

# AIMA JOURNAL



Commodity investing in the age of ESG and inflation  
*Auspice Capital Advisors Ltd.*

Five issues for traditional hedge fund managers to  
consider when investing in digital assets.  
An update  
*Simmons & Simmons*

Is 2022 the year private debt comes of age?  
*Prestige Funds*

More investors looking to APAC private markets  
*State Street*

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AIMA

# The Long-Short Podcast

A window to the alternative  
investment universe

Latest guests include:



Robyn Grew,  
COO & GC at Man Group  
Chair of AIMA's DE&I Steering Committee



Bill Kelly,  
President and CEO of CAIA Association



Stuart MacDonald,  
Managing Partner at Bride Valley Partners  
Host of the radio show The Naked Short Club



Henry Arslanian,  
PwC's crypto leader



For more information visit [aima.org/media/the-long-short.html](https://aima.org/media/the-long-short.html)

## “ Message from AIMA’s CEO



**Jack Inglis**  
CEO, AIMA

War in Ukraine, mounting sanctions on Russia, roiling commodity markets, a correction in cryptocurrencies and equities capsized due to being top-heavy in tech stocks.

As if that wasn’t enough, COVID continues to lurk, most recently rearing its head in China, with Shenzhen – a major regional tech hub – back in lockdown. Inflation is surging in the US, the UK and elsewhere, largely unchecked by rate hikes; for now.

Meanwhile, managers are grappling with a deluge of new rule proposals by the SEC aimed at private funds under the auspices of improving investor protection and market transparency.

And it’s only March!

The Q1 AIMA Journal reflects on many of these pressing issues and answers the question: what does all this mean for you?

Investors are facing the prospect of rebuilding their books to reflect market conditions we haven’t seen in nearly 40 years.

As a result, they are increasingly venturing out of equities into alternative investments in search of yield, diversification, and downside protection. For many allocators, the answer seems to be leaning further into private markets as well as hedge funds to offset anaemic equity returns. Articles in this edition outline why this could mean 2022 is the year that private debt comes of age.

In a similar vein, contributors provide helpful roadmaps to avoid the common pitfalls ahead for those entering the digital assets space.



Another contributor approaches the same trend from the other side and explains why institutional investors must look before they leap by ensuring their due diligence processes develop in tandem with their more sophisticated risk appetites. For managers, this will mean becoming more transparent with their investors, either as part of the IR process or due to new regulatory mandates, on everything from fees to ESG policies.

Speaking of ESG, what is the cost of transitioning to net-zero? And how can commodity investing co-exist with responsible investing? Contributors address these complex issues head-on.

It is worth noting that all these articles were penned before the invasion of Ukraine.

In the regulatory sphere, the Financial Services Act, the consolidated tape, and the ongoing fallout from the collapse of Archagos are just some of the topics dissected by contributors.

As always, the AIMA Journal provides a timely and thoughtful review of the themes across the alternative investment industry that matter to you, written by those that know it best.

My thanks to all the contributors for their insights.

**Jack Inglis**  
CEO, AIMA



# Upcoming AIMA conferences

ALTERNATIVE  
CREDIT COUNCIL

AIMA

**20 April**

AIMA CyberTech  
Virtual Forum 2022

**21 April**

AIMA Singapore  
Forum 2022

**11 May**

AIMA Digital Assets  
Conference 2022

**26 May**

AIMA Next Generation  
Manager Forum 2022

**7 June**

Alternative Credit Council  
Global Summit 2022

**15 June**

AIMA APAC Annual  
Forum 2022

**8 September**

AIMA: Putting ESG  
into Practice 2022

**22 September**

AIMA Australia Annual  
Forum 2022

**8 December**

AIMA China  
Live 2022



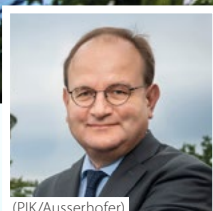
For more information and to register visit [www.aima.org/events](http://www.aima.org/events)



## 3 & 4 May, 2022

### Pre-Event on ESG: Data & Research on 2 May, 2022

### Kap Europa • Frankfurt/Germany

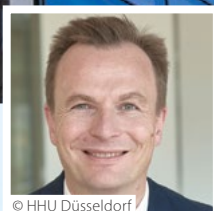


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TU Berlin

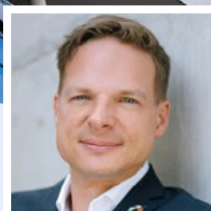


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University of Cologne

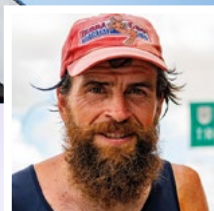


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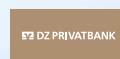
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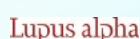
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# How to thrive in hedge funds in 2022: An assessment of the risks & opportunities ahead



**Heinrich Merz**  
Senior Hedge Fund Advisor  
**Pictet Alternative Advisors**

## 2022: A year of volatility & dislocation

In our 2022 Hedge Fund Outlook, published during the waning days of last year, we argued that markets were primed for higher volatility and at increased risk of dislocation. That view is being borne out.

Broadly effective vaccination campaigns, waves of COVID-variants that have, thus far, had a diminishing impact and supportive central banks had pushed valuations past their pre-pandemic highs and stoked inflation.

The US Federal Reserve acknowledged that slowing growth, rising inflation and fading disinflationary forces originating in China caused a policy conundrum. This, in turn, sparked ructions across fixed income markets and drove a vicious rotation out of growth to value in equities during December and January.

As 2022 develops, central banks will face an ever more challenging tightrope walk. Poor rate communication and/or taper sequencing may lead investors to lighten up further on any number of still exuberantly priced investments. Set against this are healthy consumer balance sheets, an active corporate sector and a private equity community flush with cash and hunting for growth and yield to stave off inflationary debasement. A continuing retreat of market makers means depth remains ephemeral. Put this all together and you have a recipe for continued volatility.

The backdrop will be further complicated by domestic politics and geopolitics. In the US, Democrats are likely to lose their razor-thin congressional majority allowing legislative gridlock to reassert itself. In China, all eyes will be on the 20th CCP Congress and the management of the nation's stock of real estate debt. Europe will face its challenges as it seeks to roll back Covid-support programs during a presidential election year in France, new leadership in Germany and continuing Brexit-related adjustments in the UK.

## Hedge funds: Positioned for dispersion

For the hedge fund industry, the challenges that volatility, dispersion and dislocations pose to the traditional 60/40 portfolio model will likely be a boon. The relative value arbitrage strategies that thrive on the elevated volatility that accompanies rising rates should prosper. From 2016 to 2019, continually decreasing rates, low inflation



and falling volatility across equities and rates markets led many of these arbitrageurs to struggle, prompting some even to close shop. The coming years may well see the reversal of this trend. Those targeting volatility, convertible and capital structure arbitrage opportunities will increasingly be able to differentiate themselves.

As the pandemic recedes, its impact on mid-cap corporate balance sheets is becoming clear. Debt issuance and levels of corporate leverage hit new highs while credit quality deteriorated, particularly in the consumer discretionary industry and in travel and leisure. This has left many of these firms vulnerable to rising rates now that the cycle has started to turn. As the cost of debt rises, increasing input costs put pressure on margins – which will be further affected by a rolling back of economic support programmes. This will open up fertile ground for event-driven strategies such as merger arbitrage and activist strategies, among which we prefer managers who create their catalysts as well and those who seek out less crowded niche M&A deals. We also like opportunistic managers able to shift capital between equity, credit and risk arbitrage trades as market conditions alter. Within the relative value space, Special Purpose Acquisition Company (SPACs) arbitrage has become less fevered. As managers shift capital out of the strategy, return drivers will diversify further.

We expect distressed credit strategies to benefit from a growing pipeline of restructuring opportunities as the year progresses. Even following their latest spike, credit spreads have remained close to their tight pre-pandemic levels across both the US and European markets, especially in large-cap names. For mid-cap corporates, any shift in rates or liquidity as wage pressure tightens margins could release a tightly coiled spring. Although the trend remains in its infancy, 2022 may provide a good entry point for patient investors with the skillset to sort through and renegotiate the market's abundance of light covenant agreements.

For equity long-short strategies, December and January's growth/value rotation marked the end of the 're-opening trade' that followed the 'work-from-home trade' of the prior year. The broad top-down themes that will heavily influence other strategies are less likely to determine the positioning of equity long-short managers overall – aside from the diminishing risk of a new, virulent COVID variant. Instead, we see a return to idiosyncratic factors as being drivers of equity returns. As a result, we favour specialist equity managers with stock-specific short books whose fundamental bottom-up approach, lower market net exposures and constrained levels of leverage give them the staying power to hold positions through periods of higher volatility. The market environment should increasingly favour those able to hold short positions as central banks progressively pare back excess liquidity and people return to work.

We continue to favour Asia-based managers focused on niche domestic industries with relatively less exposure to global trade, given that rising geopolitical risks are bleeding into markets. A volatile but less thematically imbalanced market is likely to provide a further tailwind to diversified multi-manager platforms and quantitative equity market neutral strategies.

To thrive in 2022 – a year of transition both from the pandemic and a negative rate environment – will, as ever, require effective risk and asset-liability management. But it also demands a set of underlying strategies that benefit from the resulting heightened volatility. These are likely to be the same strategies that faced the most challenging time in the low volatility, pre-pandemic years leading up to 2019, which is to say, arbitrage strategies.

# Commodity investing in the age of ESG and inflation



**Tim Pickering**  
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## Introduction

While many would agree that commodity-related investments are amongst the best ways to protect against inflation risk, it has become complicated for many investors given ESG considerations. To date, there has been little discussion about commodity futures within ESG frameworks - neither the Organization for Economic Cooperation and Development (OECD) nor the UN Principles for Responsible Investment (UNPRI) provides comprehensive guidance on commodity futures.

We have researched this and published a comprehensive white paper entitled 'Commodity Investing in the Age of ESG and Inflation' available on [SSRN](#) and at [auspicecapital.com](#).

In the white paper four key ESG considerations related to commodity futures are discussed:

1. Well, functioning futures markets are critical to the development of commodity markets important in the green transition.
2. Futures markets are essential to companies for managing risk, improving transparency, and providing liquidity. This aligns with many ESG principles, particularly the often underemphasized societal and governance considerations.
3. Futures offer exposure to commodities with zero environmental impact.
4. Futures offer superior risk management and diversification benefits for investors, particularly with respect to inflation protection.

This article summarizes the third consideration above, that **futures offer exposure to commodities with zero environmental impact**.

“

*What ultimately matters for carbon accounting is who 'owns' a company. All the owners of a company together provide the capital that enables its economic activities and emissions.*  
(Markwat, 2021)

### Commodity Futures – Lowest Impact Commodity Exposure

A study conducted by researchers from the University of Chicago and Harvard published in the Nation Bureau of Economic Research (NBER) concluded that divestment was a less effective approach than active engagement in addressing climate change (divestmentfacts.com, 2020). In contrast, a recent think tank study claims that the active engagement of leading Canadian pension plans “may be more talk than walk” (Canadian Centre for Policy Alternatives, 2021).

To date there has been significant progress, but there remains uncertainty and debate around the measured impact of divestment and active engagement. Divestment proponents will note that an active investment in the equity of a resource company that is making significant, proactive changes still represents an investment in a company that has a (often large) carbon footprint. Further, the measured impact of various green initiatives in reaching net zero is often minimal, and greenwashing is increasingly a concern.

What is less uncertain however are considerations around commodity futures investments, such as Commodity Trading Advisor (CTAs) and ETFs backed by commodity futures. Consider that the equity and bonds of a company make up its' capital stock. If one purchases the equity or bonds of a company, it is directly involved in its' financing and is entitled to various rights associated with the financing. For a resource company, purchasing equity or bonds directly finances the production of a resource. A company's capital stock at any given point in time is finite and can be directly tied to its' carbon footprint.

This relationship does not hold with futures, and there are no associated rights. Futures investments do not require physical extraction to back, as is the case with traditional equities and bonds, and they do not link to the environmental impact from resource extraction, an inherently invasive process. There is a clear difference between the ownership of a company versus having exposure to a commodity risk factor.

Consider a large energy producer that has completely hedged its production through short positions in energy futures. If futures have a carbon footprint, and the producer has hedged its price risk through short positions in futures, are they carbon neutral? What about an investor who has a stake in the company's equity or bonds and an equivalent stake in an offsetting short futures position -is that a carbon neutral investment?



**The answer to these questions should be an unequivocal no. Futures do not affect consumption or production – they affect exposure to risk, and these are fundamentally different.** The ability to invest in an instrument that's value is affected by nothing other than the underlying price of the commodity itself is undeniably the lowest impact method of attaining valuable commodity risk exposure.

Broadly less than 5% of commodity futures contracts are taken to delivery (Hecht, 2021). In the case of CTA funds and futures backed commodity ETFs, this number is effectively zero. Delivery of physical commodities often is explicitly prohibited by the investment policy statements of these funds. With no delivery there is no increase or decrease in production, no financing, and importantly, no consumption.

## Conclusion

Commodity futures do not create or consume the underlying commodity. As opposed to an equity or bond investment, with futures there is no resulting increase or decrease in production, no environmental impact.

While the environmental considerations of commodity investments often take precedent, we encourage you to review the white paper to fully consider the importance of the futures market. The benefits not only align with ESG principles, specifically societal and governance considerations, they are essential in this green transition.

Commodity futures historically have also provided strong inflation protection – particularly important in today's inflationary regime. Considered alongside low equity correlation, the collective characteristics are compelling. It is not surprising that some of the most sophisticated investors are including CTAs in "Risk Mitigating Strategies" and "Crisis Risk Offset" portfolios. The white paper expands on this while also looking at the historical benefits of commodity futures during inflationary periods.

A responsible investor must consider ESG factors alongside investment merit and portfolio considerations. Commodity futures and CTAs offer compelling attributes and may be preferable to investments in equities and bonds of resource companies.

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# Costing the transition to net zero

Ashok Kumar Muthusamy

Senior Quantitative Researcher

Man Group

## Introduction

Over the next 30 years, the world will alter unrecognisably. The scale of the change will be comparable to any of the great secular revolutions that changed the way we lived – the industrial revolution, the mechanisation of agriculture, the age of technology.

Decarbonising a world addicted to oil, coal and gas will require innovation, creativity, collaboration. It will ask management teams to construct new futures for their businesses decoupled from carbon.

Investors will also need to reimagine their portfolios in a net zero world. We believe that – notwithstanding the elements of uncertainty in the route to net zero – it's incumbent on us as portfolio managers to attempt to put a cost on the process of transition. As such, we have constructed a dynamic model that works with the most up-to-date climate models and company information to show how valuations will change as we move towards 2050.

## The cost of transition

It goes without saying that companies begin their path towards net zero from different starting places, and that therefore the cost of transition is different based on how far the company needs to travel from its current business model to reach net zero. Figure 1 (page 15) shows the two dimensions we use to track where a company is on its journey to net zero.

We have scored the S&P 500 Index according to two different elements. The first is what their current emissions are. This is largely a facet of which business they are in. We then look at how closely aligned they are to the emissions reductions required by the Paris Agreement.

To do this, we use data provided by the Science Based Targets Initiative ('SBTI'). This is a partnership organisation – between the Carbon Disclosure Project, the United Nations Global Compact, the WWF and others – that has come up with a framework to determine the extent to which each industry must reduce their emissions if we are to achieve the Paris Agreement. The SBTi data looks at both the realistic measures firms in an industry might take to reduce their emissions and what lower-carbon alternatives there might be to their business models, before allocating each firm a series of emissions targets.

