AIMA JOURNAL

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AI in asset management:
A lightbulb moment
Man Group

Private credit:
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Clifford Chance

and more...

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Message from AIMA's CEO

What do you do when the regulator comes knocking? Who is the newest addition to the C-suite? What are some of the largest tech-focused managers really using generative AI for? These are just some of the questions answered in this edition of the AIMA Journal.

This edition delivers specialist insights on the latest AI and blockchain technology advancements from genuine market leaders, offering the kind of realistic and hype-free analysis that's hard to come in many other venues. Multiple writers identify a tension between the potential of gen AI to relieve operational frictions and the need to develop greater trust that these tools are as intelligent and reliable as they seem at first glance. While the rest of the world frets about chips and global semiconductor supply chains, our contributors suggest that the greater barrier to adoption by asset managers may be much closer to home.

Sticking with the theme of innovation enabled by technology, and in keeping with the Innovation Day we hosted in London in early September, this edition presents the argument that the modern demand for marketing specialists has given rise to a new role in a firm's leadership: the Fractional Chief Marketing Officer (FCMO). Curious readers should delve further into this journal to learn more about this curious new edition to the C-suite.

Elsewhere, readers are presented with welcome news on the increasing number of hedge fund launches and valuable updates on the latest regulatory developments in the US and the EU, all of which come together to create another impactful edition of the AIMA Journal.

My thanks go to the contributors for making this journal an engaging resource each quarter.

Sincerely,

Jack Inglis
CEO, AIMA

Upcoming AIMA Conferences

Learn, connect, collaborate.

AIMA
THE ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION

2024

25 Sept	AIMA Australia Annual Forum 2024, Sydney
02 Oct	Alternative Credit Council Global Summit 2024, London
08-09 Oct	AIMA Global Investor Forum 2024, Toronto
23 Oct	Alternative Credit Council APAC Day 2024, Hong Kong
24 Oct	AIMA APAC Annual Forum 2024, Hong Kong

2025

27 Jan	AIMA & ACC Private Credit Investor Forum, Miami
25 Feb	AIMA China Live, Shanghai
11 Mar	AIMA Global Policy & Regulatory Forum, New York
25 Mar	AIMA Singapore Annual Forum, Singapore
24 Apr	AIMA Digital Assets Conference, New York
15 May	AIMA Japan Annual Forum, Tokyo

For more information on AIMA's events, to view playbacks and to register for upcoming events visit www.aima.org/events

Global Policy and Regulatory Forum 2025: “What’s Past is Prologue”?

Daniel Austin
Head of US Markets Policy and Regulation
AIMA
Email Daniel Austin

There’s hardly been time to exhale over the past several years given all of the regulatory and policy developments. In the US, there has been a torrent of new and proposed regulations, particularly by the Securities and Exchange Commission (SEC), impacting every corner of the financial services industry, both in the US and globally. The UK has engaged in a Wholesale Markets Review and addressed hard-dollar payments for research. Meanwhile, the EU has finalised significant changes to AIFMD/UCITS and MiFID/MiFIR and adopted new legislation to address cybersecurity/operational resilience and anti-money laundering. From global standard-setting boards and others, we’ve seen a heightened focus on risk posed by nonbank financial intermediation (NBFI), financial technology, climate-related financial risks, digital assets and cybersecurity.

Take all of this into consideration and add in extensive geopolitical turmoil and conflict, and the years since the start of the COVID-19 pandemic have been nothing short of nonstop activity for the alternative investment industry.

What could possibly be next?

At AIMA, we can’t predict the future, but we hope to do our best, and look back on the year that was, when we host our 25th Annual Global Policy and Regulatory Forum on March 11, 2025 in New York City.

GPRF is AIMA’s leading annual regulatory event that provides a unique opportunity for the hedge fund and private credit industries to engage with senior policymakers and regulators, including senior representatives from the SEC, the European Security and Markets Authority, Financial Conduct Authority, Financial Stability Board, IOSCO and many more.

Next year’s event will cover five high-level topics.

First, macroprudential policy and NBFI continues to be a main focus of policymakers and regulators and their goal of maintaining financial stability, whether via enhanced reporting or leverage and liquidity constraints. How will these changes and others affect the asset management industry?

