exchange (ICE) Benchmark Administration (IBA), LIBOR's administrator, finally announced the definitive end dates for the reference rate.

Transition Risks: Operational, Legal, Political and Conduct

Because LIBOR rates play such a fundamental role in banks' day-to-day business and importantly in their valuations and risk management, transition away from LIBOR carries significant risks. Banks have been focusing their efforts on transitioning legacy business and internal operational processes and systems capabilities. It has been estimated that banks across the world have spent more than US$10 billion in their transition planning activities and the relevant competent authorities have been keeping an increasingly vigilant eye on their efforts.

U.K. and Europe Accelerate Adoption of Alternative Rates

In the U.K., the FCA states that the Bank of England's Sterling Overnight Index Average, or SONIA, compounded in arrears, is the preferred alternative rate for derivatives and securities markets. The industry-led Working Group on Sterling Risk-Free Reference Rates opined that the same rate will become the industry standard for the loan markets. Over the course of 2021, there was an accelerated adoption of SONIA across derivatives, floating rate notes and securitizations. This consistency of benchmarks across multiple markets has provided market confidence and its pervasiveness has become self-reinforcing.

Along with LIBOR cessation, across Europe there have been reforms and replacements of other national benchmark rates that are in varying degrees of completion.

Banks in Europe continue to see the biggest transition obstacles on the asset side of their business (loans and securities) for a number of reasons. These include legal difficulties in renegotiating existing contracts to implement fallback language for identifying a replacement rate if a benchmark (e.g., USD LIBOR) is not available, concerns around litigation and conduct risks, and operational challenges internally. Meanwhile, on the liabilities side, debt issuance is markedly more under control.

This mismatch between asset and liability benchmarks causes a particular headache for collateralized loan obligations (CLOs), which take groups of leveraged loans, package them up and use them to back payments on new debt issuance. CLO managers have been rushing to close transactions ahead of the anticipated rate disparity for existing and new debt and that, combined with very buoyant new CLO volumes (collateralized by plentiful cheap COVID loans), meant there was a large surge in issuance late in 2021.[1] CLOs starting from Q1 2022 may be buying loans from late 2021, notes Bloomberg.

> "The industry-led Working Group on Sterling Risk-Free Reference Rates opined that the same rate will become the industry standard for the loan markets."

U.S. Regulators Focus on Enforcing Transition Plans

In the U.S., there is near universal consensus that derivatives markets and capital markets products should transition to the Secured Overnight Financing Rate (SOFR). The loan markets, however, aren't quite so clear cut: the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) even stated that they have not endorsed a specific replacement rate; indicating that banks can determine the most appropriate alternative, be that SOFR or another reference rate fitting its funding model and borrower requirements.

Timing for the transition of USD LIBOR is extended due to the sheer number of live legacy contracts. However, the FCA and U.S. regulators jointly stated that financial institutions were "encouraged" to stop entering new USD LIBOR contracts no later than December 31, 2021, highlighting the safety and soundness risks those institutions would face should they fail to do so. With the ultimate cessation dates of USD LIBOR being set as June 30, 2023, this provides financial institutions with an additional window to work on their transition projects, allowing high volumes of legacy contracts to mature.

> "The approach is two-fold: adopt global benchmarks such as Dollar and Sterling, and adopt local benchmarks, which regulators have been developing in partnership with the banking industry."

With this in mind and safe in the knowledge that SOFR rates have been published by the Federal Reserve Bank of New York since 2018, market participants are not chomping at the bit to switch over. The second half of 2021 saw large U.S. corporate lenders using alternative rates for less than 1% of floating rate loans and 8% of derivatives. U.S. regulators are now laser focused on enforcing transition plans to ensure compliance with the deadlines.

Asia Navigates Transition Complexity

In Asia the situation is more complex and, with each jurisdiction having different approaches to benchmarks, several countries may end up with multiple rates.

Asian countries must not only adopt changes to the global benchmarks, but refine their own in local markets, notes a Euromoney article.[2]

The approach is two-fold: adopt global benchmarks such as Dollar and Sterling, and adopt local benchmarks, which regulators have been developing in partnership with the banking industry.

While Sterling transition is well underway, the region is very dollar heavy and many of the swaps, loans and bonds are linked to U.S. Dollar LIBOR.

Asia Pacific jurisdictions are split on whether to take a regulator-led or industry-led approach to benchmark rate transitions, noted S&P Global ratings in an October report. Industry-led approaches can be found in China, India, and Taiwan. Of the other Asia Pacific jurisdictions, the Philippines, India, Singapore, and Thailand have local benchmarks linked to Dollar Libor. In Singapore, the central bank has played an instrumental role in guiding the transition from SOR to SORA.

Then there is a second group: Australia, Hong Kong, New Zealand, and Malaysia which are taking a multi-rate approach, maintaining an existing benchmark while adding a new alternative reference rate.

Industry Appears to Have Coped, but 2022 Will Be A Pivotal Year

While most non-USD LIBORs ceased on December 31, 2021, the FCA requires the benchmark administrator to publish 1, 3 and 6-month Sterling and Yen rates in 2022 for use in select contracts that are difficult to transition, considered "tough legacy" contracts. These rates will be set in a modified "synthetic" form and will not be used for any new business.

The significant changes resulting from benchmark reform have been accompanied by new legislation and regulations. U.S. LIBOR legislation expressly includes full safe-harbour and contract continuity provisions to provide protection from litigation and associated mis-selling claims. In the U.K. and EU, legislation includes more limited protection via inclusion of contract continuity provisions but not safe-harbor protection from litigation as is currently seen in the U.S.

LIBOR transition impacts a wide range of transactions globally, including securities, loans and derivatives which use LIBOR or any other affected benchmark to determine the interest payable. Firms have undertaken extensive due diligence, both using software where feasible, and individual contract review where more tailored or bespoke arrangements and documentation exist, to inform remediation strategies and planning.

The approach adopted for amending documentation depends on the type of product as well as client preference. The ISDA Protocol[3] assists in handling LIBOR transition, providing agreed alternative replacement rates for certain products with counterparties that also adhere to the Protocol, but it does not eliminate the complexity entirely; bi-lateral renegotiation is required for contracts not covered by the Protocol.

For many financial products, the legal aspects of the transition went smoothly overall, while operationally they were more testing.

Loans were even more problematic. The amendment process was a lot more onerous and labor-intensive in the absence of an ISDA equivalent. Many large banks whose business includes consumer through to institutional loans, often backed by swaps, have faced a hugely tough burden to resolve.

Loans documented using standard template documentation were a lighter lift. However, for syndicated lending, where firms were not necessarily in the driving seat, the transition process was more onerous. Certain software proved useful for high volume repeat transactions such as aircraft loans but not applicable where significant redrafting of individual deals was required.

For 2022 and beyond, many financial institutions are focused on so-called "tough legacy" remediation efforts together with building plans for USD transition. For the Asia Pacific markets, where products are in large part USD denominated, these are being reviewed by banks in conjunction with the USD LIBOR piece. While life after LIBOR appears to be in insight there is still a lot to do for many products that for more than 35 years have been pegged to the popular rate. These leftovers will take a while to consume.

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[1]https://www.bloomberg.com/news/articles/2021-10-26/sales-in-european-clos-hit-record-thanks-to-buyout-debt-surge

[2]https://www.euromoney.com/article/29bt45w3xv4d4l3yfej9c/capital-markets/asia-races-against-libor-deadlines

[3]https://www.isda.org/protocol/isda-2020-ibor-fallbacks-protocol/

https://www.eba.europa.eu/sites/default/documents/files/document_library/Risk%20Analysis%20and%20Data/Risk%20reports%20and%20other%20thematic%20work/1021964/Final%20Thematic%20Note%20on%20benchmark%20rates%20transition%20risks.pdf

Gensler's Huge Year Ahead

As the U.S. Securities and Exchange Commission pursues an agenda more aggressive than we have seen from the market watchdog in decades, its leader must find a delicate balance between fostering market growth and innovation with investor protection principles

As we enter 2022, and the U.S. Securities and Exchange Commission pursues an agenda which is more ambitious than we have seen from a market watchdog in decades, it may be fair to say the regulator has never had a more extensive or time critical suite of topics to address since its inception in June 1934. Of course, proposing extensive rule changes is not the same as getting them through the process of U.S. rulemaking, particularly in the current political climate. Still, nothing ventured nothing gained.