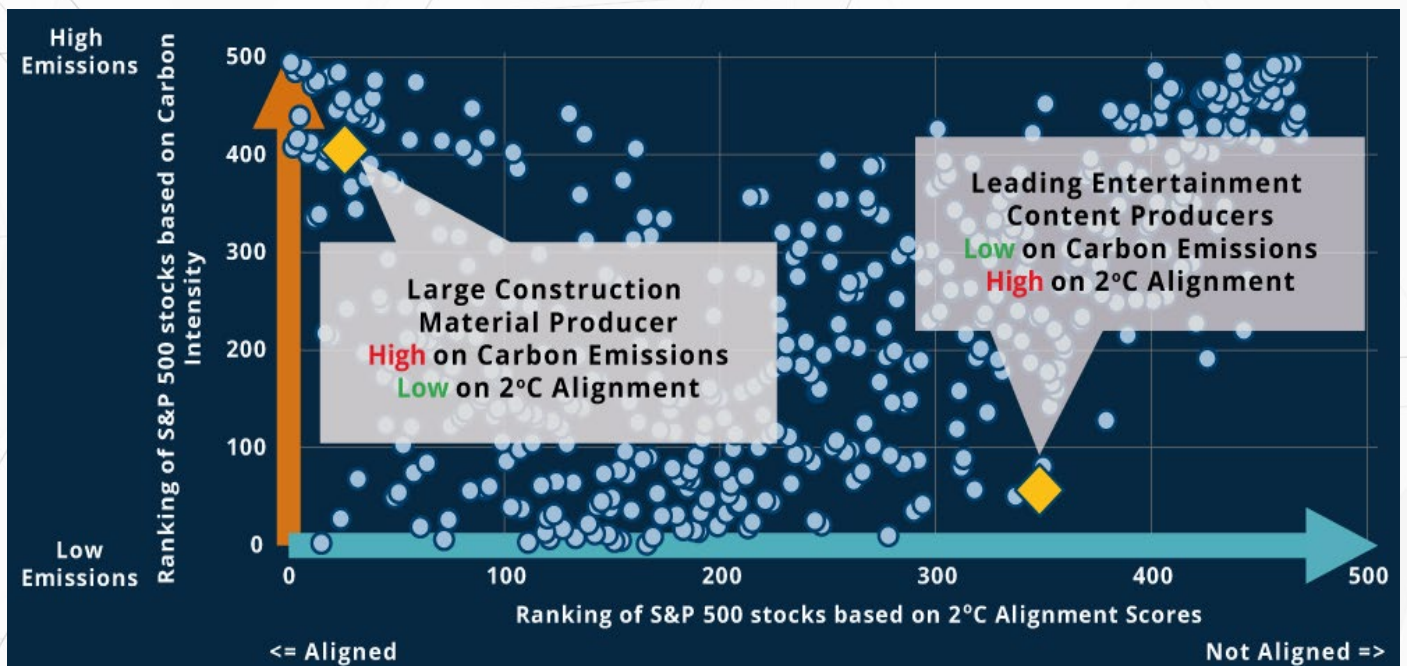
The top left point of Figure 1 represents a 'large construction material producer', which necessarily emits a lot of carbon and hence scores very highly on the carbon emissions dimension. However, we don't have any alternative for cement yet. Thus, in order to support the economy, we have to allow cement companies to keep emitting. Therefore, notwithstanding the higher emissions, from an alignment angle, this company scores amongst the highest in the S&P 500 (note a lower score here represents better alignment).



On the other hand, let's look at the example of a 'leading entertainment company' on the bottom right. The company emits very low amounts of carbon but still doesn't score well on the alignment angle because compared to its industry trends and based on what it could realistically achieve, it is still emitting more than it ought to be emitting.

So, transition costs are a function of both the current level of emissions and the potential for alternatives/reduction in carbon usage of each company's current business model.

Figure 1: The Two Dimensions of a Company's Carbon Footprint



Source: Man Group, TruCost; as of April 2021

Transition costs can manifest themselves in a variety of different ways, and we would suggest that the model above is just the starting point for a discussion of transition risks. It is, for instance, more difficult for heavily emitting firms to secure insurance, given the greater risk profiles of their businesses. Seventeen major firms, including Chubb, Generali, Swiss Re, Axis Capital, QBE, and Allianz, have announced that they will limit insurance provided to energy firms because of climate concerns. AXA has announced that it will cease providing coverage to any new oil pipelines, coal plants, and tar sands projects. As the company's CEO, Thomas Buberl, put it: "A +4°C world is not insurable."

It's also harder for such firms to get even basic banking services. HSBC, for instance, has announced that it will no longer finance the construction of offshore petroleum projects in the Arctic, tar sands developments in Canada, or most coal-fired power plants. Other large banking institutions such as ING, BNP Paribas, Wells Fargo, Morgan Stanley, Legal & General, JPMorgan, Deutsche Bank, and the World Bank have announced similar policies regarding their relationships with fossil fuel companies.

It's important to draw a distinction between 1.5-degree alignment and carbon intensity as measures of a company's vulnerability to transition risk. Different firms will be in different positions as far as a number of elements extraneous to the mandates of the Paris Agreement are concerned. These include the stringency of local regulations and government interpretations of pledges – note that the Netherlands pursued Shell in the landmark court case last year even though other energy firms are far less aligned; on the other hand, Australia has been consistently unwilling to penalise coal producers. There are also second-order impacts like investor sentiment and pressure from employees, suppliers, customers and other stakeholders.

In order to achieve a rounded picture of transition risks, it's important to consider not only where a firm lies in relation to its declared goals, but also to the second order pressures that it faces from its wider ecosystem.

One final point worth noting here: it may seem at first glance that we will therefore be predisposed to invest in companies who are less likely to face pressures from government, investors, and their wider stakeholders. This is obviously a perverse situation, and we remedy it by increasing our estimates of the physical costs faced by these companies as a result of climate change.

Physical costs represent the higher price of insurance as well as natural disaster risks the company may face and recognises the fact that transition risk and physical cost are to some extent mutually exclusive. That is, if a government cracks down on a company's emissions, it will face near-term costs to meet regulations but potentially be less impacted by overall climate change; conversely, firms who aren't penalised may benefit in the near term but suffer more serious long-term consequences.



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# Lifting the lid on the systematic trading: The most common compliance pitfalls



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ACA Group  
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Compliance officers in systematic investment firms can feel like they are in a niche corner of the asset management industry where every part of their role is different compared to other non-systematic firms. Not appreciating the differences in regulatory risk between a traditional hedge fund and a systematic trading firm can result in irregular testing, unchallenged risk management, inadequate trade error management, and poor model and algo deployment controls. A significant failure in any of those areas can lead to adverse impacts for investors, losses or reputational damage, losses, or reputational damage.

Like any good relationship, the secret to the success of compliance officers in these firms relies heavily on communication. Honest discussions and continued information flow with the rest of the business will build a strong foundation of trust and understanding.

We summarise the most common compliance errors that we see first-hand, but which can be rectified with a little confidence and technical guidance:

## 1. Not knowing the operating model of your firm means not knowing where the risks really are

Systematic/algorithmic trading firms are not structured like other investment firms, which have an investment team on one side and operations/risk on the other. Instead, it is structured with research, production, implementation and operations and risk teams. Understanding where these teams are and what they do in the chain of events that lead to an executed trade, as well as who is doing the stress testing, conformance testing, etc. is fundamental to knowing what the regulatory risks are and how they are monitored.

Compliance officers should ask upfront questions and map out the firm's structure if an operating model diagram does not exist and find out where the compliance feedback points and information reporting are, or where they should be.

## 2. Your Compliance Monitoring Programme and policies are not tailored to the specific rules or requirements around MiFID II RTS6 or the SEC<sup>1,2</sup>

It sounds obvious but a systematic manager should not have the exact same compliance programme as a non-systematic manager. Even well-understood regulatory areas of testing, such

<sup>1</sup> [https://www.ecfr.gov/current/title-17/chapter-II/part-275/section-275.206\(4\)-7](https://www.ecfr.gov/current/title-17/chapter-II/part-275/section-275.206(4)-7)

<sup>2</sup> <https://www.sec.gov/rules/final/ia-2204.html>. Advisers with U.S. clients may also be subject to Rule 206(4)-7 under the Investment Advisers Act of 1940, which requires advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of U.S. federal securities laws



as best execution, requires in-built pre-trade controls which are coded by non-compliance staff and that need to be reviewed in the monitoring programme. Make sure the policies and working practices are in keeping with how the business is actually working.

In the UK and EU, compliance with MiFID II's RTS6 will mean that a separate section of your testing is likely to be allocated to production, implementation, risk and operations. Therefore, clear tests and good information feedback or reporting from those teams or individuals is required.

### **3. Compliance testing is happening, and controls are built into the model, however, you're not sure what exactly is being tested or why**

Pre-trade controls, post trade controls, stress testing – all of these elements are developed and coded into the trading model so that trading is optimised. However, these are also your best execution, market abuse and trade error controls, and can only be built in by the production team.

The compliance officer must make sure they are apprised of changes and the output of such testing. They must be prepared to challenge the production team's rationale if a control or stress test does not generate meaningful results, and request to see where any failures or breaches are reported.

Similarly, risk reporting on liquidity and leverage limits are typically monitored and reported by the risk team on a daily basis in systematic trading. If there are exceptions or outliers, or decisions made by the risk committee that result in changes to these limits, the compliance officer must be included and informed.

Changes to certain limits may also require regulatory notifications in the UK, along with a documented change in the underlying calculations, reporting or process. Decisions of this materiality should be seen to have fair input from relevant parts of the business, and the right committees.

### **4. Manually testing data (such as best execution), when automation is available**

A compliance officer that is pulling down order management system (OMS) data and looking for best execution outliers manually is introducing a layer of preventable risk in the compliance function. Choosing to do testing in this way means that compliance is not optimising their time, resource, or tools effectively.

Ironically, in a systematic trading firm, where all processes are as optimised as possible to generate alpha, it goes against the ethos of the very firm they work for. Trading is typically more frequent and higher volume than a non-systematic firm, therefore data pull-downs at any given time will be larger. In our opinion, regulators do not expect a systematic trading firm to have a heavy reliance on manual compliance testing.

Manually scraping through OMS data to find erroneous trades (when pre-trade controls are built-in) is a time-heavy task that generates meaningless results. Picking random samples from that data and investigating the trade rationale is not strategic or robust. The compliance officer should decide what the best execution factors are (price/cost/speed) for a particular strategy, and speak to the operations and risks teams about what the prevailing concerns are – has the transaction volume changed in the last few months leading to higher costs?

Is the firm testing for cost slippage and making sure prices executed are within a certain tolerance of basis points? In addition, testing for basis point slippage is important; this type of outlier data is available in extracted reports at the firm, and the compliance officer should be in open communication with the risk team about what is the most useful and relevant.

## **5. Believing that the model's controls are inherently robust and so testing and monitoring is not relevant**

A common statement from systematic trading firms is that it would be impossible for it to commit market abuse because there are “many” controls built-in the model.

However, it is not uncommon that when pressed for the detail, these types of firms could not point to when market abuse controls were developed, by whom, or whether there was regular compliance testing or reporting on those same tests. It may be plausible that the firm could not commit market abuse without the entire business being involved all at the same time, and the conformance testing could be robust enough to prevent market-moving trades from being executed. However, if the firm needs to explain this to a regulator such as the UK's FCA or the US SEC, it will need a documented and evidence-based approach.

## **6. Allocations and fund by fund performance monitoring, are assumed to be correct**

Allocations between funds can potentially be non-discretionary and decided by the model (with the CIO's approval). However, like any investment firm with different performance fees across funds, compliance should be testing whether the allocations are inherently fair and in the best interests of all investors. It's therefore important to check the methodologies used, and challenge whether they ought to change if the firm has grown over time (does it now have several strategies or new portfolio managers in the pods?).

## **7. Lack of compliance officer confidence means a lack of senior manager challenge**

A lack of confidence in the compliance officer means that they do not challenge how or why certain tests are being done. The compliance officer knows what FCA requirements or SEC regulatory procedures are needed for any particular test, whereas the operations or production team who have coded some of the compliance testing, may not.

In the UK's Senior Managers and Certification Regime (SM&CR), the compliance officer must take all reasonable steps in preventing breaches or failures in their area of responsibility. Compliance officers always have the right to ask if they are unsure of what is being done to meet these requirements and challenge whether the tolerances or testing frequencies need to change. Equally, if the regulatory environment is changing, the compliance officer needs a clear and open channel of communication with those teams to allow for new tests to be coded in good time.

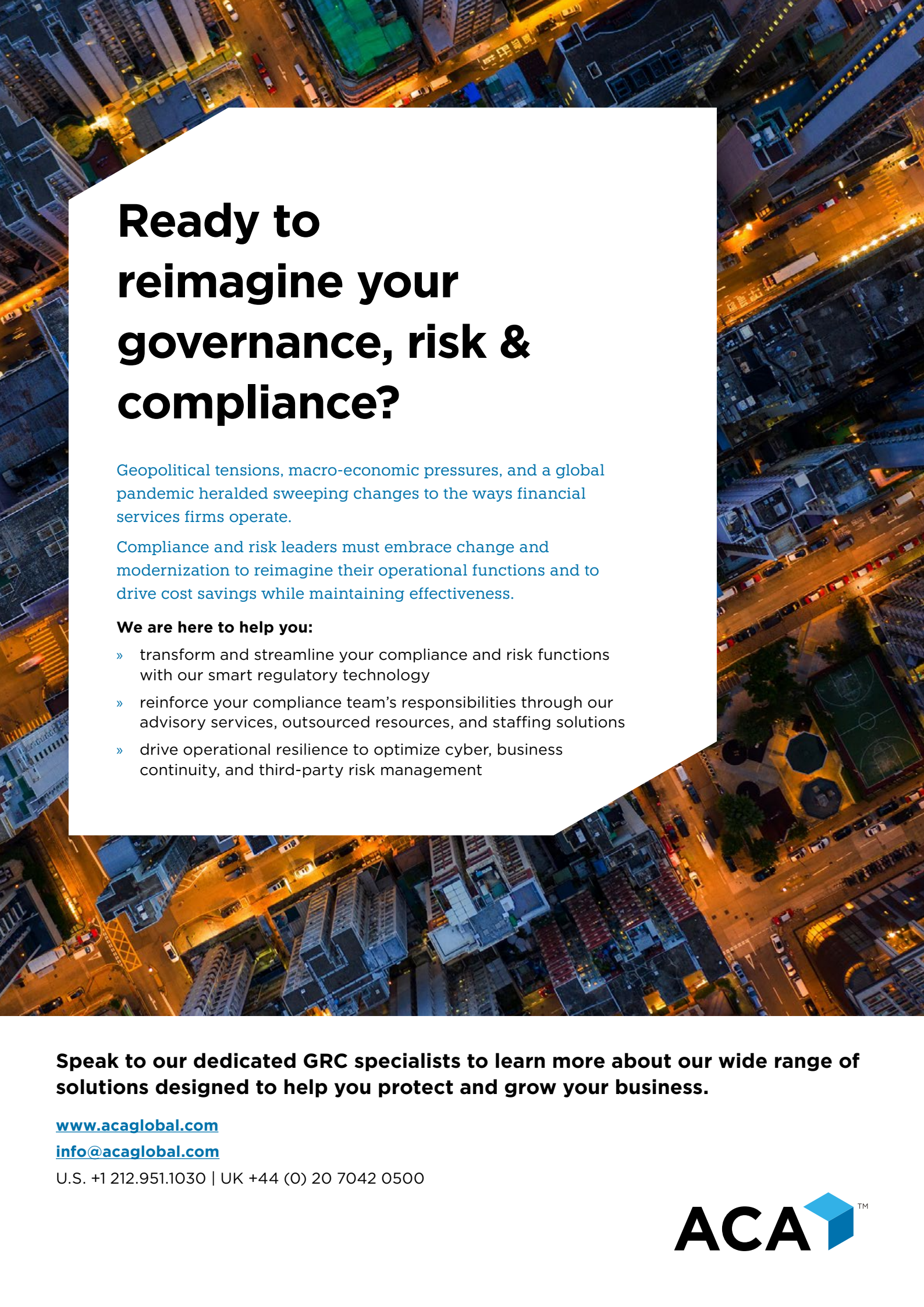
## **8. Governance structures are in place, but compliance reporting is inconsistent**

Management, operations and risk committees, are required by firms to show mind and management in the UK (MiFID II), hierarchical separation (AIFMD), and of course, risk control. The compliance officer should attend these meetings and report to senior management with meaningful updates. They should receive management information from the various teams that are doing the testing and monitoring the control environment.

From this small sample of the most prevalent issues, it's clear that there are no 'one-size fits all' solutions when it comes to risk and compliance control in systematic investment firms.

As with all things that involve excelling in an unfamiliar regulatory space, it starts with asking the right questions.





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# As allocation strategies evolve, so too must approaches to manage diligence



Shlomo Mirvis  
CEO & Founder  
Intelligo Group

Public pensions, foundations, endowments, and sovereign wealth funds are the gatekeepers of institutional capital. They decide which managers are allocated billions of dollars to support retired workers, education, medical research, the arts and more. CIOs and investment committees rightly look at these managers' historic performance to help ensure they deliver strong risk-adjusted financial returns. But how closely do they examine human capital risk when making allocation decisions?

According to a [survey from Seward and Kissel](#), 42% of investors are planning to allocate more to alternative strategies this year— especially private equity, private credit, and venture capital strategies. About 86% of respondents are already directly investing with outside fund managers, showing the fervent interest in alternatives. Ironically, however, while institutions are active in mandating their fund managers to closely diligence each investment opportunity, the vetting that institutions perform of their fund managers is often softer and more improvised.

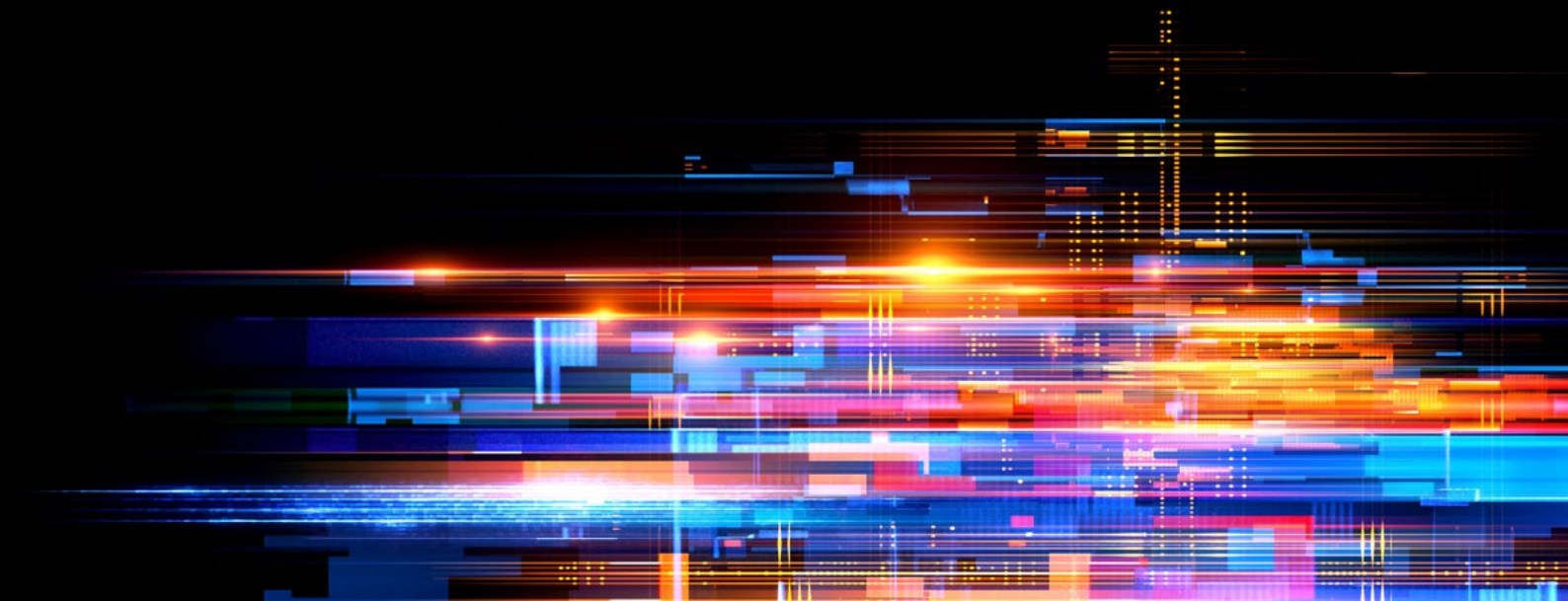
Now, more than ever, the conduct of the executives leading the fund managers you do business with can negatively impact your own reputation and even the performance of the investment itself. Yet there are far more data points and jurisdictions to cover to gain a full view of that conduct. Limited partners (LPs) need to integrate sophisticated risk intelligence into their allocation decisions for holistic due diligence that protects the institutions they represent.

## The outset of the relationship

Background checks that expose red and yellow flags on fund manager personnel are a critical step in the due diligence process. The competition to access high-returning funds is intense, and the background check process as it is conducted in legacy systems today is complicated, non-transparent and requires a lot of time and resources when using traditional methods. Many LPs will view this issue as a balance between due diligence and availing themselves of maximum investment opportunities. But that doesn't need to be so.

Of course, some nuance is required. For example, it is not unusual to have background checks flag a high volume of bankruptcy cases. However, involvement in bankruptcy cases is part and parcel with being a distressed credit investor. False positives like this grow much higher in volume when the funnel is opened wide and create potential bottlenecks in the process. More sophistication is required of due diligence platforms—both to reduce those false flags, and to be able to contextualise data





points that may be natural to the asset class, segment, or sector in scope. It also illustrates why the integration of AI is crucial to the advancement and evolution of these platforms. It can automatically 'learn' what is and is not important for each situation, and elevate the most important developments as priorities.

Investors need new technology that can deliver deeper insights in hours or days, not weeks. They also need to use a more collaborative and transparent process that allows a primary user to share the information with all relevant stakeholders. New software platforms use AI to scan tens of thousands of data sources at 4X the speed of traditional background checks and identify what matters.

### Potential risks to not performing background checks

Some assume that individuals in large investment firms are above suspicion, but the reality is that in 2020, 72% of Intelligo searches found "yellow flags", like being a subject being sued multiple times over a short period, gaps in employment history or jobs not listed on their resume. We've seen everything from investment professionals flagged for being involved in foreign corruption scandals to a breach of contract lawsuit to even seeking to launder money overseas and poison a witness! With an ever-growing range of sources for AI-powered platforms to cull from, we are flagging bad behaviour from a wider range of potential adverse events than ever before.

### Ongoing monitoring

The challenge of performing proper due diligence does not end with the initial manager selection process; indeed, it is just the beginning. Even the most carefully compiled risk intelligence report is only current on the day it was compiled.

The prudent investor throughout the term of their investment continues to perform due diligence, monitoring for new behaviors that cause concern. New due diligence technology can alert users to new information, on companies or individuals, that could come to light and significantly alter the impression of an earlier background check. This allows for investors to take immediate actions that can reduce the future risk of any allocation or manager relationship. The time and resources lost to frequent, static background checks that are processed once per year or even once per six months are significant and do not offer the same coverage or peace of mind compared to AI-enabled monitoring.

As institutional allocators do more direct investing in private markets, they have a great impetus to protect the assets of their constituents, to help ensure the long-term financial security for academic institutions, charitable foundations, pension participants and others. More than ever before, reputational issues can have a disastrous impact on the trust constituents have in an LP allocator's manager selection and broader decision-making ability, and it is incumbent on LPs to enhance the due diligence on the firms they partner with so that it meets or exceeds the diligence those firms due on the actual investments.

# Transforming investor relations from reactive to proactive: With customised due diligence



Wissem Souissi  
CEO  
Diligend



## The cost benefit of a proactive approach for due diligence responses

**R**isk management is the cornerstone of due diligence. Investors perform due diligence on potential or existing funds and fund managers to minimise the potential financial risk, operational risk, and reputational risk to their business. These risks are becoming increasingly complex and difficult to manage requiring investors to seek more information at an increased rate from their asset managers.

The due diligence process is an integral part of the investment process but not necessarily one that alternative managers relish. Standardised DDQs like those published by [AIMA](#), [ILPA](#) and the [PRI](#) have been well received and provide useful intelligence into the type of questions that investors across the industry are asking. Managers that use these standardised DDQs as a basis to formulate responses accordingly will find that they are somewhat prepared to respond to a wide variety of investor requests. However, most investors require additional information and files to supplement the standardised answers. These non-standard requests take up a large proportion of the managers' time allocated for information requests, because they require internal experts to review the questions and provide new data points. These experts are better suited to drive the search for alpha but they are required to provide transparency for the end investor. This is the dilemma; should the managers push back on the investors and risk impacting fundraising potential or should they utilise resources to provide more clarity and transparency.



## Increasing complexity in portfolios

Investors need answers because as market conditions change and new asset classes emerge, investors are increasingly broadening the scope of their portfolios. Many investors are extending beyond their core investments to include a greater exposure to alternatives. Private markets allocations continue to rise, following [strong private equity and credit performance in 2021](#) and both hedge funds that investing in private credit and venture capital and private equity managers will see greater allocations. As more new funds pour into alternative asset classes, more questions and greater diligence will be mandated. There are signs of greater regulatory pressures already on the horizon.

## ESG and diversity

Public interest in environmental, social and governance (ESG) and diversity issues has swelled in the past decade in parallel with significant principles-based regulatory changes. These combined factors mean that institutional investors almost without exception, recognise the necessity of sustainable and ESG related investing. The challenges lie in collecting, analysing, and presenting real time and forward-looking data, in a manageable way.

## Digital assets

While institutional investment into digital assets is still relatively low level, the tide may be turning, and some early successes have been [reported across the media](#). Crypto assets are being introduced slowly to diversify portfolios or increase returns, but the risk remains high and the approach to due diligence is different. The SBAI has produced a useful toolbox to help investors and managers satisfy the specific requirements of crypto asset due diligence, but as the space develops, a non-standardised approach will almost certainly be required.

## Customised due diligence responses

Whilst this diversification is great news for alternative managers, how can they turn it to their advantage? One way of standing out is to provide customised due diligence response data that meets the specific needs of every investor or investor type. By understanding and pre-empting investors' due diligence needs managers can demonstrate a deep knowledge of their products, and associated risks. They can provide greater transparency to investors and cut through the noise. All while reducing the ad-hoc demand on the firm's internal experts.

## Digitisation and automation

However, providing customised responses to every request is time consuming and complex without the digital tools to support it. Managers with no tools, that typically prepare standardised responses will find a big leap in resources and time required to create custom responses. However, those managers that can do this effectively will be able to respond faster, improving their visibility amongst the investor community.

Investors will appreciate the tailored information and reduced burden on portfolio management teams when sifting through manager responses.

Automation is the underlying technology that allows managers to provide customised responses quickly and efficiently. Tools that can recognise similar questions and suggest responses using a bank of previously submitted response data can speed up the process and reduce manual intervention. Fee pressures

Reducing manual intervention with automation tools can only have a positive impact on managers' costs, where portfolio management and investor relations expertise come with a significant price tag.



Managers' fee structures are being scrutinised and squeezed by investors, leading them to examine current operating models for further efficiencies. Those that continue to charge higher fees will be expected to provide greater service levels, transparency, and insights. Standardised due diligence questionnaire responses and self-serve data rooms will not suffice. Additional investor relations resources may be needed, and managers will need to balance whether they should invest in automation or in headcount.

Those that reduce fees to compete will need to drive efficiencies in the operating model to maintain profitability. Toolsets that allow managers to do more with less resources, will be essential where margins are paper thin.

### Hybrid working

Additionally, as we move out of the pandemic and towards a new hybrid working model, it becomes important for managers to implement digital toolsets that allow them to collaborate and communicate effectively at a distance. For portfolio management and investor relations teams, this means establishing data stores that are secure, yet easily accessible, that utilise qualitative and unstructured data sources, but provide a reliable single source of truth. Not only would this enable greater efficiency for the investor relations teams but more importantly reduce the risk of providing incorrect or stale data to the investor.

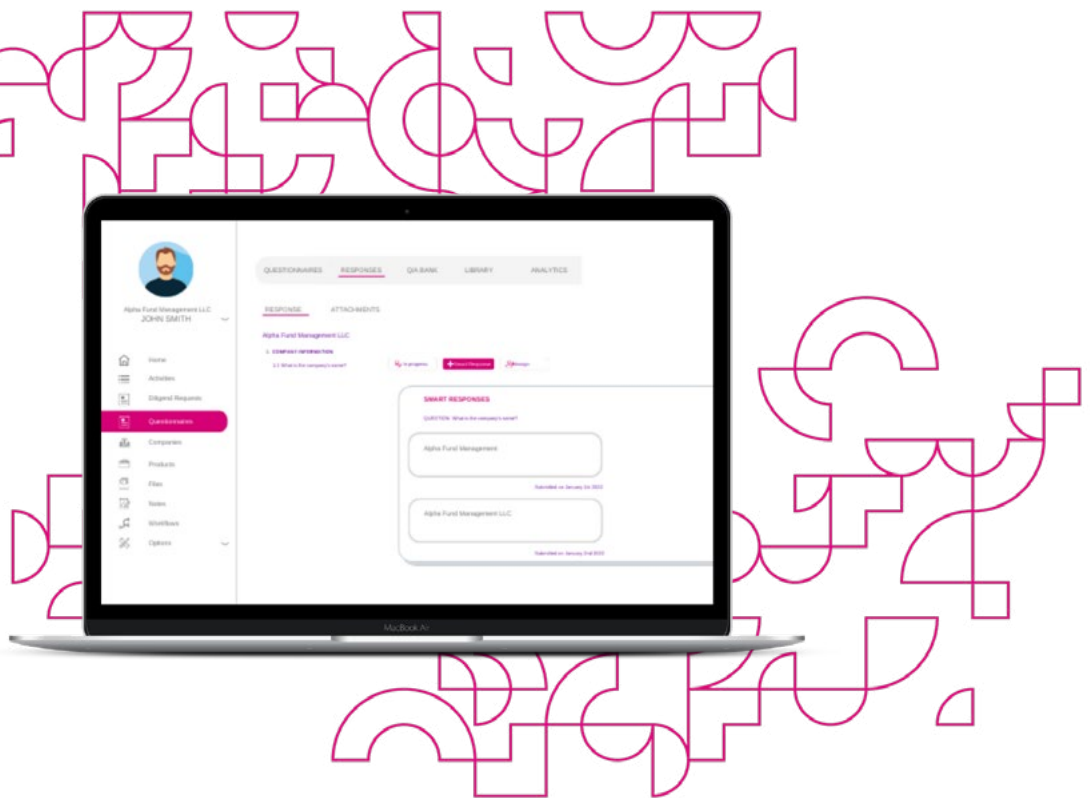
### The final word

In responding to increasingly frequent investor demands for greater transparency and ever more complex and custom data points as part of due diligence and monitoring exercises, managers will need to adapt their approach to respond quickly and retain a competitive edge. In fact, regulatory changes and pressures to disclose more information than ever to investors may also force managers' hands, making new disclosure or response tools a necessity rather than a choice.

#### Digitising the due diligence response process: a checklist

- Compile a list of investor requests for information, by whom and in what format
- Identify the questions and answers sought
- Calculate time spent on different tasks; questionnaire ingestion, investor communication, sourcing data, compiling responses, comparing data from different sources
- Detail the resources that would typically be required to fulfil a due diligence request
- Identify data sources: notes, emails and files
- Gather previous responses
- Understand the data requirements across each asset class
- Identify a shortlist of platforms that can process the right data formats
- Undertake proof of concept testing to visualise the potential time savings and customisation options

# Diligend Respond Fund Manager Platform



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Smart Response auto suggestion

**Natural Language Processing (NLP) tech scans questions and auto-suggests most likely response**



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**Assign specific questions to team members and monitor progress with oversight dashboards**



Microsoft Word plug-in and editor

**Respond to investor requests in original Word format, leveraging Diligend's automation features**



Investor profile with file management

**Maintain a rich investor profile in a comprehensive, integrated CRM platform**



Full audit trail

**Meet compliance and investor requirements with full audit trails for all RFP and DDQ activity**



Word/PDF/Excel document scraping

**Dramatically accelerate processes with advanced automated data ingestion and smart matching**

# Private debt funds in Luxembourg



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Private debt and private debt funds have become an essential source of financing for companies (and in particular small-and-medium-sized enterprises (SMEs) as well as the real economy and are now a permanent fixture in the alternative investment fund space. Persistently low interest rates, companies' demand for financing and the hunt for yield among investors have been contributing factors to the success of private debt over the past decade, which prior to the global financial crisis was considered a niche asset class. While the private debt market in the US is the largest and most mature, the European and Asian private debt markets have grown considerably in recent years. Market sentiment in the European Union (EU) remains highly positive across all market segments.<sup>1</sup>

In Luxembourg, the evolution and growth of this alternative source of financing has accelerated year-on-year with Luxembourg private debt funds' assets under management (AuM) increasing by 41% in the past year alone.<sup>2</sup> By June 2021, AuM in private debt funds domiciled in Luxembourg had surged to €181.7 billion.<sup>3</sup> This builds on the significant growth experienced in 2020 and the growth outlook for the private debt market heading into 2022 and beyond remains strong.