2022 will be an incredibly busy year for all U.S. asset managers with the policy agenda brim full of important issues under review. From insider dealing reform to proxy advisors, from meme stock and cryptocurrency fads to a more serious overhaul of the fundamental structure of equity trading, there is no corner of the U.S. markets that it seems the SEC will shy away from addressing.

Its chairman, Gary Gensler, who has produced an amazing catalogue of 49 new pieces of regulation in the past year, must thread the needle carefully to foster greater transparency, competition and investor protection while at the same time not stifling the market at a very sensitive point in history. This mandate is made ever more complex at a time where several new innovations like digital currencies and environmental, social and governance (ESG) themes seem in need of balanced and proportionate rulemaking. Given his background, 2022 looks set to be a huge year for the SEC regardless.

Mr. Gensler is a former Goldman Sachs executive who served as chairman of the Commodities Futures Trading Commission under President Barack Obama, where he notably took a hard line on regulating the US$400 trillion derivatives market following the housing crisis in 2008. Immediately prior to taking the chair at the SEC, Mr. Gensler also served a stint as a professor at the Massachusetts Institute of Technology, a tenure that convinced many supporters of cryptocurrencies that he would be sympathetic to their cause. However, this has not turned out to be the case, at least so far. In fact, he has said digital money should be regulated as securities instead of as currencies, much to the horror of the growing crypto industry. 2022 will be the year where jurisdiction over cryptocurrency, digital assets, stable coins and all other areas of distributed ledger technology will be decided upon and rulemaking at the SEC and elsewhere is likely to occur.

Some of the key issues on the extensive agenda for 2022 include:

ESG Rulemaking

It is almost a certainty that new rules focusing on environmental, social and governance issues will come forth this year. The regulations that emerge are likely to be far less draconian than the ESG rules that already have been adopted by the European Union and will likely address two main points: greenhouse gas emissions and diversity on company boards of directors. The latter point will not only focus on gender diversity but, because of the recent strength of the Black Lives Matter movement, also attempt to rectify racial injustice. Mr. Gensler has already advocated for climate and "human capital" metric disclosures for public companies as well as far more stringent disclosure regimes for providers of funds and investment services.

A Focus on Environmental Risks to Investors:
Mr. Gensler has asked SEC staff to draw up regulations requiring disclosures of "a variety of qualitative and quantitative information about climate risk" in company 10K filings. He added that although most major corporations make climate disclosures, the information provided is not consistent or comparable across companies. He wants climate disclosures to be "decision useful" to investors, detailing such things as emissions data and how close the company is to achieving climate goals. The SEC's climate regulations are also likely to take aim at fund managers who offer funds that claim to be climate-friendly.

The SEC is also likely to require companies to disclose Scope 1 and Scope 2 greenhouse gas emissions—Scope 1 being emissions from a company's operations and Scope 2 from its use of electricity and similar resources. Disclosure of Scope 3 emissions—that is, emissions generated by third parties in a company's supply chain—could also be required. "When it comes to sustainability-related investing, there's currently a huge range of what asset managers might mean by certain terms or what criteria they use," he said. "I think investors should be able to drill down to see what's under the hood of these funds."

Many firms will hope that the SEC doesn't add to the ESG rule fragmentation that is fast becoming a problem in itself, as regulators and other bodies roll out rules across the globe. The SEC has also floated the idea of linking its rules to a particular global benchmark, like the framework created by the Task Force on Climate-Related Financial Disclosures. This would be most welcomed by U.S. asset managers rather than the creation of another unique and idiosyncratic ESG weighing and measuring system.

A Focus on Social Issues:
In terms of its focus on diversity and inclusion, this is an area likely to intensify in 2022. The SEC last year already approved a board diversity rule encouraging (but not requiring) companies on Nasdaq's public exchange to have at least two diverse directors—one who identifies as female and another who is an "underrepresented minority or LGBTQ+". The rule will require companies on the exchange to annually disclose their board-level diversity data. Companies not meeting the diversity objectives will be required to explain why in their proxy statement, information statement for their annual shareholder meeting, or on their website concurrently with their proxy statement or information statement. Failure to meet the requirements—effective Aug. 8, 2022, or the date the company files its proxy or information statement for its annual shareholder meeting during 2022 (whichever is later)—could result in a company being delisted from Nasdaq.

Further to the Nasdaq rules, Mr. Gensler seems very attentive to the theme of broader workforce diversity and employee composition. The SEC has touted a rule that could have significant ramifications for U.S. workforce and hiring practices and which "could include a number of metrics, such as workforce turnover, skills and development training, compensation, benefits, workforce demographics including diversity, and health and safety," Mr. Gensler tweeted in August 2021. Soon after that tweet, while attending the Senate Banking Committee in September, Mr. Gensler said: "I think investing in a company—the human capital, the workforce—is a key asset. I've always found that if you're going to buy a company or sell a company—when I was doing that at Goldman Sachs—that people really wanted to have a thorough review of that workforce and its ups and downs."

The debate about ESG rules is also likely to expose the differences among members of the commission. Hester Pearce, a Republican appointee to the SEC, for example, has opposed forcing firms to adopt ESG disclosures because there are no widely accepted definitions of the practices. ESG rulemaking is a political hot potato in every country across the globe, however it can be particularly divisive in the U.S. where some States have a much greater carbon and petrochemical dependence than others. 2022 will be the year the SEC adopts ESG rules, and the scale and breadth of those rules will be worth watching.

Market Structure

In just one appearance before the House of Representatives last year,[1] Mr. Gensler promised to take on a range on market structure issues including payment for order flow, trade settlement timing, social media promotions of meme stocks and many others. Mr. Gensler tends to "go big" when grappling with market events and this certainly rings true of his willingness to address payment for order flow (PFOF). It is estimated that the top U.S. brokerage firms generated about US$2.5 billion in revenues in 2020 alone and that an elimination of PFOF would wipe that revenue stream away with one stroke of Mr. Gensler's pen.

"The high concentration of retail orders routed to a small number of wholesalers raises a number of questions about market structure," Mr. Gensler said, referring to the payment for order flow issue raised by the Robinhood brokerage. "In essence, does this segmentation and related sector concentration best promote fair, orderly, and efficient markets?" While posing these as questions, he said he asked his staff to consider what policy changes might be recommended without saying what he prefers.

It seems unlikely that there will be an outright ban on the practice of PFOF, as is the case in the U.K. and Canada. After all, thanks to Robinhood and brokers like them, many novice investors have begun investing in equities, which is a good thing. However, given the system is quite opaque, Mr. Gensler is likely to seek greater transparency so investors can see exactly what they are getting with the so called "free trades" and are assured the broker is acting in the best interests of their clients under the existing best execution rules.

Another sub-plot to the GameStop event of 2020[2] was that it put the framework for U.S. clearance and settlement of securities transactions under the spotlight like never seen before. It has led to widespread and vociferous calls demanding the U.S. trade settlement cycle be reduced from the current two days to one or even same day, as the current method is seen by some as archaic in an era of lightening paced activity.

Other areas of market structure likely to come under Mr. Gensler's watchful gaze include reporting and transparency for total return and other security-based swaps stemming from the spectacular collapse of Archegos Capital Management in 2021.[3] The lack of disclosure due to the entity type and instruments used meant that the Archegos collapse blind-sided the SEC completely, an event which Mr. Gensler will be keen not to see reoccur.