## Impact of COVID-19

Notwithstanding the growth experienced in 2020 and 2021 or the healthy outlook for the future, the private debt industry has also had to navigate COVID-19 over the past two years. The nature, the duration and the uncertainty of the pandemic have resulted in many challenges to all areas of the global economy and the private debt sector is no exception. It was the first economic downturn faced by the European private debt industry and it undoubtedly slowed down the exponential (and generally uninterrupted) growth the industry had been experiencing in the aftermath of the 2008 global financial crisis and led to drop-offs in deal flow as well as fundraising as investors paused allocations at the beginning of the pandemic.

By contrast, COVID-19 has also offered some private debt funds, who were fortunate enough to have significant capital commitments, an opportunity to engage in new business activity and capitalise on transactions in the opportunistic credit, distressed and special situations spaces. In addition, direct lending strategies continued to be a popular investment strategy of private debt funds during the pandemic. As the focus shifts to post-pandemic recovery efforts, private debt can play an important role in the recovery of the global economy by meeting additional liquidity needs of borrowers and providing an alternative source of finance to companies where access to traditional bank financing, for one reason or another, is in decline or has declined or where traditional bank financing is not the preferred source.

<sup>1</sup> EIF Private Debt Survey 2021: Private Debt for SMEs – Market Overview.

<sup>2</sup> Association of the Luxembourg Fund Industry (ALFI) Private Debt Fund Survey 2021.

<sup>3</sup> ALFI Private Debt Fund Survey 2021.



## Private debt funds in Luxembourg

Luxembourg remains the preeminent European jurisdiction for private debt investment funds and the structuring options available to these types of funds are vast and varied. Private debt funds in Luxembourg may be established as unregulated or regulated structures. Within these two categories, various types of vehicles are available. Unregulated limited partnerships have, however, generally become the vehicle of choice for most managers which wish to establish private debt funds that are domiciled in the EU.

In circumstances where it is preferable to establish a fund which is subject to a regulatory regime, the reserved alternative investment fund (*fonds d'investissement alternatif réservé*, the 'RAIF') and the specialised investment fund (*fonds d'investissement spécialisé*, the 'SIF') are most frequently used. In contrast, the investment company in risk capital (*sociétés d'investissement en capital à risque*, the 'SICAR') is seldom chosen on account of its restricted investment policy. The application of one of these regulatory regimes can provide additional structuring flexibility and help to accommodate specific commercial and regulatory considerations.

A wide range of different factors, including the choice of available legal vehicles, the likely preferences of target investors and the extent of local regulation, will influence and determine the fund structure which the manager of a private debt fund ultimately selects and implements.

## Luxembourg limited partnerships

The legal framework for limited partnerships has existed in Luxembourg for over a century. However, in 2013, the Luxembourg legislature modernised the Luxembourg limited partnership regime by revamping the legal regime of the common limited partnership (*société en commandite simple*, the 'SCS') and introducing a new type of partnership vehicle – the special limited partnership (*société en commandite spéciale*, the 'SCSp'). Luxembourg's limited partnership regime now comprises three types of limited partnership: (i) the SCSp; (ii) the SCS; and (iii) the corporate partnership limited by shares (*société en commandite par actions*, the 'SCA'). This has set the scene for limited partnerships, and specifically the SCSp, to become the legal vehicle of choice for private debt funds established in Luxembourg, with 88%<sup>4</sup> of unregulated debt funds formed as SCSPs.

The regimes for the SCSp and the SCS are modelled on the successful Anglo-Saxon limited partnership regimes and offer features similar to foreign partnership regimes applicable in England, Scotland, Delaware and other common law jurisdictions. By contrast, the SCA is incorporated under Luxembourg law and exhibits a number of corporate and partnership characteristics, so that it is a hybrid entity. An SCA is entitled to make elections about its treatment which are respected under the laws of various foreign jurisdictions, including the USA. This can avoid difficulties with entity classification rules which might otherwise arise.

Each limited partnership is formed under the Luxembourg law of 10 August 1915 on commercial companies, which contains a number of provisions particular to each respective type of limited partnership. Such provisions in respect of the SCS and SCSp are very limited and therefore they afford great structuring flexibility and contractual freedom.

Each limited partnership will also be subject to Luxembourg's general commercial and civil rules. In addition, a Luxembourg limited partnership will be subject to a specific Luxembourg funds law if it elects for that law to apply to it and, to the extent applicable, the supervision of the Commission de Surveillance du Secteur Financier, Luxembourg's financial regulator (CSSF).

4 ALFI Private Debt Fund Survey 2021.

## AIFMD and beyond

The majority of private debt funds set up in Luxembourg qualify as alternative investment funds (AIF) and fall within the scope of the regulatory framework of the Alternative Investment Fund Managers Directive (AIFMD). While private debt funds have thrived under the AIFMD framework, the uptick in popularity of private debt funds has led to increased regulatory scrutiny and regulation in this sector is likely to increase.

This is particularly true in the context of debt originating funds, i.e., 'loan originating funds', where the European Commission (Commission) proposes to introduce a new and specific regime for alternative investment funds managers (AIFMs) managing loan-originating AIFs (LOAIF)<sup>5</sup>. The Commission has cited regulatory fragmentation in the private debt market as well as the need to react to market-wide effects and to promote an efficient internal market to support the implementation of a LOAIF regime.

Under the Commission's proposal, such AIFMs would be required to implement (and annually review) policies and procedures for granting credit, credit risk assessment and administering / monitoring the credit portfolio, and ensure:

- that any loan to a single financial undertaking<sup>6</sup> or a fund borrower does not exceed 20% of the LOAIF's capital;
- the LOAIF does not lend to the AIFM or its staff, the depositary or a delegate of the AIFM (e.g., an investment manager); and
- the LOAIF retains 5% of the notional value of loans originated by it and subsequently sold.

To mitigate the risk of liquidity mismatches, it is also proposed that a LOAIF must be closed-ended if the notional value of its originated loans exceeds 60% of its net asset value.

The consultation process is well under way and a range of stakeholders have provided feedback to the Commission in relation to potential rules around loan origination, some of which could lead to further development, expansion and growth of a vital source of funding.

## ESG considerations and conclusion

Many private credit managers already integrate environmental, social, and governance (ESG) factors into their investment strategies and they are a driving force behind engagement with businesses on sustainability. With the focus on ESG issues growing, responsible investing, sustainability and ESG are becoming ever more important factors for private debt strategies. In addition, private debt is already playing a vital role in supporting the sustainability transition among SMEs and mid-market companies.

The upward trajectory enjoyed by the private debt market to date looks set to continue for the foreseeable future and there are a number of trends that will shape the private debt industry. Two of these trends are: a) the Commission's proposal to amend the AIFMD and address (at least to a certain extent) the lack of homogeneity in the different European jurisdictions with respect to loan originating funds and b) responsible investing and ESG issues, which dominated the regulatory and public arena prior to COVID-19 and continue to be focal points.

Crucially, whatever the future holds, it will be necessary to ensure that the current and future regulatory environment does not impede the continued development of the private debt market.

*In Luxembourg, the Maples Group provides full service legal advice through our independent law firm, Maples and Calder (Luxembourg) SARL, which is registered with the Luxembourg Bar.*

<sup>5</sup> Note the investment restrictions in the proposal are without prejudice to applicable limits for ELTIFs, EuVeca or EuSEF funds.

<sup>6</sup> As defined in Solvency II, primarily being an entity authorised to provide a regulated financial service in the EU such as credit institutions, (re-) insurers and MiFID firms.



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# Is 2022 the year private debt comes of age?



Craig Reeves  
Founder  
Prestige Funds

**A**s a private debt fund manager, we see some major themes emerging this year which will contribute to the further growth of this asset class. But beyond that, they will raise some big questions for the wider hedge funds industry to answer. While the attraction of private debt for investors looks set to increase in 2022, there are big challenges ahead that the wider fund management industry will need to get to grips with.

## Inflation

Inflation will remain a major point of concern for investors this year: US inflation has just hit a 40 year high. What does this all mean for public markets versus private alternatives? Inflation has never been good news for equities. It is highly unlikely that every listed company out there will be able to pass inflation costs on to their end customers. Many will, but many will struggle. This will eat into margins and slow or even stop earnings growth.

This year looks like it is setting up to be another tough one economically. While the global economy has started to recover from the pandemic, some sectors are still in pieces and various areas of the supply chain remain constrained. Ahead of them now is a challenging inflationary environment and we can anticipate more volatility across markets, including in the government bond markets.

From an economic perspective, we have shifted from literally decades with zero inflation to a much higher inflation environment than we have seen in many developed economies since the late 1980s. Macroeconomic factors are at work here, which central banks seem to have underestimated. While we are now in a tightening environment, investors are still facing negative real yields. Therefore, real yields have never been harder to attain consistently and in scale.

Institutional investors are also facing a demographic shift in Europe, which, despite immigration, indicates a population getting older all the time, and living longer lives. Germany and Italy have two of the fastest ageing populations in the world and this is creating a demand for assets that can still provide a consistent yield profile.

These circumstances are going to combine to create more demand for alternative investments as investors seek to reduce risks and allocate to areas of the economy that are simply less correlated to the public markets.



## Commodities crisis

Energy has inevitably moved to the forefront of many investors' – and households' – minds over the past few months. It is reinforcing the pressing need for European countries to address the source and nature of their energy supplies.

Geopolitics is playing its own roll in energy costs with Russia continuing to use gas supplies in Europe as a bargaining chip. But beyond that, both oil and gas prices have picked up speed considerably over the winter.

The focus is now very much on our reliance on fossil fuels, and whether there should be other, viable alternatives. We have long been active in the clean energy space, providing private lending facilities for biogas facilities in the UK which now power approximately one million homes. This was well before such projects became 'trendy'.

Many of our early investors were well ahead of the curve when it came to backing biogas projects, but they could see the impressive sustainability benefits of anaerobic digestion for both waste management and early wins in controlling methane emissions from the UK agriculture sector.

Prestige Funds is now seeing broader interest in the sector from larger fund managers who wish to tap the expertise of our lending teams. What has changed?

There is more of a realisation from asset managers that they should be able to demonstrate how their activity is helping to change the world for the better. This situation will not change, fund managers will be held to account by the newer generation of investors in ways that they simply were not previously.

Biogas is already playing an active role in providing electricity for farms in the UK and sending excess power onto the UK national grid. Unlike wind power and solar, it can run 24/7 – this level of consistency is a major appeal for both investors and power consumers especially since the average yield on some UK wind and solar assets was lower in 2021 compared to 2020.

Clean energy production will require considerable action from the private investment market, including private debt specialists. While the UK is considered one of the leaders in the clean energy sector, much still needs to be done to finance the further expansion of the sector.



## Sustainability

Last year's United Nations COP26 conference seems to have achieved less than many expected, but the pressure is on for fund managers and institutional investors to deliver solutions that meet the already high expectations of stakeholders.

Many of the solutions still seem subject to nationalist politics, yet climate issues aside, the growth in the global population continues apace. Global warming and investor (and stakeholder) concerns over sustainability mean that we face a situation where there is more demand for impact strategies than ever before.

Below is a short analysis of how Prestige Funds' own lending operations measure up against the common breakdown of responsible investment approaches. We have based this off the template established by the UN Principles for Responsible Investment (UNPRI) in their excellent paper on the topic.<sup>1</sup> We think this can be seen as typical of the sort of challenges facing private debt fund managers as they consider the sustainability of their activities.

In our case, we have been lucky in that we have already evolved sophisticated lending operations with the technology to maintain detailed screening criteria as well as a sub-strategy that has already evolved to become a green energy financing business.

Obviously, the private debt sector is much broader and varied than our area of speciality – namely direct lending. Managers of all types of private debt are having to evolve their own criteria for screening their portfolios and engaging with some of the themes outlined above. In the case of direct lending or infrastructure debt, projects can be unique and managers will have to develop their own framework for reporting the ESG contribution of that project.

ESG criteria can be embedded in the credit decision making and reporting process. Direct lending fund managers have already evolved sophisticated, technology-driven processes that help them in managing risks and evaluating lending decisions. The companies we engage with are also becoming more aware of their own ESG reporting responsibilities, and as lenders, we are helping to educate businesses about investor expectations in this respect.



<sup>1</sup> Principles for Responsible Investment: Spotlight on Investment in Private Debt

	Objective	Key Considerations	Examples
<b>Negative screening</b>	Excluding sectors and companies from the lending portfolio	<ul style="list-style-type: none"> <li>Screening criteria needs to be clearly established</li> <li>Screening can be implemented within the lending criteria of a direct lending fund</li> </ul>	<ul style="list-style-type: none"> <li>We do not lend to gambling or vice sectors</li> <li>Screening of farming operations we lend to for our Shariah fund</li> </ul>
<b>Positive screening</b>	Companies or projects that make a positive social / environmental contribution	<ul style="list-style-type: none"> <li>Strategy needs to target positive outcome projects</li> <li>Clearly identifiable ESG value drivers</li> </ul>	<ul style="list-style-type: none"> <li>Lending strategies focused specifically on clean energy technology</li> <li>Islamic fund supporting green energy projects</li> </ul>
<b>Thematic</b>	Lending to companies or projects that have demonstrable ability to address specific environmental or social challenges	<ul style="list-style-type: none"> <li>Specific ESG themes</li> <li>Option to provide measurability of social / environmental impact</li> </ul>	<ul style="list-style-type: none"> <li>Measurable clean energy generation from funded projects</li> <li>Waste processing capacity</li> <li>Measurable job creation in UK rural sectors</li> </ul>
<b>Impact investing</b>	Positive environmental / social benefits that can specifically 'do good' – intention to do so must be explicit	<ul style="list-style-type: none"> <li>Trade-offs between negative ESG impacts and positive outcomes</li> <li>Financial returns</li> <li>Impact reporting criteria</li> </ul>	<ul style="list-style-type: none"> <li>Carbon capture projects</li> <li>Sustainable circular waste to energy projects</li> </ul>

## Expansion of the private debt sector

Private debt as an alternative asset class remains in good health and has come through the pandemic with its credentials in better shape than ever. Research group Preqin is forecasting steady growth in unlisted assets, with private debt alone expected to grow by 11.4% per annum between now and 2025.<sup>2</sup> This compares with growth in other alternative markets of around 5% per annum.

According to Morgan Stanley,<sup>3</sup> even those investors who typically have lower allocations to private assets are upping their stakes at the moment. This is partly being driven by innovation in products, but also by easier access to private funds.

Private debt is ranked just behind private equity as the favoured alternative asset class, having really been considered a niche market 20 years ago. Larger and larger fund raisings have testified to investor demand for this area.

Preqin's recent forecasts have been supported by extensive polling of investors on their appetite for various asset classes as well as feedback from fund managers themselves.

Dedicated investor allocations to private debt have been on the rise – on average the target allocation is now 6.2%. This compares with 13.8% for private equity and 10.1% for real estate. The overall growth in private debt is being driven by a big expansion in both distressed debt and direct lending strategies. According to Preqin, going into 2021, direct lending formed the largest sub-category within the private debt universe.

## Conclusion

Private debt is now set to be a major contributor of capital to the companies and projects that will play an active role in helping to slow and even turn around climate change. The asset class has evolved in the last couple of years to offer investors more specialist options to meet their requirements, including ethical screening and impact criteria. With almost six million companies in the UK almost all of which are privately owned, the private debt industry is increasingly playing an important role in helping to finance them and shape sustainable policies. Furthermore, with high inflation and more volatility now in public markets, these sorts of private assets are enjoying a further surge in popularity.

<sup>2</sup> Preqin: Global Private Capital Market Overview

<sup>3</sup> Private capital industry soars beyond \$7trn (Financial Times, June 2021) - [Private capital industry soars beyond \\$7trn | Financial Times \(ft.com\)](https://www.ft.com/content/1d1d1d1d-1d1d-1d1d-1d1d-1d1d1d1d1d1d)





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# A deconstructed view of a consolidated tape

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**T**he mood music around the introduction of a consolidated tape (CT) in the UK and the EU has been growing louder over the past six months, with the recent crescendo replaying some of the basic use cases and policy challenges - again!