Cryptocurrencies

This is another area where the SEC is likely to be sharply divided. While Mr. Gensler has expressed the need to regulate digital currencies as securities, Pearce believes they should be allowed to flourish unimpeded. It's also an area where the cryptocurrency community have been up in arms at Mr. Gensler's approach to date. He previously likened cryptocurrency to the "Wild West" and pledged to increase scrutiny, both to enhance investor protections and increase collaboration between other federal agencies that regulate commodities trading and banks. The crypto community were up in arms with some of Mr. Gensler's comments at the Senate Banking Committee where he said of cryptocurrency: "This asset class is rife with fraud, scams, and abuse in certain applications. We can do better." The SEC has already taken legal action against Coinbase's purported crypto lending platform called "Lend" and that process is ongoing.

Cryptocurrency is an area where the SEC will probably not act alone. This owes to the fact that the definition of cryptocurrency and who has jurisdiction in the U.S. often depends on the type of digital currency or asset. Currency issues involve not just the SEC, but also the Commodity Futures Trading Commission, the Federal Reserve and Office of the Comptroller of the Currency. Each of these bodies claim jurisdiction and each will have to reach a joint decision on crypto's fate to have a comprehensive U.S. solution. Without exception, whenever the SEC has been formally asked (including prior to Mr. Gensler's stint) for a determination on whether a cryptocurrency is a currency or a security, the answer has been the latter. Mr. Gensler said that the SEC will "be very active in trying to bring this market into what I'd call the investor protection framework."[4]

The other major area of scrutiny that the SEC will have to decide is the extent to which it will allow investors to put money into crypto-based exchange traded funds (ETFs). While it allows Bitcoin futures ETFs, it rejected a proposal to amend the rules to allow for an ETF that tracked spot movements in the digital currency. Given the huge current demand, it's unclear how long the SEC can resist the pressure being brought to bear to free up crypto trading. It is an emotive and complex topic which makes rulemaking difficult but also inevitable.

Cybersecurity Governance

During the pandemic, the SEC looked at cyber security defenses at asset managers and concluded that while many were robust, there's a lot of variability in the standards. Mr Gensler told the SEC's Asset Management Advisory Committee in September 2021 that he asked staff to develop proposals "both on the issuers' side and on the funds' side. These could address issues such as cyber hygiene and incident reporting."

It appears likely the SEC under Mr. Gensler will decide to set minimum consistent cyber standards, a bar which no firm will be allowed to drop below. In addition, there may be a requirement to cyber proof second and third-party vendors, because investor protection is only as strong as the weakest link. The New York State Department of Financial Services has already adopted a comprehensive rule for financial institutions that work on Wall Street, so the new SEC rule will apply to those beyond New York's reach.

The cybersecurity focus extends beyond the SEC and has become a key pillar of U.S. national security concerns. Cybersecurity, particularly ransomware, has received the full attention of the Biden administration. The Department of Justice unveiled its Civil Cyber-Fraud Initiative in October 2021[5], which made it clear the agency will be less tolerant of companies that do not report ransomware, breaches, and other cyberattacks promptly to the government. Also, the U.S. Treasury, through its Office of Foreign Assets Control (OFAC), has issued sanctions on ransomware criminals and the financial networks they use,[6] while the Financial Crimes Enforcement Network (FinCEN) has updated guidance to banks and financial institutions regarding their responsibilities to report suspected ransomware payments transmitted over their networks.

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[1] HHRG-117-BA00-Wstate-GenslerG-20210506.pdf (house.gov) sales-in-european-clos-hit-record-thanks-to-buyout-debt-surge

[2] https://abcnews.go.com/Business/gamestop-timeline-closer-saga-upended-wall-street/story?id=75617315

[3] https://www.bloomberg.com/news/articles/2021-11-24/fed-says-archegos-collapse-revealed-weaknesses-in-global-banks

[4] SEC Chair Gensler likens crypto to 'early seed investing,' warns many coins will 'fail' - MarketWatch

[5] https://www.itpro.com/security/cyber-attacks/361152/justice-department-unveils-civil-cyber-fraud-initiative-to-battle

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U.S. Regulatory Overview: What to Expect in 2022

BBH's Adrian Whelan sat down with **Amy Matsuo**, Principal and Leader of Environmental, Social and Governance (ESG) and Regulatory Insights at KPMG, to discuss the main regulatory drivers for the U.S. asset management market in 2022

Adrian Whelan (AW): What are the key regulatory trends that U.S. asset managers should be particularly attentive to in 2022?

Amy Matsuo (AM): Great question because KPMG have recently published our Ten Key Regulatory Challenges for 2022. We anticipate that regulatory "perimeters" will continue to expand and expectations (with or without new regulations) will rapidly increase. We have bucketed the regulatory challenges into three distinct areas:

1. Rapid Change
2. Maintain Focus
3. Mitigate Risk

AW: The three KPMG buckets interest me since they are quite like the themes contained in this Regulatory Field Guide for 2022. In particular, the reference to rapid change is one which many global asset managers will recognize. Can you tell us a little more about which rapid changes you think will impact in the U.S. in 2022?

AM: Sure. We have highlighted four specific areas within the rapid change bucket:

1. Fairness & Inclusion
2. Climate & Sustainability
3. Crypto & Digital Assets
4. Platforms & Conduct

In terms of fairness and inclusion, a mixture of investor demand, public awareness, social unrest and the priorities and directives of the Biden Administration have focused regulatory attention on supervision and enforcement of consumer and investor protection on a broad scale. They have also expanded the parameters of "fairness" to include all consumer touchpoints.

AW: One of my recent catchphrases I've been using is "ESG is everywhere" as global regulators move to integrate ESG principles into their policymaking. Do you agree that ESG will rise significantly up the U.S. regulatory agenda in 2022?

AM: Yes. Pushed largely by significant and widespread investor demand and facilitated by myriad voluntary disclosure frameworks, financial services companies are working toward measuring, monitoring, and mitigating their climate related financial risk. Regulatory expectations in this area have experienced sweeping changes that will continue with rigor into 2022 under existing and expanded jurisdictional authority. Federal financial agencies must develop, and execute on a strategy to quantify, disclose, and mitigate the financial risk of climate change on both public and private assets. Public policy seeks to advance "consistent, clear, intelligible, and accurate disclosure of climate related financial risk" and "to mitigate that risk and its drivers, while accounting for addressing disparate impacts on disadvantaged communities and communities of color.

AW: It was stiff competition but perhaps the most vociferous regulatory debate of 2020 in the U.S. was in relation to cryptocurrency. Is it likely that crypto and digital assets will continue to dominate the U.S. policy landscape in 2022 until such time that the rules of engagement have been agreed upon?

AM: Regulatory activity around crypto and digital assets is intensifying as usage by investors, companies and even some central banks show widespread interest and adoption at retail and institutional levels. The regulatory landscape in the U.S. is evolving alongside the market expansion, with state and federal regulators and legislators all considering approaches to add clarity. Key issues include a focus on chartering, licensing, fraud and financial crimes risk, and consumer and investor protections.

AW: In many ways, crypto is merely another manifestation of the rapid increase in nascent technology across the financial landscape. Is the technological shift also influencing U.S. regulators' minds something we are set to see much of throughout 2022?

AM: Rapid developments in technology, increases in digital banking activity, growing sophistication of data collection, and the increasing influence of social media is reshaping the financial services landscape in ways never seen before or anticipated. These unprecedented times, underscored by ongoing social and economic changes associated with COVID-19, have fostered and accelerated unique advancements in the consumer experience – and given rise to new risks related to data security, fraud, and conflicts of interest.

KPMG's report can be accessed here: Ten Key Regulatory Challenges of 2022

U.S. T+1 Settlement: Hitting the Accelerator

Following dramatic market volatility events, the U.S. post-trade industry is deftly mobilizing to move securities settlement cycles to T+1. Adrian Whelan and Derek Coyle explore why shortening the U.S. settlement cycle is so significant to asset managers globally

U.S. stock markets have been on a rollercoaster ride over the last two years. Starting with the stock market crash on Monday, March 9, 2020 which saw the Dow Jones Industrial Average fall by its largest amount ever, two more record-setting point drops followed on March 12 and March 16, respectively. These triggered several unparalleled instances of trade volume and market volatility spikes.

All this occurred due to the uncertainty and fears around the rapid spread of the coronavirus globally, oil price concerns, and the looming possibility of recession after a sustained period of growth and relative certainty. Thankfully, the stock markets recovered, even as the pandemic persisted, and healthy trading volumes (and returns) were restored.

That didn't last long. A confluence of events at GameStop led to a populist movement of retail traders that ultimately led to record levels of stock trading and the skyrocketing of the video game retailer's stock price by 8,000% over a six-month period. On January 28, 2021, Robinhood, the de facto trading app for retail traders, controversially halted buy trades in the GameStop stock. A public outcry about unfairness to retail traders subsequently led to U.S. Congressional hearings to assess the events leading up to and including January 28.

One outcome of the hearings was that the U.S. Securities and Exchange Commission (SEC) was tasked with assessing areas of improvement in the U.S. securities trading infrastructure. This included settlement cycles for U.S. securities, a vital but largely unheralded area of stock market commentary usually, and the functioning of trade margin requirements at the U.S. Depositary Securities Clearing Corporation (DTCC).

> "Longer trade settlement windows equate to higher counterparty risk, which further result in increased margin requirements designed to mitigate those risks."

The review resulted in a robust technical analysis of post-trade settlement. In the aftermath of the GameStop event, many market participants made loud and vociferous calls for atomic settlement (T0), or the instant exchange of two assets whereby the transfer of one asset occurs if and only if the transfer of the other asset also occurs, and the certain assertions of the imminent necessity to substitute the antiquated securities infrastructure for more modern solutions such as Distributed Ledger Technology. However, U.S. post trade industry has used this high-profile event as an inflection point to properly discuss the advantages and challenges of a shortened settlement cycle for U.S. trading.

Billions, Trillions & Quadrillions

The significance of that discussion lay in the sheer size of U.S. stock markets. In 2020 alone, the DTCC and its subsidiaries cleared and settled more than US$2.15 quadrillion ($2,150,000,000,000,000) in securities trades.

At the height of the March 2020 pandemic fueled volatility, the DTCC set a new single day record, processing more than 363 million equity trades. That beat the prior high around the time of the 2008 financial crisis by 15%. Material increases in intraday margin calls during periods of heightened volatility can greatly impact trading firms, and liquidity can be strained as traders draw down credit lines and increase liquidity buffers. Longer trade settlement windows equate to higher counterparty risk which further result in increased margin requirements designed to mitigate those risks. It all adds up to additional trading costs and reduced liquidity for asset managers, usually within the most volatile and stressful trading sessions.

Major Gains

The last major revision to U.S. securities settlement happened in September 2017, resulting in a successful transition from T+3 to T+2 across the securities settlement ecosystem. Put simply, the longer a settlement cycle, the more time there is between trade execution and settlement for a trading counterparty to become insolvent or for the value of a trade to deteriorate. In other words, the longer its settlement cycle, the greater the credit and operational risk attached to the trade.

> The move to T+1 is also underpinned by a strong desire to bolster the efficient use of capital across U.S. trading markets."

This time/risk dynamic impacts the amount of margin and collateral that is required to be deposited with the clearinghouse as a risk mitigation to the securities trade. It then follows that a reduced settlement time equates to a reduction in risk as well as margin and collateral requirements. So, the move to T+1 is also underpinned by a strong desire to bolster the efficient use of capital across U.S. trading markets.

On average US$13.4 billion is held in margin at the DTCC daily just to manage counterparty default risk in the system. Shortened settlement cycles could reduce this margin amount which could instead be actively deployed for trading purposes and alleviate liquidity pressures, particularly on days of heightened volatility. Therefore, the most logical way to reduce the underlying risks that drive margin requirements is to shorten the settlement cycle. DTCC's published risk model simulations show a 41% reduction in the volatility component of its margin by moving to T+1.

In addition to reducing certain risks, shortened settlement cycles in turn open-up an opportunity for asset managers and others to capture certain ancillary benefits. These include more efficient use of funds as less cash is tied up in margin calls, thus conceivably reducing potential drag on fund performance and the opportunity costs associated with holding larger cash buffers. Market liquidity, even in times of volatility, is also likely to improve as brokers have fewer margin calls and capital concerns so can make better use of their capital to facilitate trading.

Forcing Firms to Automate

An indirect but likely effect of the shortened cycle is that it will force less efficient firms to automate manual processes and upgrade trading technology to meet the heightened demands and constrained timelines inherent in T+1. This has benefits for the wider market as its likely to create industry-wide virtuous circles of operational risk reduction and increased productivity. More efficient trade processing naturally results in the elimination of sub-optimal or redundant processes which in turn saves time, reduces errors, and decreases trading costs. The exponential market impact of everyone being a little bit more efficient and greater standardization of industry practices should not be underestimated.

Hitting the T+1 Accelerator

While the reasons for the change are compelling, there are important initial requirements for U.S. stock market participants to take in. Industry groups have already provided a useful roadmap entitled "Accelerating the U.S. Securities Settlement Cycle to T+1" setting out the technical requirements. The scale of securities in scope means that this transition has multiple considerations, and the overall project must insulate investors from further risks resulting from the changeover.

Additional important considerations include:

- Protecting the market from undue disruption caused by the change;
- Using the project as an opportunity to improve upon existing industry practices particularly where there are natural opportunities for increased process automation and efficiencies, and;
- Ensuring that the benefits of the transition to T+1 ultimately outweigh the risks and that new risks are not introduced from the modifications.

In terms of the initial practical impact assessments here are the top 10 considerations as the market looks to assess the shift towards U.S. T+1:

1. **Trading Workflows** Compressed timeframe for all aspects of the lifecycle of a trade may require multiple operational and behavioural amendments.

2. **Foreign Exchange (FX)** The U.S. dollar plays a seismic role in global cross border trade and U.S. T+1 triggers multiple funding and settlement considerations across almost all global FX markets.

3. **Corporate Actions** Revisions and coordination of corporate action ex-date and record dates are necessary, which will further require material amendments to SWIFT messaging and instruction automation for U.S. securities.

4. **Exchange Traded Funds (ETF)** The existing NSCC ETF batch service already operates to tight timeframes and operational change and credit line support are possibly required for U.S. ETFs with global securities where settlement cycle is longer than T+1 for non-U.S. securities.

5. **Trade Amendments** Remediation of incorrect trade inputs is now under an even tighter timeframe to avoid trade fails, so increased focus on prevention and remediation of trade errors will be crucial.

6. **Prime Brokerage** The SEC's Prime Brokerage (PB) No Action letter will need to be revised to allow PBs to effect settlement through continuous net settlement models. Significant PB contractual changes are also required to reflect T+1.

7. **International Coordination** U.S. T+1 will create some new settlement misalignments where foreign securities will operate to different settlement timeframes. In addition, other countries such as India are also moving to T+1 settlement. Alignment or managing such misalignments will be a key factor.

8. **Securities Lending** Standard batch processing and security recalls should operate in a much-compressed timeframe, as such streamlined processes and tighter deadlines will apply to the current general operating model for U.S. securities lending.

9. **Documentation** A multitude of industry documentation will need to be revised to reflect the new settlement cycle. The NSCC buckets these documents into three types: (1) transactional (2) administrative and (3) agreements.

10. **Not Merely a U.S. issue** Given the move to a shorter settlement cycle affects any global asset manager or bank that trades U.S. securities, it's important that there is some form of global coordination to assist this latest vast market transition.

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IOSCO: What's Next on the International Regulatory Agenda?

Martin Moloney, Secretary General of the International Organization of Securities Commissions, talks to BBH's Adrian Whelan about the key issues and trends shaping the global regulatory landscape in 2022

Adrian Whelan (AW): Why is the International Organization of Securities Commissions (IOSCO) best thought of as the 'Basle Committee for Securities'?

Martin Moloney (MM): In one sense it is similar. IOSCO during the 1990s and the early 2000s rolled out a range of standards covering all the major areas of securities markets-related activities. It is a critical part of what we do now that we keep those standards up-to-date and we adapt them to technological and financial innovation. That is a full-time job itself. But it's not our only job.