However, against a background of rapidly changing market structures, innovative and accessible products and rapidly developing technologies and solutions, a CT can make a significant contribution to standardising transparency, improving market pricing and investment strategy, and delivering key public policy goals.

## Transparency drives trust

The relationship between transparency of information and market outcomes can be separated into two fundamental elements - information asymmetry and predatory trading.<sup>1</sup> The former addresses the relationship between transparency and market outcomes, in the context of market participants possessing differing degrees or levels of information, based on whether or not information access is costly. The latter is subject to considerable regulatory attention, in terms of ensuring fairness and best execution for retail clients.

Asymmetric information discourages market participation, where people feel it is difficult or costly to access basic data to inform investment decision-making. It also leads to a degree of caution on the part of investors in terms of engaging with financial markets that they feel they don't trust or understand.<sup>2</sup> If we take the example of seemingly transparent markets - such as the US corporate bond markets, where the Financial Industry Regulatory Authority (FINRA) operates the Trade Reporting and Compliance Engine (TRACE) CT - even this system does not provide a total, global view of all US corporate bonds traded.

While the issue of data quality has been highlighted as central to the CT debate, it is also wrapped up in a broader point about accessibility. This concern also features in the European Securities and Markets Authority's (ESMA) MiFID II/MiFIR Review Report (September 2020), where, in relation to changes to the regime, the sell side 'group' noted that *"priority should be given to working on accessibility, readability and quality of market data"*. Similarly echoed by a section of the larger buy-side 'group' who cite *"the need to improve the standardisation, the accessibility, and the quality of MiFIR market data"*.

The current MiFID II rule requires access to 15-minute delayed data that must be made public by the various venues and data providers. However, as we highlighted in the first of our series of [whitepapers](#), while access is available, it requires a degree of technical knowledge that would overwhelm most retail investors (and even some asset managers). This is because the array of file formats presented makes aggregation of the data from those different providers, almost impossible.

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1 FCA Occasional Paper No. 6 Transparency in the UK Bond Markets: An overview January 2015.

2 They still haven't told you Knuteson SSRN-id3998202

## What are the market benefits of a CT?

Transparency is a key benefit of a CT and there are more concrete examples of how the mechanism can benefit the market, when we look at the implementation of TRACE in the US:

1. **Reduction in trading costs:** Research at the University of Chicago's Booth School of Business<sup>3</sup> estimated that the introduction of mandatory dissemination of price and volume information for corporate bond trades (via TRACE) reduced overall market trading costs, across all types of bonds, by some US\$605m per annum.
2. **Cost of capital savings for issuers:** Recent research<sup>4</sup> on behalf of the European Finance Association, has focused on the relative importance of potential economic mechanisms that link secondary market transparency and primary market costs. The analysis identified how regulatory reform impacts cost of capital and highlighted that improved post-trade market transparency (via TRACE) is associated with a fall of 14 bps in the yield spread of a typical issue - corresponding in their sample to a 1.1% cost of capital 'saving' for issuers.
3. **A complete view of liquidity:** Fragmented reporting limits the visibility that the market has in terms of a complete view of liquidity. In TRACE's case, while it provides a comprehensive view of corporate bonds traded on US venues, research has shown that when data from EU venues for those same US corporate bonds, is included, the actual total weekly volume and number of trades were respectively 15% and 17% higher, than those reported in TRACE alone.<sup>5</sup> Similarly, in the UK and the EU, a single source of comparable data should allow a more complete view of total liquidity to emerge.
4. **Understanding inter-connectivity of securities:** Where there are connections between different parts of the markets - for example, a high yield bond ETF - it is often useful to be able to observe the prices of the underlying components. Recent research<sup>6</sup> has shown that including a bond in an ETF has a favourable impact on the bond's liquidity and this can impact investors' assessments of those bonds, as well as ensuring a better understanding of the bond price dynamics.
5. **Buffering market volatility:** An area of focus from some global regulatory bodies has been how to stabilise prices during periods of financial markets turmoil - to encourage institutional investors to reprice securities, rather than exit markets. Recent analysis<sup>7</sup> examined whether retail investors had a stabilising effect on stock prices, using the COVID-19 pandemic as an exogenous shock. It found that shares likely held by retail investors have 17% higher liquidity and at least, 24% lower 'crash' risk. This indicates that retail investors are rational, according to their trading patterns and do not necessarily follow institutional investors.

## Long standing policies

Since 2015, the EU has been pursuing an ambition to complete its Capital Markets Union (CMU) Programme as a core pillar of the EU itself. At the end of November 2021, the European Commission adopted a package of measures to ensure that investors have better access to market trading data, to deliver on several key commitments in the [2020 CMU action plan](#).

3 The Effects of Mandatory Transparency in Financial Market Design: Evidence from the Corporate Bond Market, Asquith, Covert and Pathak April 2019

4 Secondary Market Transparency and Corporate Bond Issuing Costs Brugler, Comerton-Forde and Martin (on behalf of the European Finance Association), Oxford Review of Finance July 2021

5 Bond liquidity and dealer inventories: Insights from US and European regulatory data, Ivanov, Orlov and Schihl, FCA Occasional Paper SEC DERA Working Paper February 2020

6 The Impact of the HYG ETF on the Liquidity of the Markets for the Underlying High-Yield Bonds, Finnerty and Reisel, Gabelli Business School Fordham University July 2021

7 The Impact of Retail Investors on Stock Liquidity and Crash Risk, Hufner and Strych Karlsruhe, Institute of Technology December 2021



In 2022, they want to help connect EU companies with investors, improve their access to funding, broaden investment opportunities for retail investors and better integrate capital markets.

A CT is seen as a key mechanism from the review of the Markets in Financial Instruments Regulation (MiFIR), with a series of proposals published to help deliver part of that action plan.

Meanwhile in post-Brexit UK, the HM Treasury outlined an initial policy perspective through its Wholesale Markets Review in mid-2021 and the recent WMR response has confirmed the focus on delivering fixed income CT.

### The detail is in the data

In both the EU and UK, the issue of data quality will need to be addressed as part of any CT process. While there are detailed regulatory technical standards (RTS 1' and RTS 2) defined by ESMA, when we looked at the MiFID transaction records' data, we found inconsistencies in the transaction records published. In our [analysis](#), we break the data quality issues down into three categories: consolidation and aggregation, consistency and coherence.

Both the UK and the EU have launched or plan to launch consultation processes on these standards. However, a better solution might be to ensure that there is a uniform approach and standardised practices by market participants and venues around the common application of the existing RTS standards – an 'instructions manual', if you will.

Most market participants hope that, while the CT process may take different paths in the UK and the EU, the basic infrastructure, data standards and transparency rules will be the same, to ensure an effective implementation of CT initiatives across markets.

### Conclusion

FINBOURNE agrees with industry bodies, regulators, and market participants that a CT is both necessary and beneficial. There are a myriad of issues still to be decided but the sense of direction is clear, while the need for market participants to contribute to the debate and start to get ready for a CT is equally obvious.

We believe that the time for engagement is now and we're inviting market participants to keep in touch with developments in our Design Council, as we take the first steps to address the data challenges and build a technology-led market focused CT.

*To learn more and for details on how to join the Design Council or to speak to us about CT, get in touch at [ctp@finbourne.com](mailto:ctp@finbourne.com).*



# SETTING THE STANDARD FOR ACCESSING, CONTROLLING AND UNDERSTANDING YOUR INVESTMENT DATA

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BY FINBOURNE

**A better way to manage your  
investment data. For everyone from  
start-up fund managers to global  
investment institutions**



# The Financial Services Act: Much ado about (almost) nothing?



**Anne Empain**  
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## Background

The Financial Services Act (FinSA) came into force in January 2020. Foreign promoters providing financial services, such as dealing in financial instruments for clients, asset management services or investment advice, on a commercial basis for clients in Switzerland were subject to a new set of rules, in particular the duties to segment clients, implement organizational measures and certain rules of conduct depending on the type of clients targeted. In addition to these rules, foreign promoters became subject to a duty to join an ombudsman (mediation body) as well as to register their client advisers in a so-called client adviser register under certain conditions.

All these rules were subject to various transitional periods, namely (i) two years for client segmentation, conduct rules and organisational rules, (ii) a moving target for the duty to join an ombudsman and the duty to register client advisers. As of 1 January 2022, all these rules are in place and effective, all transitional periods having ended, certain of which already in 2020, respectively 2021 (in particular for ombudsman affiliation and client advisers registrations).

This contribution focuses on the requirements to join an ombudsman and to register client advisers for foreign promoters based outside of Switzerland and promoting foreign funds in the Swiss market. To the extent relevant, other aspects of FinSA and the Swiss Collective Investment Schemes Act (CISA) will be discussed.

## State of play early 2022

### *For the ombudsman affiliation*

The requirement to affiliate with an ombudsman office originally applied irrespective of whether the end-client was a private client or a professional client under FinSA. After a revision of applicable rules, this requirement is now only applicable to foreign promoters providing financial services to private clients or elective professional clients. The rules and the affiliation process as such are relatively straightforward. Contrary to client advisers' registration, only the promoter itself has to be affiliated and not its employees (but the pricing of various ombudsman offices may differ based on the number of employees of the promoter).



### For the client advisers' registration

Any individual providing a financial service, such as the offering and sale of funds units, shares or interests in funds to end-clients in Switzerland qualifies as a client adviser under FinSA. Only individuals are subject to the registration requirements. In short, client advisers are those persons, who provide financial services by interacting with the end-clients.

No registration is required for client advisers of (i) FINMA prudentially supervised institutions (i.e. Swiss institutions), and (ii) foreign institutions which are subject to prudential supervision abroad and provide financial services in Switzerland exclusively to per se professional or institutional clients. According to the practice of the registers, based on their interpretation of the legal provisions (interpretation challenged by certain practitioners, but to date the registers have not changed their practice), client advisers of foreign promoters selling funds to elective professional clients, such as high-net-worth individuals (upon opting out) must register.

This registration may prove cumbersome and challenging from an operational perspective and may make no sense (in terms of business) if the foreign promoter only targets elective professional clients occasionally.

### *For the Swiss representative and Swiss paying agent appointment*

The appointment of the Swiss representative and the Swiss paying agent are product-based level requirements. In comparison, ombudsman affiliation and client advisers registration are institution-based level requirements. This distinction is important in practice, as promoters should not make confusion between the rules embedded in CISA and FinSA. CISA rules will apply to the product, namely the fund itself, while FinSA rules will concern the promoter.

Obviously, the rules are not “watertight” and concrete marketing efforts imply interplay between these requirements. However, promoter should keep in mind that navigating through FinSA rules and CISA rules is somewhat different.

As a general observation, CISA rules have not changed in their essence, but in their scope. Even if the scope is narrower now, practical and risk-based considerations are key drivers when foreign





promoters ask themselves to which extent they may decide not using the Swiss representative and the Swiss paying agent services. In addition, if a foreign promoter expects to target directly end-clients, who are elective professional clients, it will have no room for risk-based considerations and the appointment of a Swiss representative and a Swiss paying agent will remain the rule. Moreover, even when the distribution is channeled through an intermediary (indirect distribution), depending on how such intermediary is structured and on how it conducts its marketing/placement activities, compliance with CISA may still be required. So to speak, from a risk-based perspective, indirect distribution may still require to use the Swiss representative and paying agent services.

### How to navigate through the rules?

#### *Who are my investors?*

The first question a foreign promoter should ask is: what is my target market? If the considered market includes elective professional clients or could include such segment, it becomes important for the promoter to structure its marketing channel properly if it does not wish to deal with the ombudsman affiliation and the client advisers' registration (see below "How I market?"). This analysis will also allow the promoter to determine the scope and extent of the conduct rules (as these rules vary depending on client segment).

On the contrary, if the considered market only includes per se professional and institutional clients, assuming that the promoter is prudentially regulated abroad, FinSA will have a small incidence on the operation of the promoter. Impact will be limited essentially in complying with client segmentation certain conduct rules and organizational measures, the practical impact of which should not be overstated, but no affiliation with an ombudsman and no registration for client advisers.

#### *How shall I market?*

At that point it is important to determine the market channels: direct or indirect distribution or a combination of both methods. The reply to this question may not only condition the needs to affiliate with an ombudsman and register the client advisers of a foreign promoter but also the need to apply the rest of FinSA requirements (conduct rules and so one).







As a matter of principle, as discussed above, direct distribution to end-clients, who are elective professional clients will trigger FinSA and CISA requirements. In case of indirect distribution, the end-client interactions are in principle not in the hand of the foreign promoter.

In particular, when the intermediary in charge of the marketing efforts is prudentially regulated, the interactions between the foreign promoter and such intermediary does not fall within the ambit of FinSA. As a rule, the FinSA requirements will apply to the regulated intermediary at the point of sale. This scenario may thus be conducive to the establishment of efficient marketing channel from a FinSA standpoint.

Obviously, on top of it, CISA requirements will come at play, as previously discussed, but here again, it is possible to get rid of them, provided the distribution risks and channel are clearly identified and in compliance with applicable requirements. In case of doubt, it may however be recommended to maintain a Swiss representative and a Swiss paying agent.

## Conclusion

Depending on the business model and client structure, FinSA impact may be clearly mitigated. On one hand, the implementation and application of the conduct rules and organisational measures is generally achievable without having to conduct a massive overhaul of the operation and process of the foreign promoters.

On the other hand, the affiliation with the ombudsman (which remain a “mere” mediation body) and the registration of client advisers are not a fatality, even when elective professional clients are targeted. In the end, FinSA is probably not the revolution expected, even if it may take a certain time to adapt to the new rules.



# Archegos opens a Pandora's box of regulatory consequences



Larry List

Head of North America  
VoxSmart

One of the most talked-about financial markets events of last year revealed major regulatory and supervisory loopholes across both the buy and sell sides which are not easy to close. If the collapse of Archegos and ensuing market fallout uncovered some significant dark spots, the sharp rise of hybrid working over the past two years has presented the market with a pressing need to adapt to ensure that future problematic events of that scale do not occur. As new ways of working emerge from the shadow of the pandemic, regulations must reflect the physical disconnect that now exists between the workplace and the worker – and the way that firms approach their internal supervision of staff across all business lines must follow suit. Post Archegos, regulators now have their attention focused on several key areas that could cause major problems further down the line if financial institutions are not properly equipped to deal with them.

Take record keeping for example, the rules around this vital area of internal business infrastructure are certainly outdated, when considering the post-Covid world we now live in. They are in no way reflective of the modern hybrid working approach that most asset managers and investment banks find themselves employing now. This is surely why the SEC [recently proposed](#) a whole host of updates to electronic recordkeeping requirements – three years ago, nobody could have foreseen a world in which traders would have been permitted to regularly trade remotely, let alone encouraged to do so. It is, however, clear that this trend will not entirely reverse. Even as we emerge from the virus-affected business landscape, more and more market participants are signalling their intent to allow flexible working to some degree throughout not only the back and middle office, but also front-office functions.

As staff have become more detached from working in the same physical space as their managers and colleagues, record keeping is inevitably becoming increasingly important as a way of supervising staff. And in cases such as we have seen with Archegos, it will be vital to be able to track back on how so many mistakes were made on both sides of the relationship and to understand why, so that financial institutions can put processes into place to avoid future market meltdowns.

The focus cannot only be on written records over emails or social media channels, such as WhatsApp or Telegram, but also on voice communications. With hybrid working, we have seen a significant rise in the use of video channels being used by asset managers to connect with counterparties and colleagues on a daily basis. The trouble is that the current rules around retaining and reviewing voice communications are nowhere near strong enough when one considers the amount of business that is conducted vocally. Generally, financial institutions are only required to retain these records for one year and most market participants will dispose of records once the regulatory requirement has expired. This makes sense from a risk management perspective if they do not have the means to assess the records for potentially damaging activity. The challenge however is that these records can provide crucial context when assessed properly in the moment to give trading heads a deeper insight into the activity and productivity of their desks, as well as providing the capability to look back at situations to critically analyse outcomes. This insight can be incredibly helpful in avoiding potentially catastrophic incidents further down the line. This is certainly an area that regulators should be looking at as we continue to adapt our ways of working.