Something we also do, which is not as much of a focus for other global standard setting bodies is that we provide capacity building support on a substantial scale to the securities regulators all over the world, in large and small jurisdictions and in developed and emerging markets. This is a huge commitment for us and it means that we are constantly working to help securities regulators communicate effectively with each other, learn the lessons of each other's experiences and build a global cohort of securities regulators with a shared understanding of emerging risks and good regulatory practices.

In addition to that, a key part of our work in the last decade has been to deal with the consequences of non-bank financing relentlessly moving towards eclipsing bank financing in the terms of influence in the global economy. That transition is far from complete, but it puts a huge focus on the impact of securities markets on the resilience of the global financial system. A global financial system that can resist shocks like COVID-19 and the Global Financial Crisis of 2008-10 as well as lesser shocks like the taper tantrum is a must.

What we can't have is that shocks within the financial system turn into depressions in the real economy. That would make the global economy far too vulnerable. There will, of course, be shocks to the financial markets. Everyone active in markets knows they are volatile. They can be driven by sentiment into sudden adjustments. Those sudden adjustments need to be able to happen without turning into damage to the real economy. We work hard with the Financial Services Board to build policy frameworks which help to make the system more resilient. We do all of that from our headquarters in Madrid – not Basle – like other standard setters – and with the close engagement of our members from all around the world.

AW: What is your key ambition for IOSCO for 2022?

MM: 2022 is going to be a major turning point for the asset management sector, if we are successful in what we plan for this year. Our ambition is to prove that we can generate global standards related to sustainable finance issues that can be adopted across the world. We want to set a baseline for the industry and the markets meeting that urgent demand that is out there on the part of investors to be able to have a sustainable finance-focused investment mandate delivered on with confidence and transparency. A particular issue we will focus on is climate-related disclosure by primary market issuers. The new International Sustainability Standards Board, set up by the International Financial Reporting Standards, will develop the standard and IOSCO will go through a careful endorsement process to see if it is fit for purpose. On that basis, we would hope that in 2023 jurisdictions will look favourably on adopting this standard. If we are successful, this will be transformational for financial markets in terms of their ability to respond to insistent investor demand in this area.

AW: With ESG coming of age, has it reached maturity in terms of data transparency for investors and the information distributed by the asset management sector?

MM: We have done a lot of work in 2020 and 2021 looking at what is actually happening in markets in relation to both ESG data and ESG ratings on the one hand and, on the other hand, the risk of green washing by the asset management sector. In both cases we have found a lack of sufficient transparency for investors as to what is going on. In both cases, when we have looked behind that lack of transparency, we have identified points of concern in terms of the data being relied on, the resources and expertise being applied and the risk management. This is not surprising.

The industry has tried to pivot very fast to changing investor demand and you can't build a new ecosystem overnight. In 2022 we will push on to engage with the industry to get better at this. Where you can get good data, that is great. Where you cannot get good data you have to be open with your investors about the risks attaching to the data you can get. This industry relies on the trust and confidence of its clients. So let's work together in 2022 to really nail this issue and ensure that the customers have confidence in all of us that we are doing everything possible to deliver sound sustainable finance-focused products.

> "An international standard for climate related disclosure will be transformational for financial markets."

AW: What do you think of the continued rise and rise of crypto? You seem very focused on Stablecoin?

MM: There is a sense in which both in relation to sustainable finance and in relation to crypto, current trends are about altering that ecosystem of finance to be able to do new things. In one case this could be to deliver on new kinds of investor mandates and, in the other case, to be able to apply the full range of financial management techniques to a new kind of asset.

Wherever crypto ends up, it is clear firstly that the technology of finance has been altered with this innovation and, secondly, that crypto has brought with it a very significant amount of investor harm – as well as huge benefits for those who got their timing right and avoided the various frauds. We in IOSCO have focused a lot of attention on stablecoins, because they are a key bridge between fiat currency payment systems and crypto. The integrity of payments systems is, arguably, even more important than the integrity of even financial markets themselves. So that focus has been correct.

A lot of the challenge here for regulators arises from the specific structures of a jurisdiction's individual legal frameworks, which is not something we can alter at the global level at which IOSCO operates. But we do a lot of work behind the scenes helping members to share experiences and work out effective strategies to limit the harm. We have more to do in 2022 both on stablecoins and on wider trends in in crypto. Crypto is not going away.

Anti-Money Laundering Surveillance:
A Regulatory Perennial

Global asset managers and policymakers remain engaged on the eternal areas of anti-money laundering regulatory policymaking. Adrian Whelan reviews the latest developments

Perennial
/pəˈrɛnɪəl/

Lasting or existing for a long or apparently infinite time; enduring or continually recurring.

As global asset managers and policymakers are engaged in the nascent areas of societal and technological change such as environmental, social and governance (ESG) investing, cryptocurrency and artificial intelligence, there remains some perennial areas of regulatory policymaking which still demand our continued focus and attention.

These topics are, in fact, the ones that have the greatest influence on the proper functioning of the asset management industry on a day-to-day basis. Anti-money laundering (AML) practices fall into this underrepresented bucket, yet they are a cornerstone of cross-border fund distribution.

It is a crucial "regulatory perennial" which undergoes iterative change year-on-year, is a crucial consideration for every asset manager, yet often is left solely to the Risk, Compliance, and Legal community to discuss amongst themselves. Despite its often low-profile, a momentous amount of time, energy, and resource are expended by a broad range of stakeholders across the asset management ecosystem to stay up to date and on the right side of the ever-evolving and increasingly challenging compliance requirements relating to AML.

All the while, bad actors find more sophisticated ways of penetrating the system. For decades now, AML practices have been a thorn in the side of global regulators and an area of consistent policy focus across the globe. However, despite the relentless supervisory rigor, sizeable regulatory fines, increased sanctions, and a litany of regulatory rollouts, policymakers continue to struggle to keep pace with the bad actors, who themselves continue to evolve and become more sophisticated and efficient than ever before.

Redrawing AML Lines

In the absence of a truly globally coordinated approach, with persistent national and regional divergences, regulatory fragmentation creates complexity for global firms operating in multiple jurisdictions.

AML therefore remains a hot topic and continued area of regulatory focus across the globe. The U.S. and the EU are both moving to re-draw lines and add more granular and stringent control expectations. This is in reaction to the fact that despite the continuous resources expended to curb illicit global transactions, there continues to be a steady stream of scandals, revelations and from time to time successfully executed enforcement actions on high profile failures within the global finance industry. As such, banks and asset managers need to stay attuned to this crucial area of policymaking.

U.S. National Security

In the United States, in December 2021 the Biden-Harris administration published the United States Strategy for Countering Corruption, a wide-ranging policy document explicitly highlighting "the fight against corruption as a core national security interest of the United States". To curb corruption, the U.S. Government has committed to organizing itself around "five mutually reinforcing pillars of work" namely:

1. Modernizing, coordinating, and resourcing U.S. Government efforts to fight corruption.
2. Curbing illicit finance.
3. Holding corrupt actors accountable.
4. Preserving and strengthening the multilateral anti-corruption architecture; and
5. Improving diplomatic engagement and leveraging foreign assistance resources to advance policy goals.

This policy document demands a significant increase in resources in support of Financial Crimes Enforcement Network (FinCEN), an arm of the U.S. Treasury. It allows the build out of a new beneficial ownership data system for use by U.S. law enforcement agencies to identify, investigate, and take enforcement actions against fraud, money laundering, terrorist financing, and proliferation financing.

Also, in December 2021, FinCEN published proposed regulations to implement the beneficial ownership information (BOI) reporting requirements of the Corporate Transparency Act (CTA). These bolster the Anti-Money Laundering Act, 2020 which was originally drawn up to modernize the U.S. government's efforts to deter money laundering, tax evasion, fraud and other financial crimes.

FinCEN is now tasked with:

1. Implementing beneficial ownership rules for legal entities who conduct business in the U.S.;
2. Developing protocols for access to and sharing of BOI; and
3. Amending the existing customer due diligence (CDD) rule applicable to financial institutions to account for the CTA

A public consultation on the complex and detailed proposals closes in early February 2022, and there is no clear timeline for final implementation of these proposed rules. However, there is no doubt that the U.S. is taking financial crime very seriously and that the ripple effect will have practical consequence for all banks and asset managers who transact with the country.

EU Ambition

The EU also sees the curbing of illicit payments as core to its future financial viability and success. In October 2021, Mairead McGuinness, the European Commissioner for Financial Stability, Financial Services and the Capital Markets Union, delivered a statement to the European Parliament on increased efforts to fight money laundering by the European Commission. She urged EU authorities to pursue any EU Member States lagging on the transposition of the Fourth and Fifth Anti-Money Laundering Directives into their national laws, citing the fact that such delays inevitably lead to the "cracks and loopholes" being exploited by bad actors wishing to conceal their activity to make illicit payments. In a connected multi-national system such as the EU, the system is literally only as strong as its weakest link given the interdependence and interconnectedness of its markets.

There are plans to conduct to national assessments of whether supervisors and Financial Intelligence Units are sufficiently staffed and resourced. The EU Commission already has a process where they issue Country Specific Recommendations (CSRs). The Commission is determined to follow up on these to ensure that the recommendations are followed through on by Member States through concrete action and their implementation will be monitored through milestones and targets.

The EU is focused on implementing a harmonized AML framework across its member states. It has plans which include a move to a directly effective regulation, proposed enhancements of the existing beneficial ownership regime under the Single Rulebook and, perhaps most significantly, the creation of the new EU AML supervisory authority, AMLA, expected to commence its activities in 2024.

> "National supervisors still play a crucial role in the ongoing system of supervision. AMLA is suggested as a body capable of providing additional support to existing national resources."

Anti-Money Laundering Authority (AMLA)

In Europe, the European Commission has decided that it needs a single overseer to eradicate recurring regulatory arbitrage and disjointed implementation timelines. AMLA is a direct policy reaction to a string of revelations in recent years that showed that despite much progress there remained some cracks and loopholes in the EU banking system. The EU AMLA should be established by 2024 with direct supervision scheduled to begin in 2026.

However, there remain many questions around how and where it will operate, financing, and particularly its interactions with national regulators, legal systems and judiciaries, and financial intelligence units (FIU). In its current guise, AMLA will have powers to make binding decisions applying to the entire bloc and sanction and fine directly supervised entities. Its powers to directly fine entities are extensive and may run to 10% of annual turnover or €10 million, whichever is higher.

The plans suggest AMLA will have 250 dedicated staff who will take over responsibility for the AML Counter Financing of Terrorism database from the European Banking Authority and the FIU.net, the "secure communication network" for FIUs. AMLA's direct responsibilities are limited to the financial industry. That means it will still be up to governments to tackle dirty money within other sectors, such as gambling, diamond dealers, legal services and auditing.

National supervisors will still play a crucial role in the ongoing system of supervision. AMLA is suggested as a body capable of providing additional support to existing national resources. The idea of instituting a superseding EU-wide FIU was "rejected as disproportionate" by the impact assessment of the European Commission. However, AMLA is empowered to take over the supervision of specific cases if it is deemed that a national authority has failed to do their jobs properly.

AMLA's work with FIUs will include facilitating complete and swift information exchange, promoting cooperation among member state FIUs, conducting periodic reviews of supervisory bodies to ensure adequate resourcing, powers to draft binding regulatory and technical standards, and guidelines in relation to AML. The wide-ranging brief of the AMLA also includes full application of the anti-money laundering and CFT rules to the burgeoning cryptocurrency sector and imposing a new EU-wide limit of €10,000 on large cash payments. Additionally, the AMLA will directly supervise some of the riskiest financial institutions operating in multiple Member States or require immediate action to address imminent risks.

This changing EU AML infrastructure will be a significant area of focus as it develops throughout 2022 and generally it looks clear that this regulatory perennial of AML policymaking will grow vibrantly once again this year.

ELTIF 2.0: Second Time's a Charm

New revisions to the European Long-Term Investment Fund remove many of the regulatory and structural impediments managers face when utilizing them currently and place them neatly into the EU regulated fund structure toolkit, writes Adrian Whelan

"I did then what I knew how to do, Now I know better, I do better"

- Maya Angelou

There has been a lot of industry chatter regarding the democratization of regulated, illiquid funds by making them available to a wider spectrum of eligible investors. While it has become a global theme, the real action was in Europe where both the European Long-Term Investment Fund (ELTIF) and the U.K.'s Long-Term Asset Fund (LTAF) caught the attention of policymakers, investors, and asset managers alike.

Since inception, the ELTIF has not captured investment flows as intended for a variety of reasons, including an eligible asset universe generally considered to be too narrow. Evidence of this opinion may be found in the lack of ELTIFs since its launch in 2015 and the ones that have launched were both small and comprised mainly of local investments and investors in a handful of EU countries (e.g. France, Italy, Spain). Only around 28 ELTIFs have been established, with a low asset base (below €2 billion).[1]

ELTIF has become more popular and there was discernible growth in 2021 with asset managers launching usually in partnership with a private bank or wealth manager. With that said, for now ELTIFs remain a small corner of the EU regulated funds market. However, with sizeable revisions to its ruleset imminent, are the fortunes of the ELTIF about to change?

The European Commission (EC) has removed many of the suggested barriers to ELTIFs' success to make ELTIF 2.0 more attractive for asset managers. The proposed revisions make both portfolio composition and the distribution to a broad range of investor types easier and more attractive. The ELTIF changes form a sub-set of a range of policy measures which underpin a more general makeover of the EU's Capital Markets Union and an overarching desire to diversify the financing to Europe's real economy beyond bank lending.

ELTIF's future success is not guaranteed. However, this revamp greatly enhances the structure's attractiveness to product manufacturers, distributors and ultimately investors. So there is rightly some genuine enthusiasm mobilizing around ELTIF and hope that at the second time around, it may act as a legitimate third option within the EU regulated funds landscape to compliment the highly successful Undertakings for the Collective Investment in Transferable Securities (UCITS) and the Alternative Investment Fund Managers Directive (AIFMD) frameworks.

Here's a brief walk through of the latest ELTIF revisions which could mean that the second time's a charm for ELTIF 2.0.

1. Wider Range of Eligible Assets

Several changes to the ELTIF eligible asset rules significantly widen its investment opportunities and attractiveness, including:

- **Global Investments**
  There is explicit clarification that ELTIFs may invest freely in non-EU ("third country") exposures. Previously ELTIFs were designed as a means of channeling investment into EU industries primarily and non-EU investments had additional conditions ascribed. That constrained investment opportunities and was cited as slightly protectionist. The clarification now allows for a far more diverse range of investment opportunities.
- **Real Asset Definition**
  A revised definition of "real asset" now includes any asset with "intrinsic value" rather than one that can provide "investment returns" or "predictable cashflow" – this change shows that the devil is always in the detail when framing a fund structure's ruleset.
- **Real Asset Threshold**
  The minimum investment in a real asset by an ELTIF is also lowered from €10 million to €1 million making real asset investments much more accessible.
- **Listed Assets Threshold**
  The market capitalization threshold for permitted listed investments is raised from €500 million to €1 billion (at time of initial purchase).
- **Other investment funds**
  ELTIFs may now invest in Alternative Investment Funds (AIFs) who themselves invest in eligible assets on a "look through basis"; previously an ELTIF could only invest in other ELTIFs, European Venture Capital Funds (EUVECA) or European Social Entrepreneurship Funds (EUSEF) structures.
- **Securitizations**
  ELTIFs may now invest in eligible securitizations which include mortgage-backed securities, commercial, residential, and corporate loans, as well as trade receivables.
- **Minority Co-investments**
  Another notable revision to allowable investment permissions is that an ELTIF can now make a minority co-investment

[1] https://www.institutionalassetmanager.co.uk/2021/01/27/294976/efama-outlines-strategy-improve-eltif-regime

> ELTIFs can be distributed across the EU with a passport to both professional and retail investors without being subject to national rules."

directly or through investment conduits but doesn't need to be owned directly or via a "majority owned" subsidiary. When twinned with the allowable investments in other eligible fund structures, the ELTIF now has the type of investment flexibility usually found in other similar regulated fund structures seeking exposure to private market investments and allows for the implementation of indirect investment strategies.