But as rule-makers mull over how to legislate the new world of business, existing regulations such as the Uncleared Margin Rules (UMR) are having a more immediate impact on existing ways of working. A set of reforms that encourage more over-the-counter (OTC) derivatives to move to a cleared environment, UMR legislates that financial institutions have to provide end-of-day valuations and receive, or pay, margin bi-laterally on certain OTC derivative instruments. With Phase 6, even more buy-side firms will be brought into scope, as it will lower the average aggregate notional amount (AANA) threshold for firms to US\$8 billion. When considering Archegos and the incredibly precarious positions being held, the requirement for greater margining by fund managers is obvious.

From a trading perspective, if a head of desk has a problem with a client that is consistently not posting enough margin or posting late, they will need the ability to review all communications with the client to analyse and ultimately approve why that is being sanctioned. This idea can equally be applied to consider internal communications between different departments working together to highlight and escalate margining issues. For the buy-side these interactions will be vital to help demonstrate compliance by firms who will be required to establish a Derivatives Risk Management Program.

The focus with Archegos has overwhelmingly been on what happened and what we can learn to ensure it does not happen again, but not enough focus is being given to forensically determine how it was allowed to happen in the first place, and only by learning from it can we work to stop a similar incident upending the market again. Point-to-point analysis of the interactions between buy-side players and those at prime brokerage houses has never been more important as a way of empowering supervisors and compliance teams to proactively manage what we call 'interesting situations', rather than being left to reactively pick the pieces up after the event.

Now is the time for regulators to turn their focus to improving the framework of rules within which buy- and sell-side participants function effectively. By using the power of technology to take a proactive approach to risk management, we can all enjoy a more flexible working life without the fear of another Archegos-sized hole being punched into the market.





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Sandra Clark

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mobile



**Jacob Murray**

Incoming Call

10.55am

**Rebecca Gavin**  
I'll take 200m.



# Six key steps to combat process and technology drift within a services firm



**Joe Maxwell**  
Head of Technology  
SS&C GlobeOp  
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In the financial services industry, a firm's reputation is partly defined by the consistency of the services it provides to its clients. Many service-level mandates depend on this reputation. The COVID-19 pandemic emphasised this axiom once again when firms had to test their business continuity capabilities. Quickly, the industry evaluated the cracks within a service provider based on its response to COVID-19. In the early days of the pandemic, the industry gossip channels gave a good indication of which firms were thriving and which were struggling. Any firm paying attention to its processes and technology model has a better chance of achieving greater margins and handling industry shockwaves, such as a pandemic, more smoothly. Our new fund admin platform SS&C GOCentral incorporates AI and better processing to allow firms more transparency.

## Processes and technology will drift from its original design

Designing and implementing superior processes supported by leading technology yields valuable business results. However, setting up processes and technology and forgetting about them leads to process drift. Process drift is best described as the natural deterioration of process and technology efficiency over time due to organisational changes and outside influences. There are several different change factors contributing to drift, leading to efficiency deterioration:

- Expansion or contraction of business
- Regulatory changes
- Advancements in industry infrastructure
- Technology advancement
- Management or employee changes
- Bespoke client requests
- Competition

These change factors act as catalysts to the business operation, stimulating change. Their impact can be subtle and resolved by quick adjustments. For instance, the business team involved in the process may create a spreadsheet to handle the change or request a change to the core system. However, the change factor can sometimes generate a panic response, resulting in an 'emergency project' approach if there is a perception the firm is losing revenue. The issue with an emergency project is it acts as a 'repair' instead of a re-examination of the business process and technology in alignment with corporate strategy.

Drifting from original process decisions without an examination of overall workflow impact can deteriorate efficiency. While it may not look impactful at first, the effect will erode margins over time. These changes start to become the silent killer of efficiency.

### Time to examine your process drift

The need to achieve a daily deliverable sometimes masks the need to zoom out and re-examine the overall process and technology used to provide those deliverables. Retooling processes and technology when paying attention to clients and delivering can be difficult but necessary. The biggest argument against preventative maintenance is: "We are hitting our deliverables and margin—everything is fine." The counter to this statement is: "With improved processing and technology—could we be doing better?" Management teams driving process and technology deep into their business strategy inherently know the answer.

### Six steps to examining process and technology drift

To do a process review, a firm should consider the following:

1. **Start with a focus on a goal**

Don't try to rebuild the entire engine. Instead, pick the highest-priority process areas and select a single area to focus on first.

2. **Create a process map with the cognitive process steps**

Break down your processes into steps conducted daily. Then, record these steps into a process-mapping document. The Value Stream Mapping technique stemming from the Lean For Service methodology is an excellent template to use. We found it is crucial to capture the distinct process step definition, the data used within the step, the duration of effort, wait cycles, and staffing when mapping a process.

As AI technology becomes more prominent, capturing the cognitive process steps is also critical

Find out what the end-user thinks during the process and how those thoughts translate into a processing activity. The process engineer should be an expert in uncovering hidden details by constantly asking why things are done a certain way. Then, AI technology can build solutions to transform the cognitive process steps into huge efficiency improvements.

3. **Take inventory of your technology**

Inventorizing the tools used within each process step and the connectors between tools is critical. These tools are the crucial gears to push processes and data through the organisation. Typically, older systems patched many times over the years with added functionality to the original design and a high degree of user intervention are good areas to focus on for efficiency. Of course, legacy systems aren't always inefficient, but they are a place to start when looking for a business process and technology reduction of efficiency.



**4. Assess your IT leakage into the business**

IT leakage happens when the end-users build their desktop tools to supplement the core system functionality. This leakage is one of the greatest areas of process drift and can be an efficiency killer. For example, the role of spreadsheet processing is widely misunderstood. A spreadsheet should only be used as a stop-gap until the technology team can provide a solution. As a rule of thumb, if a spreadsheet is used in the production process for more than six months, the functionality of that spreadsheet should be prioritised into the development plan of the core system it is supplementing.

**5. Assess your efficiency**

The process engineer responsible for researching the process and technology drift will need to take an unbiased view. This is not always easy if the staff assessing the environment was instrumental in building the process and technology. This is typically why a firm will use outside consulting help to get an unbiased opinion.

Start with manual processes and then move to automated ones. First, it is essential to answer these questions:

- What is the processing throughput?
- Is there an excessive amount of wait time between process steps?
- How long have these steps been in place?
- What is the data being moved through the process?
- What percentage of the overall end-to-end process is done manually?
- How much is spreadsheet processing used?
- Is there an increase in FTE when there is an increase in volume?

The more challenging part of the assessment will come from analysing the cognitive steps. Assessing the impact of these steps brings new information regarding the overall delivery process and creates a potential for automation.

**6. Measure twice, re-engineer once**

Measuring the cost of the current state process is an important exercise. So is measuring the downstream impact of the process and technology on other workflow processes in the business value chain. Equally as important is measuring the newly implemented process or technical change outcome. The outcome measure compared to the starting point will provide the success factor.

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# Navigating the tech selection minefield: A six-stage process



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**W**hen it comes to selecting and implementing new technology, there are some asset management firms that know precisely what they want and need. Then there are those that think they know. And finally, there are those that know they don't know.

Whichever category your firm falls into, procuring a new system can be a minefield. It is easy for something to go wrong at every stage and some of the decisions a firm takes can help or hinder its operations – and its long-term strategy – for years to come. So, it pays to hear from people who can tell you where the pitfalls lie.

At the very least, bringing in consultants to help manage a technology selection process can remove much of the heavy lifting, saving firms valuable time and letting them focus on their core business.

After years of working with buy-side firms of all types, we've developed our own process to ensure that the technology an asset manager ends up choosing is truly what it needs. The process has six stages, and each one, in its way, is critical. Together, they add up to a kind of tech procurement best practice.

## Phase 1 – Getting the lay of the land

This is the getting-to-know-you phase, when a trading firm meets with consultants like Ergo Consultancy to talk about requirements, objectives and options. The firm often will have a view that it wants to buy a new system of one kind or another. It may be for trading, order management, risk management or middle- and back-office functions. Whatever the target purchase is, this stage involves an initial discussion about the firm's requirements.

One of the odd things about this phase is, often a firm believes it knows what it wants, but once you scratch the surface it becomes clear that their real needs are actually different. For instance, these discussions may highlight how addressing one set of issues offers an opportunity to address another operational aspect which has held the firm back.

In this stage, there are two things we always want to do. One is to gain a clear understanding of the current operating model. The other is to hear from stakeholders. Technology decisions are almost always better if you involve people who will use the new system, not just the head of the fund or the COO.

## Phase 2 – RFPs and due diligence

This phase involves drawing up requests for proposals (RFPs). Before we can do that, however, we need to make sure everyone is agreed on what the new operating model will look like. A firm might want to start with a clean sheet of paper and think about an ideal scenario. Or, it may want to go for a more evolutionary approach, starting with what it has and seeing what might come from adjustments.

Once those discussions have been held, bespoke RFPs can be prepared. Consultants can help here not only by drafting and issuing RFPs, but also by collating the responses and working out the pros and cons of different options. From this, we can present a detailed picture of what each vendor can offer and build potential timeframes for implementation.

Any consultants involved in this phase need to be thoroughly up to date as to what is available in the marketplace. But the value firms like Ergo offer extends beyond that. Using consultants allows for anonymity, which may be valuable if a fund does not want to advertise to its current suppliers that it is considering other options. Also, the buy-side firm avoids getting inundated with sales calls. The consultants can field all of those so that the fund can focus on its core business.

As the RFPs return, we would also ensure due diligence on the responses. Anything presented to the client in Phase 3 needs to have been checked out. There's no room for overoptimistic scenarios or pitches that have not been stress-tested.

## Phase 3 – The beauty parade

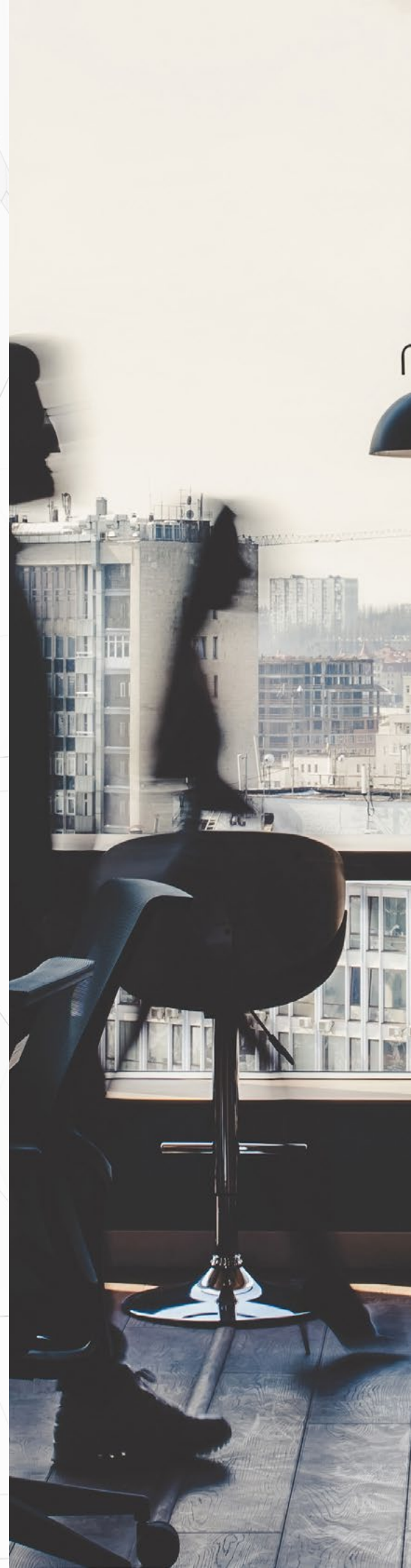
After the RFPs have come back and been checked, a short list is made. Then, it's time for the client to see what's on offer.

In our case, we would not only arrange the presentations, but also advise the client in advance on questions it could ask to help it make a decision. The questions may be different for each supplier. Because we have been working with the vendors in this sector for years and know their strengths, we're in a position to help generate questions that the client might not know to ask.

If needed, we could then work with the client to help with any internal deliberation as they select the firm they want to go with.

## Phase 4 – The L word

Many firms are so focused on the first three phases that they don't realise how critical Phase 4 is. The L in this case stands for Legal. This part of the process will generally be dictated by a client's own internal policies and by the flexibility that a supplier has in tailoring its contracts.





Phase 4 can involve a lot of back-and-forth. The client may have clauses it deems crucial. The supplier may have red lines that cannot be crossed. Somehow, those two sides need to be married. For a large firm, the process may take four to six weeks or more. It's important that funds factor the time that Phase 4 can take into their own schedules.

While it may be frustrating for trading firms that are eager to start using new technology as quickly as possible, it's important that they bear in mind that choosing and installing a new system means they are entering a long-term relationship. If there's one phase that can trip a fund up, it's this one.

### **Phase 5 – Implementation**

The I's have been dotted, the T's have been crossed and it's time to get the new system implemented. In this stage, we would formalise the new target operating model discussed in phase two. We need to know how a new system will fit with the firm's other systems.

This essentially is a project management phase. We identify deliverables and dependencies, building a timeline for the individual pieces of work that need to be done. Typically, we would create a working group with the client so that each part of the process can be signed off by the right people at the firm, using a RACI matrix (Responsible, Accountable, Consulted and Informed).

### **Phase 6 – The green light**

The final phase involves user acceptance testing, training and documentation. The documentation involves much more than a user manual. It includes a description of the new operating model, flowcharts, business continuity planning, policies and procedures.

At long last, the firm is ready to move to a live environment. First, test trades are conducted with the new system. A firm then may choose to have a hand-shake approach, where the old system stops and the new one begins to handle 100% of the trades. Or, it can adopt a phased approach, with some of its trading taking place on the old system while other parts go through the new one. Either way, there are risks that must be managed. Trades are going into the market to be executed, which means they are FCA-reportable. Hiccups at this stage can be expensive.

### **Budgets and beyond**

There are a lot of factors that come into play in the tech procurement process, some obvious and others not. Many firms like to focus on factors such as cost, performance and time to market. But there are also the less-obvious ones, such as the language in a legal document, the benefit of anonymity or the degree to which stakeholders' views have been taken into account.

Regardless of how the different factors are weighed, firms need to remember one thing above all else: There's far more at stake than a chunk of an IT budget. A firm's competitive advantage, its strategy and its vision for the future can all be directly affected by the decisions taken during these six phases.

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# issues for traditional hedge fund managers to consider when investing in digital assets.

## An update



**Sarah Crabb**  
Partner  
Simmons & Simmons

**T**raditional hedge fund managers (HFMs) continue to show interest in digital assets – we estimate at least half of the ten largest London based HFMs are now either investing in digital assets or actively considering doing so.

Simmons & Simmons partner, Sarah Crabb advises managers on specific points to consider for hedge funds seeking to include digital assets in their investment universe. Given the pace of developments in this area, and with input from Martin Shah (tax) and Paul Metcalfe (derivatives), she has updated her [top five issues](#) - HFMs seeking exposure to this asset class should consider.

### 1. Investment mandate

Generally, investment objective language (which is, typically, fairly broad) will not require amendment to incorporate digital assets. An addition, though, is usually recommended for investment strategy language.

Some HFMs take the view that investment of less than 1–2% of a fund's portfolio in digital assets is not a material investment so there is no need to update relevant disclosures in the fund documentation (particularly where exposure is obtained via investment in derivatives and the use of derivatives generally is included). In our view, the better approach is to expressly include digital assets and/or digital asset derivatives in the offering document.

Specific risk factors should be incorporated for funds investing in digital assets (directly and via digital assets derivatives), disclosing the particular risks of investments in digital assets (including custody risks and tax uncertainties examined below).

## 2. Custody and depositary services

Managers typically appoint new custodians in respect of digital assets. The nature of how digital assets are held – ‘hot’ and ‘cold storage’ and use of the private key to move digital assets between wallets – requires a specialist custody provider with expertise and relationships with major digital asset exchanges. As the space evolves, several alternative custody solutions are now available, with key players located in the US and UK. Differences (some substantive) between the regulatory regimes for holding assets in those jurisdictions will influence the choice and location of the custody provider. For funds managed by a UK AIFM and marketed into the UK, analysis is needed whether any digital assets must be held in custody, or their ownership verified, depending on the types of assets held and their regulatory classification. Options when finding a depositary-lite service provider to undertake these services for digital assets – especially those more difficult to categorise, such as stablecoins and security tokens – are currently limited.