2. More Flexible Concentration and Diversification Limits

The other criticism of ELTIF was that the portfolio diversification parameters were overly rigid and too narrow to allow for flexible portfolio composition for illiquid strategies. As such, there are substantial proposed changes to a range of investment permissions and restrictions to allow for a much wider investment universe for ELTIFs, including:

- Maximum allowable amount that may be invested in other funds such as other ELTIFs, UCITS or AIFMD funds is raised from 10%to 20% of capital
- Maximum allowable amount that may be invested in a single real asset is raised from 10% to 20% of capital
- Also, the maximum aggregate value of units or shares of other funds such as Alternative Investment Funds (AIFs), UCITS or other ELTIFs is also increased from 20%to 40% of capital
- An ELTIF may also now own 30% of units or shares outstanding of another ELTIF, EU EUVECA or EUSEF funds
- The maximum aggregate amount of securitizations an ELTIF may invest in is now 20% of the total value of the ELTIF
- The maximum amount of capital that must be invested in eligible investments is lowered from 70% to 60% of capital

3. Increased Leverage

Another element of long-term funds that was overly restricted and hence made ELTIFs less attractive was the ability to finance investments by way of borrowing or provision of leverage. This has been addressed to bring ELTIFs more in line with similar fund vehicles elsewhere. Among the changes in this regard are:

- The cash borrowing limit is raised from 30% to 50% of ELTIF value for retail ELTIFs and 100% of ELTIF value for ELTIFs solely marketed to professional investors
- The cash borrowing no longer must be in the same currency as the currency the ELTIF buys its assets, so long as it is hedged
- The fund may encumber its assets to implement its borrowing strategy – previously there was a fixed 30% encumbrance limitation, this meant it was difficult to secure borrowing as liens and pledges of portfolio assets were difficult for ELTIFs and not attractive to lenders

4. Differentiation Between ELTIFs Marketed to Retail and Professional Investors

ELTIF 2.0 formally recognizes that the ELTIF might be sold to distinct constituents and is not exclusively a retail eligible vehicle. In particular, much lighter investment strategy and borrowing requirements now apply to ELTIFs solely marketed to professional investors.

Amendments have been made to make it clear that the two-week withdrawal period applies only to retail investors and can only be effective during the two weeks following effective date of the commitment or subscription agreement.

Distribution and Structuring Enhancements

ELTIFs can be distributed across the EU with a passport to both professional and retail investors. Some positive changes have been made to streamline the authorization of ELTIFs under new proposals. The National Competent Authority (NCA) responsible for authorizing the ELTIF will be solely responsible for the authorization of an ELTIF and will not be involved in the additional authorization or 'approval' of the EU Alternative Investment Fund Manager (AIFM). The new rules also clarify that an ELTIF doesn't need to be managed by an AIFM in the same domicile.

There is the removal of duplication in the retail investor suitability tests and alignment of ELTIF to Markets in Financial Instruments Directive (MiFID) point of sale rules. This ties with the deletion of the minimum-entry ticket (€10,000), replaced with €1,000 minimum and the 10% aggregate threshold for retail investors whose financial portfolios do not exceed €500,000. ELTIFs also retain favorable capital charges under Solvency II rules, which introduce prudential requirements tailored to the specific risks which each insurer bears, so distribution to the EU insurance and pensions segment remains attractive.

Under ELTIF 2.0, retail investors may cancel their subscription and have the money returned without penalty. The two-week withdrawal period is only effective during the two weeks following effective date of the commitment or subscription agreement. The national investor facilities requirements for retail investors are also deleted to facilitate the cross-border marketing of ELTIFs and align with the new rules on Cross Border Distribution Directive (CBDD).

Second Time's a Charm

In combination, these ELTIF 2.0 revisions remove many regulatory and structural impediments managers face. Initially they have been broadly welcomed since they address many concerns market participants have with the current rules.

It is hoped that ELTIF 2.0 when applied makes the European Long-Term Investment Fund a viable investment structure for many alternatives managers to the extent they can construct a portfolio that falls within the eligible investment criteria. It sits neatly into the EU regulated fund structure toolkit between UCITS and AIFMD funds. It has a cross border marketing passport and affords opportunity to target a wide range of investor types with diversified illiquid exposures all with a robust regulatory wrapper. Owing to increasing demand from European private bank and wealth management networks, the latest proposals serve to magnify expectations of more ELTIFs in the future. While the EU approval process means that ELTIF 2.0 would become effective six months and one year after coming into force respectively, so by 2024, market participants who begin to work on their strategies now stand to be on the front foot of the charm offensive.

CONTENTS

U.K. Long Term Asset Fund: Launchpad To Alternative Future

With a growing focus in asset management on retail investor access to less liquid alternative investment funds, the U.K has mobilized the Long-Term Asset Fund (LTAF). Lata Vyas and Andrew Ritchie explain why 2022 could be a big year for this special purpose investment vehicle

"When it is obvious that the goals cannot be reached, don't adjust the goals, adjust the action steps"

– Confucius

One of the purported benefits of the U.K. leaving the European Union was that it would have autonomy and flexibility to frame regulations outside of the large EU policy making machine. An acid test of this newly found policy freedom was the Long-Term Asset Fund (LTAF), the U.K.'s initiative to create a new authorized fund structure to house less liquid investments for U.K. investors. The Chancellor of the Exchequer, Rishi Sunak, claimed that it was his ambition that the LTAF would be launched by the end of 2021 and given the Financial Conduct Authority (FCA) publicly consulted on the LTAF ruleset in May 2021, and the final rules were published in October 2021, it can be said that in terms of speed of movement it has passed that test.

The LTAF became officially available on November 15, 2021. However as the Regulatory Field Guide went to press none had yet been approved by the FCA.

The intention behind the creation of the LTAF is to provide the U.K. with an open-ended fund structure that allows investment in long term less liquid asset classes while also offering robust structural and governance safeguards. The governance framework is particularly important given the LTAF concept is largely a reaction to certain high-profile negative liquidity events found in other U.K. structures in recent years. While fund liquidity events are not unique to the U.K. market, certain sensitivities remain particularly acute within the FCA given the widespread impact of the liquidity issues faced by the Woodford funds[1] and certain authorized open-ended property funds matters that continues to rumble on.

Weighed against that backdrop, there was also great appetite within the U.K. to create a newly authorized fund vehicle to make it easier for defined contribution (DC) pension schemes, and professional, sophisticated and high net worth investors to access alternative and illiquid assets through an open-ended fund structure. Historically, U.K. investors would invest in long-term assets through closed ended structures such as limited partnerships, or investment trusts with a relatively narrow band of eligible investors granted access. It was agreed that the LTAF must be supported by strong levels of transparency, governance, and investor protection given its target investor base.

In addition to helping DC pensions with increasing exposure to higher returning long term assets with a view to bridging the widening pensions funding gaps, another touted positive knock-on effect of LTAF is its ability to act as a conduit to channel private finance towards a range of UK private market opportunities and boost the so called "real economy".

Predominantly, the U.K. asset management industry participants were pleased with the final LTAF rules, considering the FCA accommodated many of the points raised through the mid-2021 consultation. However, there are some challenges and items which need to be addressed in practical terms before asset managers can truly be up and running successfully on LTAF asset gathering. While the LTAF is technically "live," there remain crucial wrinkles to be ironed out before we see growth in the market. But what is certain is that investor appetite and latent demand is high and now the U.K. has a fit-for-purpose fund structure to cater for investors who want long term exposures, flexible redemption terms and a high level of governance oversight on their fund investments. 2022 will be a big year for LTAFs in the U.K.