UK AIFMs should also remember to submit a material change notification to the UK’s FCA if changing or appointing additional service providers to carry out depositary functions.

## 3. Exchanges

Unlike traditional asset classes, there is no central marketplace for exchanging digital assets – available exchanges vary in quality, some are relatively new, many are unregulated with no listing rules. This may carry greater risk of hacking and failure than an established, regulated exchange with greater regulatory oversight, controls and policies.

More participants in the exchange-traded derivatives space are expanding their offering to provide funds with greater access to trading digital assets. An exchange’s location and nature of the products traded can materially affect regulatory obligations (e.g. whether mandatory reporting regimes apply under EMIR or its UK equivalent). From a commercial perspective, managers are seemingly finding it harder to achieve their usual terms when trading exchange derivatives where the underlier is a digital asset, reflecting the greater volatility and increased risk perhaps associated with such strategies. With this in mind, HFMs should undertake appropriate due diligence (DD) on any digital asset exchanges to be used – for instance, requesting information about the relevant exchange’s anti-money laundering (AML) policies, procedures, sanctions controls and ownership structure.

## 4. AML

A number of HFMs have sought exposure to decentralised finance (DeFi).

This approach is viable from an AML perspective where the fund buys tokens in a primary sale by a DeFi protocol or trades DeFi tokens through a centralised venue which does full KYC on participants. However, where the fund uses a DeFi protocol that does not conduct checks on users, the situation is more problematic.

Although money laundering regulations do not oblige a HFM to do DD on counterparties, it must mitigate the risk of exposure to financial crime and FCA rules may require it to have systems and controls in place to do that. This typically includes understanding who the HFM is dealing with and, practically speaking, it is unlikely for the HFM to be able to undertake DD on users if the DeFi protocol does not.



## 5. Tax

The tax position when investing in digital assets remains crucial.

### (a) Investment Manager Exemption (IME)

Almost all HFMs operating in the UK make use of the IME, which ensures that the trading profits generated by the UK investment management entity are not liable to UK tax.

The IME is only relevant if the manager is trading for UK purposes and applies in respect of certain specified investment transactions. Since spot trading in digital assets does not (yet) clearly fit within the types of investment transactions that are specified for these purposes, it remains unclear whether the IME will apply to UK HFMs in respect of profits arising from investments in spot digital assets, where the fund's strategy is trading.

We hope to see movement towards bringing certain digital assets within the IME's scope in the not too distant future. However, nothing is yet settled - all depends on HMRC's stance in due course. We continue to 'watch this space'.

(This is not an issue for funds that invest in digital assets via derivatives - such transactions already fall within the IME.)

### (b) Yield farming

HMRC's February 2022 guidance on yield farming adopts a potentially more aggressive line than other jurisdictions on taxation of DeFi transactions.

Previous guidance focussed on taxing returns from yield farming as trading or miscellaneous income. The new guidance:

- suggests that staking and unstaking crypto assets (and similar DeFi transactions) may constitute disposal and reacquisition for chargeable gains purposes if involving transfers of beneficial ownership
- states that the specific stock lending and repos tax regime, which provides for no disposal and reacquisition in similar circumstances, is not expected to apply to cryptocurrencies and
- could significantly increase tax compliance and costs for investors in digital assets.

### Final word

Despite their increasing acceptance as a hedge fund investment, a number of points remain to be considered when embarking on diversification into digital assets.

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# Blockchain Transferred Funds (BTFs): The new frontier for investment funds



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Innovative technologies have impacted and advanced many industries, yet their integration into financial services products, processes, and infrastructure has been less frequent. The global institutional asset management industry is a [US\\$100 trillion](#) behemoth that has traditionally been impervious to new technology adoption mainly due to the significant advantage of legacy technology and strict regulation. Securities markets, in particular, are vast and complex ecosystems of interconnected participants, regulators, and service providers. Because the parties depend on each other to maintain a harmonious balance, the evolution of investment structures and funds is often sluggish, and it is challenging to effect substantive change.

## A changing of the guard

Blockchain technology introduces a compelling value proposition that gives the industry the tools and the impetus to improve upon traditional, often antiquated methods. Blockchain's decentralised and distributed technology offers peer-to-peer transferability, traceability, immutability, and enhanced security features that have the potential to transform the investment experience with greater accessibility, increased liquidity, near real time settlement, and fractional ownership. Therefore, we believe the next iteration of our financial system should combine the best of traditional finance and the transformative power of blockchain to achieve optimal performance, issuance, and investment processes.

Accordingly, Arca developed a solution to incorporate blockchain technology into the traditional pooled investment fund structure, regulated under The Investment Company Act of 1940 ('40 Act). Developed over 2 years in conjunction with financial institutions, service and technology providers, and market participants, Arca Labs—Arca's innovation division—created a blockchain transferred fund (BTF), the first registered '40 Act fund to issue shares as digital asset securities. It represents the next generation of investment vehicles that we believe will revolutionise the global financial system.

## The evolution of investment vehicles

On the occasions that financial innovations have emerged, notable paradigm shifts have propelled the industry forward, shaping the investment landscape for decades to come. One such shift was the early 20<sup>th</sup> century idea of pooling capital for investment, which led to the advent of mutual funds. This relatively simple concept transformed the way the world invested. The traditional mutual fund reigned supreme until the late 1980s, when the need for greater liquidity and the ability to track indexes with computer technology gave rise to exchange-traded funds (ETFs), sparking another dramatic evolution in investing.


The progression of pooled investment vehicles demonstrates how advancements in technology enabled the development of more efficient investment products. However, while ETFs have become the financial product of choice, integrating blockchain technology into a pooled investment structure offers the potential to create a financial product that combines the benefits of an ETF with the advantages of blockchain technology. This fusion creates a new framework to solve some of the industry's most salient challenges: transferability and time.

In 2018, Arca Labs analysed the existing financial landscape and considered the products and processes that could be improved with blockchain technology. The result was a solution incorporating blockchain technology into the traditional pooled investment fund structure, regulated under the '40 Act. Widely recognised and well-understood, the '40 Act fund provided an opportunity to innovate and improve operational efficiencies while reducing risk. After two years of research, product development, regulatory review, service team assembly, and new workflow creation using blockchain, Arca Labs launched the BTF—the first registered '40 Act fund to issue its shares on the blockchain. These shares represent ownership in the fund's portfolio and are digital asset securities that can be issued, transferred, and redeemed entirely via a blockchain.

ETFs and BTFs are links of the same evolutionary chain—the BTF integrates blockchain technology into the structure that underpins ETFs and enhances the preceding framework to offer, in our opinion, a more operationally efficient product with increased time and cost savings. The combination of public blockchains, permissioned blockchains, and distributed ledger technology (DLT) creates a new technological framework that we believe serves as a blueprint and demonstrates a pathway for registered investment vehicles to be tokenised and issued on a blockchain.







## What are digital asset securities?

Digital asset securities represent an ownership stake in real world assets that already have value (like real estate, a car, or corporate stock), where ownership is recorded on a blockchain. Initially known as security tokens, they are digital representations of fractional ownership interests in an underlying asset or company that can move freely among KYC/AML-approved investors at the asset owner's discretion. Digital asset securities must follow prescribed purchase and transfer guidelines and are subject to jurisdictional securities law and applicable regulation.

According to [The Future of Securities: A Digital Asset Securities Study](#) conducted by Coalition Greenwich on behalf of Arca Labs in 2021, 77% of respondents across all global regions agreed that most securities would be digitised and settled on a blockchain in 5-10 years. One of the most highly anticipated use cases for the convergence of blockchain and financial products is the investment fund. The survey revealed that 61% of participants wanted to see investment funds transferred on the blockchain.

Like traditional securities, the BTF abides by the conventional regulatory oversight, reporting requirements, and strong compliance mandates prescribed by the '40 Act that investors are accustomed to, encouraging further investment confidence in the BTF structure. Additionally, the BTF delivers the enhanced benefits that blockchain enables:

### '40 Act traditional regulatory requirements

- Assets held in a regulated trust
- An independent auditor, administrator, and board of trustees
- Mandatory reporting of annual audited financials, semi-annual reports, trade confirmations, monthly account statements, daily NAV, and SEC filings on material events

### BTF added benefits

- Immutable record-keeping
- Programmable security/fund registration requirements
- Ability to freeze, cancel, or replace lost or compromised tokens
- Lower fees due to the elimination of unnecessary intermediaries
- Asset ownership and history transparency
- Faster settlement
- Automated execution
- Peer-to-peer transference
- Fractionalisation

## The BTF is revolutionary – Future use cases

Following the trajectory of how ETFs built upon the mutual fund structure, we believe the next iteration of '40 Act products will similarly transform the investment landscape. Blockchain and distributed ledgers can build on previous financial instruments to offer new efficiencies and unique functionalities. For example, blockchain's peer-to-peer functionality enables the BTF's digital asset security to be held by the investor rather than a third-party intermediary. This unique quality radically shifts industry perspectives on asset ownership and has the potential to change investment behaviour and market strategies.

Beyond providing utility as an investment vehicle, BTFs offer the additional benefit of being a means of value transfer. The utility integrated into the BTF structure has the potential to enable advancements in industries like insurance, real estate, and entertainment, and can impact financial sectors that would benefit from a reduction in settlement time, elimination of laborious processes, and risk mitigation.

For example, collateral management—the pledging of assets from one party to another to mitigate credit risk and potential default—is widely used in banking and financial services. However, the current methods for collateralising are manual, expensive, and time consuming, exhibiting a prime area for innovation. US Treasuries are among the most common assets pledged for collateral management because of their stability, liquidity, and high investment grade ranking. Therefore, a BTF with a portfolio of US Treasuries that issue its shares as digital asset securities has a clear use case for institutional collateralisation. BTFs utilise the core benefit of digital asset securities—peer-to-peer transference—to reduce costs associated with cross collateralisation, abate the time required to trade reserves using traditional trading platforms, and decrease risk and error by eliminating intermediaries.

Additionally, payments is a massive financial sector that represents the mechanisms allowing individuals and entities to exchange goods and services. However, the existing structural make-up of payment networks is encumbered by layers of intermediaries between assets and owners, presenting an industry ripe for modernisation. The introduction of an instantly settled asset, such as digital asset securities, provides a means to carry out payment exchange without the need for intermediaries. This change could collapse the space between payments and investments, enabling investors to more efficiently access and deploy all of their capital. In addition, the frictionless feature of digital asset securities grants investors greater authority and earning power over their assets. BTFs add this capability to single assets represented by digital asset securities and commingled investment vehicles.

## The framework of the future

Technology has consistently been a catalyst for the transformation and growth of financial products, often resulting in redefining moments. Truly innovative technologies profoundly challenge our concept of utility and stimulate previously unimagined possibilities. Presently, blockchain technology is the stimulus for pooled investment vehicles, addressing shortcomings from archaic architecture and antiquated processes. The novel BTF structure introduces an opportunity for the industry to shepherd in a revolutionary new era and blazes a trail for other registered investment vehicles to be launched and tokenised on-chain. We believe blockchain technology will revolutionise the global financial system and will ultimately underpin all industries in the future.

[Read the full white paper](#) to discover more about the next iteration of pooled investment vehicles for professional investors.

# German regulatory framework for market participants in crypto assets



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While crypto assets and some of the associated services have started to be covered by the traditional financial supervisory regulations (such as MiFID II), in recent years the European Union and some individual EU member states have aligned and strengthened their supervisory regulations to deal with the rapid innovations in this area. These adjustments were intended to prevent an unregulated market for virtual currencies and other digital assets, especially against the background of high money laundering risks. In addition to the legislative changes regarding the regulatory treatment and classification of crypto assets, the German regulator, the Federal Financial Supervisory Authority (**BaFin**) has issued several information letters and guidance that further clarify these European and German regulations.<sup>1</sup>

This article provides a brief overview of BaFin's regulatory principles with regard to crypto assets and the associated services under German law. Please note that this can only be a preliminary assessment. In particular, the application of the existing regulations and interpretation by BaFin in the field of decentralised finance (**DeFi**) applications are currently subject to a considerable degree of uncertainty.

## Types of 'crypto assets'

The starting point for a regulatory classification of crypto assets should be a conceptual differentiation of the terminology for different types of digital assets. Defining crypto assets as tokens is too vague, because the term 'token' is only understood as a generic term of virtual assets or crypto assets. A more precise and legalistic distinction between the digital assets, such as virtual currencies, security tokens and utility tokens is crucial for answering any subsequent regulatory questions. In particular, the functionality (**use case**) of the digital asset must be taken into account. All crypto assets are based on a blockchain technology.

<sup>1</sup> BaFin – Advisory Letter (WA) - GZ: WA 11-QB 4100-2017/0010; BaFin – Guidance Notice: Second Advisory Letter - GZ: WA 51-Wp 7100-2019/0011 and IF 1-AZB 1505-2019/0003; BaFin – Guidance notice: Guidelines concerning the statutory definition of crypto custody business.



## Legal definition: crypto assets

According to section 1 para. 11 sentence 4 of the German Banking Act (**KWG**) crypto assets are defined as: *“Digital representations of a value that has not been issued or guaranteed by any central bank or public body and does not have the legal status of a currency or money, but is accepted by natural or legal persons as a means of exchange or payment or serves investment purposes on the basis of an agreement or actual exercise and which is transmitted electronically, can be stored and traded.”*

This definition reflects the EU definition in the 5th EU Anti-Money Laundering Directive<sup>2</sup> and includes digital units of value such as currency or payment tokens, which are often also referred to as virtual currencies.<sup>3</sup> Government-issued currencies are by definition not crypto assets, as well as e-money, interconnection payment systems and payment transactions of providers of electronic communications networks or services.

Pursuant to section 1 para. 11 sentence 1 no. 10 KWG, crypto assets also qualify as financial instruments. Since crypto assets can already fall under one of the other categories of financial instruments due to their diverse characteristics, section 1 sec. 11 sentence 1 no. 10 KWG was designed as a catch-all to avoid regulatory gaps for virtual currencies.

## Tokenised assets (security tokens)

The holder of security tokens is entitled to membership rights or claims to a certain asset under the law of contracts. These claims or rights are “embodied” in the token created on a blockchain and comparable to the rights of a security holder. Examples are claims for dividend-like payments, co-determination, repayment claims or interest payments.

Security tokens designed under German law regularly represent other forms of securities (e.g. tokenized bonds), or qualify as original digital securities after the introduction of the Act on Electronic Securities (**eWPG**),<sup>4</sup> which came into force on June 10, 2021. As a consequence, German securities law applies to security tokens, i.e. the Prospectus Regulation, the German Securities Prospectus Act (**WpPG**) and the German Securities Trading Act (**WpHG**) or, if designed accordingly, also as an investment fund unit within the meaning of the German Capital Investment Code (**KAGB**). At the same time, security tokens are considered financial instruments under the KWG, due to the technology-neutral definition of the “financial instrument” in MiFID II as “transferable securities”<sup>5</sup> according to Article 4 para. 1 no. 44 MiFID II.

## Utility tokens

Utility tokens provide the holder with access or usage rights to certain services or products. A repayment of the purchase price or granting of property rights is usually excluded. From this point of view, pure utility tokens can be compared with tickets or vouchers and are therefore not financial instruments. However, distinguishing them from tokenised assets or, if a payment function is integrated, from virtual currencies can sometimes be difficult and depends on the main function of the token’s use case.

<sup>2</sup> Directive (EU) 2018/843 of 30 May 2018.

<sup>3</sup> Among the most well-known virtual currencies are, for example, Bitcoin, Ether, Litecoin and Ripple. A list of virtual currencies can be found on the website [www.coinmarketcap.com/de/](http://www.coinmarketcap.com/de/).

<sup>4</sup> Law on Electronic Securities (**eWPG**), promulgated as Art. 1 G of 3.6.2021 (Federal Law Gazette I p. 1423); Entry into force in accordance with Article 12 of this G on 10.6.2021.

<sup>5</sup> “Categories of securities which may be traded on the capital market: with the exception of from Payment instruments [...]”.

## Financial services related to crypto assets

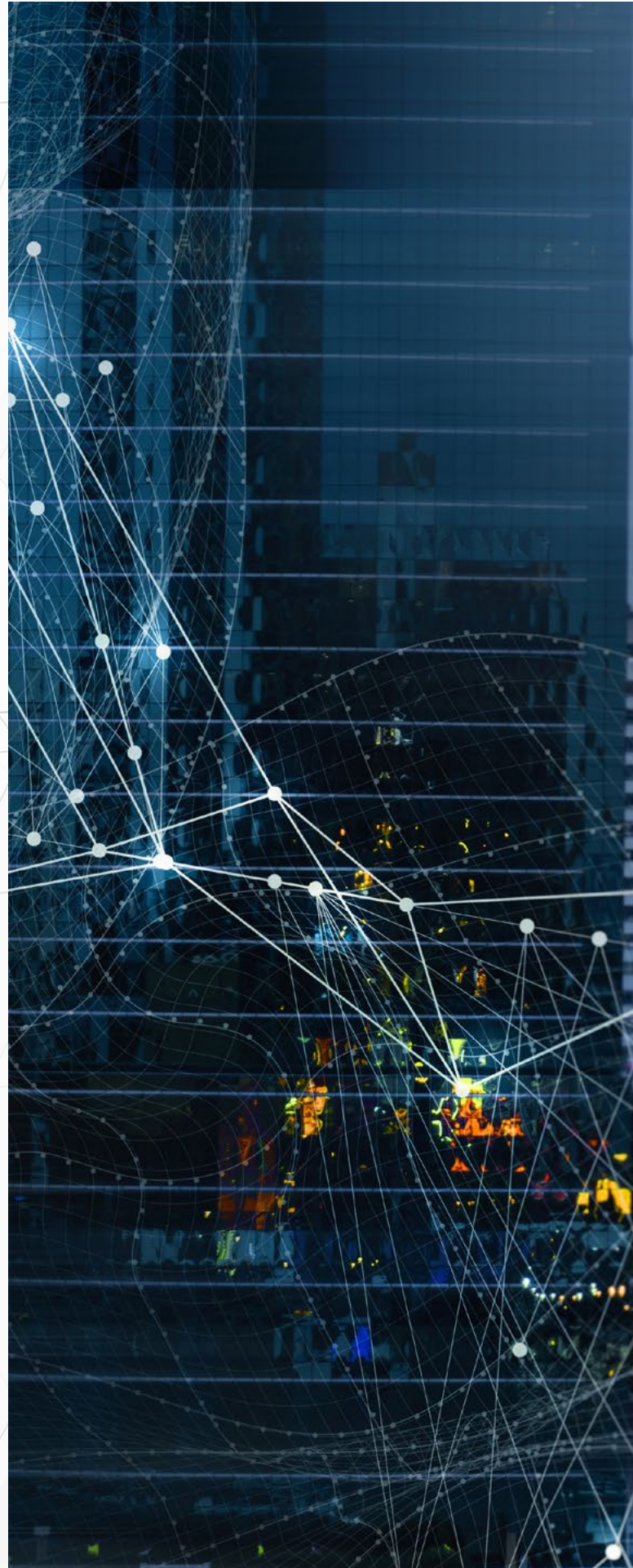
Regulatory authorisations are required in Germany for commercial services related to tokens that are classified as crypto assets, financial instruments, securities, investments or investment units. The required authorisation differs depending on the actual service and regulatory classification of the crypto assets. It should be noted (for providers as well as for users) that even if these services are offered from outside Germany to German users in a targeted manner, this may trigger a German authorisation requirement.

Depending on the factual design of the transaction, it may qualify, for example as a banking transaction, i.e. as a financial commission transaction or underwriting business. In addition, an authorisation as a financial service may be required where the service involves investment brokerage, investment advice, operation of a multilateral or organised trading system, placement business, brokerage, financial portfolio management, proprietary trading, or investment management. In this respect, there is no difference to traditional financial instruments, with BaFin referring to the 'technology neutrality' of the financial regulations.

## Crypto custody business

With the inclusion of crypto assets in the definition of financial instruments in Germany, a new financial service for the custody of crypto assets was introduced.<sup>6</sup> This financial service is defined as the *"custody, management, and securing of crypto assets or private cryptographic keys used to hold, store, and transfer crypto assets for others"*. BaFin has described the relevant criteria and requirements in detail in its guidance notice on crypto custody business.<sup>7</sup>

Whether the activity conducted by the service provider is a regulated activity often depends on if the service provider holds the private cryptographic key in its systems on behalf of the client and so has access to the decentrally stored crypto assets.



<sup>6</sup> Section 1 para. 1a sentence 2 no. 6 KWG

<sup>7</sup> BaFin - Guidance notice – guidelines concerning the statutory definition of crypto custody business.





The result may be different if the service provider only offers a software that interacts with crypto exchanges, for example via interfaces called application programming interfaces (APIs), without ever having contact with the private cryptographic keys. BaFin has expressly stated that the production or distribution of hardware or software to secure the crypto assets or the private cryptographic keys, which are operated by the users on their own responsibility, are not covered by the crypto custody business definition if the service providers do not have access to the crypto assets or private cryptographic keys held by the user. These software-as-a-service business models usually do not constitute a regulated activity under German law.

### Effects of these principles on the regulatory authorisation requirements of DeFi Services – ‘staking’ and ‘lending’

Any regulatory authorisation requirements for DeFi-Services (such as staking or lending) must also be assessed. Staking is where crypto assets are stored in a special blockchain address (wallet), blocked for the holder’s dispositions, to serve the validation of transactions on the blockchain (referred to as ‘proof-of-stake mechanism’). For the holding period of the staked tokens, their holders are rewarded with transaction fees of the blockchain (staking rewards). Another use case is liquidity staking’, in which the crypto assets are made available to increase the trading liquidity of automated trading venues (**automated market making**) of decentralised exchanges (DEX) (referred to as ‘**liquidity pools**’). As a fee, the holders will usually receive a part of the trading fees of the DEX.

Another very common form of DeFi is crypto lending, where units of crypto assets (e.g. in the form of stable coins) or money loans are transferred for use for a fee. The lending is remunerated, for example, in the form of interest or additional units of a crypto asset.

Typically, the granting of the loan is not based on the creditworthiness of the borrower, but by depositing crypto assets as collateral. For example, Bitcoin can be lent up to a certain value. In this respect, this is comparable to repo transactions in the traditional securities market, with the essential difference that the lending, control and, if necessary, utilisation of the collateral is handled



automatically via a smart contract. A distinction must also be made between this form of financing through a decentralised blockchain protocol and providers who offer secured crypto loans directly: centralised finance (CeFI).<sup>8</sup>

It is still unclear if these types of transactions may qualify as regulated lending (banking) activities under German law which, in general, require authorisation from BaFin.

### Extension of the licensing requirements by the proposed EU regulation 'MiCA'

On 24 September 2020, the European Commission published its proposal for a Markets in Crypto Assets Regulation (**MiCA Regulation**) as part of the package for the digitisation of the financial sector. This is a package of measures to further develop and promote the innovation and competitive potential of digital finance as well as to mitigate possible risks associated with digital finance. The regulation is currently in the consultation process and is expected to enter into force in the third quarter of 2022.

Among other things, the MiCA Regulation pursues the goal of creating legal certainty regarding crypto assets that are not covered by existing EU legislation in the financial services sector. The future harmonised rules for issuers of crypto assets and crypto service providers are intended to create a common, 'sound' regulatory framework and a single market. It will replace national rules for crypto assets that are not covered by existing EU financial services legislation.

The proposal of the MiCA Regulation shows that there is now greater momentum at EU level regarding the regulation of crypto assets and crypto service providers. This will further reinforce the rapid developments in national legislation in recent years as well as in the corresponding interpretative decisions of BaFin.

Issuers and service providers, as well as users and investors in crypto assets, should therefore keep an eye on the dynamic regulatory developments at national and EU level.

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8 e.g. [www.celsius.network/crypto-loans](https://www.celsius.network/crypto-loans).



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# More investors looking to APAC private markets



**Eric Chng**  
Regional Head of Alternatives and Insurance  
State Street Asia Pacific

In recent years, investors have been drawn to private markets in greater numbers, leading to more capital flowing into the asset class. Indeed, State Street research shows dry powder reached new levels in 2021, rising to US\$1.6tn globally (as of September 2021).

This trend is mirrored in Asia Pacific (APAC), where dry powder reached an estimated US\$180bn at the end of 2021. The region is also taking a growing share of capital raising – increasing from 3.7% of total value in 2012 to 20.8% in 2021. However, APAC remains a relatively young region for private markets, with many funds still in investment periods.

We expect that distributions will kick in over the next five to seven years, and capital will need to be redeployed, signalling further growth of private markets investing in APAC.

A growing middle class, and other supportive demographic trends, are accelerating wealth creation in APAC, and contributing to the increased emphasis on private markets investing.

And as private markets in the region continue to develop, we are anticipating several emerging trends.

### A time of reckoning for valuations?

Since the global financial crisis, the low interest rate environment has had a considerable impact on private markets, as institutional investors in search of higher returns have allocated more to private markets strategies.

This low-rate environment could change as economies have begun to return to normal after the COVID-19 pandemic. Indeed, the post-pandemic economic rebound is accompanied by higher inflation, as prices across a range of products and services have all started to rise.

The inflationary backdrop is putting greater pressure on central banks and policymakers to remove some of the monetary stimulus supporting markets for many years and hike interest rates from the ultra-low levels of recent years.

As a result, valuations are likely to be a key focus for investors as interest rates rise in the months ahead. For portfolios that already have low returns, higher rates could take a heavier toll in the near-to-mid-term as the cost of debt rises.

In venture capital, start-up valuations have already become a source of concern, particularly as data already suggests that internal rates of return (IRR) have been falling since second quarter of 2020.

### Is China a source of growth, or not?

The world's second-largest economy is one of the biggest growth areas for private markets in the region. It has been a strong performer over the longer term, generating an IRR of 15.24% since the inception of the State Street Global Markets Private Equity index in 2004.

Having escaped the COVID-19 pandemic with relative ease, China has experienced stronger economic growth than other developed markets. Yet, it has not translated into higher returns for investors. State Street research showed that between first quarter and third quarter last year, private markets strategies generated a modest IRR of 1.06%. Return profiles for different strategies were also highly polarised, with venture capital losing 1.99% during the same period, while private debt had an IRR of 22.86%.

Is this short-term performance trend likely to continue? Or will the longer-term growth trend re-establish itself? Regardless, the dynamism of the Chinese economy continues to present attractive opportunities for investors.



### Privatisation of real assets

Another trend we are anticipating in APAC is the greater privatisation of real assets over the long term. As many investors show growing dissatisfaction with real estate investment trusts (REITs) – one of the main ways to invest in real assets in the region – the prospect of rising debt costs becomes more real.

High levels of dry powder mean fund managers in the region are increasingly looking for more buying opportunities. However, high valuations are making them hold onto capital in the near term. With considerable pent-up demand among fund managers, we believe a wave of private capital could help investors access the region's real assets at reasonable valuations.

### Buying opportunities in corporate distress

Higher rates will also put greater stress on highly leveraged buyout funds, as the cost of financing rises and they will likely be forced to sell assets. Companies with weak cash earnings and high debt ratios will also face considerable headwinds in a rate-hiking environment.

However, buyout fund managers that are patient and backed by strong institutional investors with longer-term views will potentially see some attractive buying opportunities emerge in the region.

### The data deficit

As the region's private markets space develops, investors will likely place greater demands on fund managers, particularly around data. Investors globally are increasingly seeking more transparency when it comes to their investments – a challenge for an asset class that has traditionally been harder to value.

This growing interest in data is underscored in State Street's latest Growth Study, which found that institutional investors across APAC will prioritise technology investment in the areas of client reporting capabilities and investment performance analytics over the next year. However, a lack of standardisation for private markets data will make this an onerous task. That's why we are working with fund managers to help understand and solve their data issues.

We believe that more frequent and comparable data will enable managers to derive actionable insights, lead to more inflows for fund managers and help private markets grow in the region.

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# Japan's international financial city initiative involves unprecedented structural reforms to help foreign managers enter the Japanese market

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Since the Fall of 2020, in an effort to promote Japan as an international financial city (IFC Initiative), the Japanese government has implemented a number of legislative and regulatory reforms incentivising foreign managers to establish a footprint in the Japanese asset management market. The IFC Initiative includes unprecedented structural reforms aiming to help foreign managers who wish to open offices and be licensed in Japan. In this article, we review key elements of the IFC Initiative and provide our observations thereof.

## Key reforms under IFC initiative

The IFC Initiative includes the following key reforms and programmes:

### 1. New licensing exemptions

In 2021, Japan adopted the following two exemptions from licensing requirements specifically aimed at assisting foreign asset managers who intend to open offices in Japan, which became effective on 22 November 2021:

- a *Specially Permitted Business for Foreign Investors, etc.* (Foreign Investor Fund Exemption)—this is an exemption from Type II broker-dealer and investment management registration for fund operators of certain partnership-type funds (which have 'primarily' foreign investors) when offering certain eligible partnership-type funds and managing assets invested in those funds; and
- b *Specially Permitted Business During Transition Period* (Transition Period Exemption)—this is an up to five-year registration moratorium for foreign managers registered with a foreign authority who have foreign (non-Japanese) investors only and who satisfy certain eligibility requirements (collectively, Exemptions).

Both Exemptions, as adopted, provide meaningful access to Japanese investors. For example, the Foreign Investor Fund Exemption permits access to a wide range of Japanese professional investors so long as funds from Japanese investors do not exceed 50% of the asset under management of the relevant fund. Further, the Transition Period Exemption allows the foreign investment manager to act as a sub-manager for Japanese-licensed investment managers under a discretionary investment management agreement, which will allow the foreign investment manager to build Japan-related track records at its Japan office while relying on the Transition Period Exemption.

Challenges for foreign asset managers will likely include staffing sufficient and qualified human resources at their Japan offices. For example, while the Financial Services Agency of Japan (FSA) suggested that some levels of outsourcing with respect to compliance and investment decision-making functions are permitted, it still expects employees who are designated to be in charge of these functions and to have a minimum of one-year of relevant experience. However, as we discuss below, the FSA is currently providing monetary incentives to cover initial costs, including hiring costs, which may mitigate these challenges. However, it is worth noting that having an office in Japan may have Japanese tax implications for the manager and the relevant funds.

## 2. Launch of the Financial Market Entry Office and English language registration and supervision

By amending certain implementing regulations of the Financial Instruments and Exchange Act (Act No. 25 of 1948, as amended), in January 2021, the FSA launched the [Financial Market Entry Office](#), English-language support and supervisory desk, and began providing English language registration and supervision under which eligible applicants submit registration application documents in English and are subject to post-registration supervision in English including submission of annual reports. In addition, communication with the regulator is in English. Currently, English language registration and supervision is available to certain subsets of businesses that require registration as Investment Management Business Operators, Investment Advisory and Agency Business Operators, and/or Type II Financial Instruments Business Operators.

However, these measures currently apply only to new registrants for these three categories of licenses, and do not apply to existing registrants. In January 2022, the FSA proposed to expand the eligibility to include applicants looking to engage in certain business that requires Type I Financial Instruments Business Operators.







This was a significant structural change welcomed by global financial institutions eyeing registration in Japan.

### 3. Financial Start-Up Support Programme

The FSA currently invites foreign managers considering an office presence in Japan to apply for the Financial Start-up Support Programme, which includes support to set up an entity in Japan and support for immigration, hiring and registration, and notably, a monetary incentive of JPY 20 million (approximately US\$173,000).

Though the current program is set to expire at the end of March 2022 it is possible that the programme will be renewed. The programme is operated for a Japanese administrative fiscal year and hence interested managers should plan for eligible payments within the applicable fiscal year.

### 4. Tax reforms and immigration reforms

Tax reform under the IFC Initiative includes allowing certain asset managers to treat performance-based salaries as deductible expenses under certain conditions for corporate tax purposes and exempting overseas assets of certain non-Japanese individuals from Japanese inheritance tax, which became effective as of 1 April 2021. In addition, the Japanese government made it easier for asset manager employees to qualify for highly-skilled professional status, thereby making it easier to qualify for this special immigration status as a foreigner.

The Japanese government has indicated that it will continue to seek input regarding the needs and challenges from the industry and may make further changes and adjustments to expand Japan's role as an international financial center. Japan presents a great opportunity for AIMA global members considering a base in the lucrative and relatively untapped Japanese private fund market.



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Deadline for submission 5pm UK time Monday 23<sup>rd</sup> May | Publication Monday 27<sup>th</sup> June

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