Let's assess the top 10 LTAF points of interest:

1. Redemption Terms

The LTAF is an open-ended fund structure. Redemptions must not be available more frequently than monthly and a minimum notice period of 90 days to redeem also applies. The notice period makes sense in terms of alleviating some of the liquidity mismatch issues previously experienced. However, in practical terms it raises operational issues for the U.K. market. The LTAF is primarily targeted at DC pension schemes and wealth management segments each of whom typically access their investments through investment platforms. Platforms generally operate on daily dealing life cycles and their operational models are largely hard coded for daily dealing and therefore might not be operationally ready to accommodate these notice periods in the short term. With the LTAF potential opportunity evident, it is hoped that the requisite investments are made to accommodate this new operational reality.

[1] https://www.moneymarketing.co.uk/analysis/whos-to-blame-for-woodford-collapse/

> "LTAF comes under the definition of a non-mainstream pooled investment (NMPI) rather than a non-UCITS retail scheme (NURS)."

2. Structuring and Distribution

The LTAF may be established as a unit trust, open ended investment company (OEIC) or an Authorized Contractual Scheme (ACS). The FCA considers that the principal target market for the LTAF is professional investors and in particular DC pension schemes, as well as sophisticated retail investors. LTAF comes under the definition of a non-mainstream pooled investment (NMPI) rather than a non-UCITS retail scheme (NURS). However, the FCA has at the same time tweaked its NMPI rules to specifically allow the LTAF to be sold to certificated high net worth investors as part of a diversified portfolio. Therefore, LTAFs will be sold through wealth management channels to eligible investors providing a more diversified source of inflows beyond merely the DC pension market. The FCA is also making technical changes to the permitted links rules to help DC pension schemes accommodate illiquid assets more easily within their portfolios via the LTAF. And finally, consultation in 2022 will consider further broadening LTAF access among retail investors.

3. Investment and Borrowing Powers

The FCA expects an LTAF to invest at least 50% of its assets in unlisted securities and other long-term assets such as interests in immovables or other funds investing in such assets. This confirms an LTAF can be comprised of a mix of unlisted assets, listed but illiquid assets and investment in other illiquid funds (both regulated and unregulated, including limited partnerships). Further, there is no requirement to ensure the underlying Collective Investment Scheme (CIS) does not invest more than 15% in other CIS, which is welcome since it allows investment into "funds of funds". There are also specific initial and ongoing due diligence requirements where an LTAF invests more than 20% in unregulated funds or other LTAFs. Investment in intermediate holding vehicles, domestic and overseas is permitted. The final rules also relax some of the originally proposed restrictions in respect of the LTAF investing in loans, which will be of interest to credit managers.

Another useful outcome from the consultation is that the FCA has clarified that the LTAF should be generally invested in long term assets as a strategy and is not specifically applicable to any point-in-time snapshot of the LTAF's holdings. This gives LTAF managers increased flexibility, particularly immediately after launch when scaling up investments or in the case of significant redemptions where assets are sold off to fund redemption proceeds.

LTAF borrowing is permitted up to 30% of the net asset value which is less than the 100% allowed for QIS, but there are no rules on aggregate borrowing of underlying investments. There is no derogation of the limit during the start-up period.

4. Valuation

The valuation rules are largely retained and do not reflect much of the industry feedback from the consultation. This is perhaps indicative of the balancing act the FCA has to contend with given previous fund liquidity events and its desire to retain high levels of oversight while also fostering an LTAF regime flexible enough to thrive. Importantly, the final rules row back on a previous FCA suggestion to have LTAF depositaries determine "without qualification" that the LTAF manager has the necessary knowledge, skills, and experience to value the LTAF's assets. The final rules merely require that the depositary determines that the LTAF manager has the resources and procedures for carrying out such a valuation. An LTAF manager is required to appoint an "external valuer", unless it can demonstrate that it has the competence and experience to value the types of assets in which the LTAF invests. Valuations must be carried out monthly.

The liability standards applying to external valuers have not been amended from "simple" to "gross" negligence in valuation, and even though both the FCA and HM Treasury recognize that this acts as a significant barrier to external valuers being appointed to LTAFs (and other U.K. illiquid funds) they have committed to exploring a relaxation of some of these rules in the future.

5. Depositary Ownership of Assets

The FCA has acknowledged that the requirement to have the depositary register the title to assets in its own name, rather than the name of the fund or the manager, is not practical for all eligible assets that an LTAF might invest in. However, for now the rule is retained albeit with a carve out that LTAF's on a case by case basis can apply to the FCA to waive the Depositary registration requirements in specific instances. This is not an ideal outcome for sourcing of LTAF depositaries and it is hoped some pragmatism is shown in the case-by-case reviews but also that the consultation can look to align U.K. depositary asset registration standards with international standards such as AIFMD or UCITS.

6. Permitted Links Revisions

Given the fact that the FCA considers that the principal target market for the LTAF is the defined contribution pension market, there are some very specific rule revisions with added additional flexibility for investments in LTAFs by DC pension schemes.

These include revisions to the permitted links rules that will make it possible for LTAFs to be part of the default arrangement of an occupational or workplace DC pension scheme. The 35% limit for LTAF-linked funds that form part of the default arrangement of a pension scheme has been removed, while certain requirements remain on insurers to provide risk warnings and ensure that the fund is suitable for the ultimate investors. To ensure the proposals only apply to default arrangements, the FCA has further proposed introducing conditional permitted LTAFs and making them available only in relation to default arrangements. This carves out the LTAF from the definition of QIS for COBS 21.3 purposes, so that the LTAF would not be available for retail investors investing outside of the pension environment. With the final LTAF rules integrating into the regulatory framework for DC pension scheme investments in unit-linked long-term insurance products, this looks to be a good channel of distribution for LTAF manufacturers into the future.

7. Fee Cap

A key aspect of the commercial arrangements of any new LTAF will be the extent to which a profit allocation to the manager can be accommodated. This is an important factor both in attracting the best managers and in aligning the interests of managers and investors in most long-term asset classes. LTAF managers must disclose their performance fees/carried interest and explain to their investors how their fees work. There will be no cap on LTAF managers' fees, although, separately, the U.K. Department of Work & Pensions is considering how to accommodate these fees within the DC charge cap to ensure the charge cap rules do not present a barrier to the success of the LTAF regime.

Rather helpfully, in its Budget on October 27, 2021, the U.K. Government flagged its intention to consult later this year on further changes to the charge cap for DC schemes, with a view to considering amendments to its scope to better accommodate performance fees. This consultation will be an important factor in shaping the commercial attractiveness of the provision of LTAFs by asset managers and is worth tracking in 2022.

8. Tax

Tax is always an important fund structuring consideration, particularly for illiquid asset funds. The FCA notes that the LTAF rules permit them to be established as property authorized investment funds (PAIFs), and that an LTAF could be structured as an authorized contractual scheme (ACS). The FCA worked closely with HM Treasury and HM Revenue & Customs (HMRC) throughout the development of the LTAF. However, details on the tax treatment of LTAF specifically remains scant and there is an ongoing wider review by HM Treasury of the tax regime for U.K. funds. A tax transparent ACS structure for the LTAF could be attractive, given that the tax transparent nature of the ACS should enable tax exempt investors such as registered pension schemes to preserve their tax exemptions and access to relevant double tax treaties. As always, the final tax regime applicable to LTAF will have an inevitable impact on its attractiveness to investors.

9. Governance

The FCA sets the bar high for LTAF ongoing governance and oversight. Managers of LTAFs must be full-scope U.K. alternative investment fund managers - firms that currently only have "managing an unauthorized AIF" as a classification will need to seek a variation of permission (which may take up to six months to obtain). Such firms will also need to appoint at least two independent directors. LTAF managers must undertake additional assessments in respect of the LTAF's liquidity, due diligence, valuation of the assets and conflicts of interest, and may not delegate this responsibility.

10. Quarterly Investor Reporting

Due to the FCA's desire for high levels of transparency, LTAF managers must make quarterly reports to investors, and within 20 days of the end of the quarter. The FCA suggests that infrequent trading in illiquid markets means that reporting will generally not be unduly burdensome, but it does add another regulatory report to asset manager's inventory.

2022 REGULATORY FIELD GUIDE

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