Second, the SEC's unprecedented rulemaking agenda led AIMA to join its first legal battle against a regulator when it, along with five other associations, challenged the Private Fund Adviser Rule (PFAR). Thankfully, we prevailed, and by next year's event, we'll also have some resolution to our other pending litigation against the SEC in challenges to the both the Securities Lending and Short Sale Rules and the Dealer Rule. How does the litigation process work when a regulation is so existential or harmful that mounting a legal challenge is the only option left?

Third, PFAR wasn't the only significant asset-management related rulemaking adopted by the SEC. It also adopted two changes to Form PF, reformed the regime for SPACs, and updated beneficial ownership reporting requirements, and, as of this writing, there are a number of impactful rules still pending. The EU meanwhile updated AIFMD and UCITS and adopted comprehensive cybersecurity legislation. What has changed and what can the industry expect as these rules come into effect?

Fourth, the buy-side industry, both hedge funds and private credit funds, are playing a growing role in financial sectors where banks traditionally served the marketplace, marked by their retrenchment due to capital constraints or otherwise. Bank disintermediation by funds is indeed a growing part of the global financial services landscape. How have or will reforms to securitisation in the US, UK and EU create or stifle opportunities?

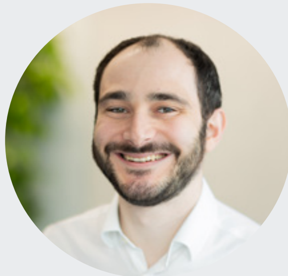
Finally, ESG continues to be a policy focus for many policymakers and regulators, both domestically and globally, with rules designed to address greenwashing, labeling and corporate disclosures generally. How are managers considering the ESG landscape and balancing investors' needs with new regulations and sometimes outright hostility toward ESG investing?

Between now and then, there's plenty of expected – and unexpected – events or developments that have occurred or will occur that will further shape the next several years for the alts industry. The balance of power has changed in the UK after a resounding Labour Party victory. The composition of the European Parliament and Commission has shifted but perhaps not enough to shift the status quo. The US will select a new president in November, a result that, either way, will have a significant impact on global geopolitics and financial markets.

We hope you will join us for next year's GPRF to explore these events and topics and much more! Visit aima.org/events if you would like to participate as a speaker, sponsor or attendee.

AI in asset management: A lightbulb moment





Harry Moore
Principal
Man AHL

Martin Luk
Quant Researcher
Man AHL

Matthew Hertz
Head of Machine Learning Technology
Man AHL

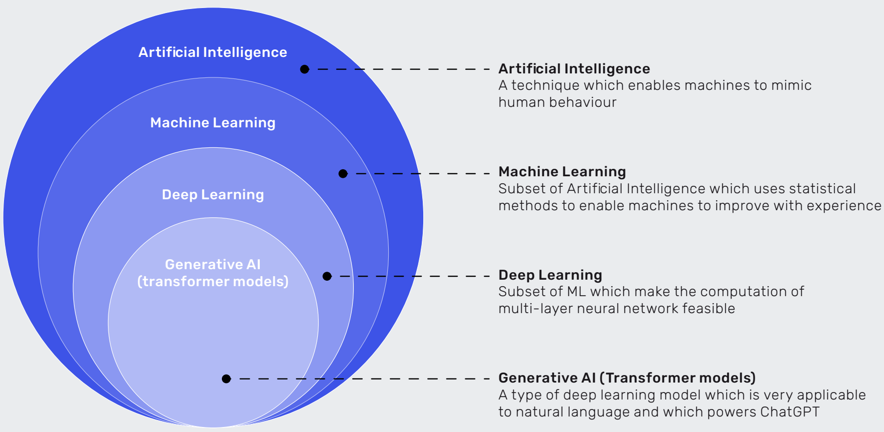
Today, it is difficult to imagine a world without power at the flick of a switch. Yet 20 years after the electric light bulb was invented by Thomas Edison in 1879, just 3% of US households had electricity. It took another two decades for mass adoption. This point is well made by Agrawal and his colleagues in 'Power and Prediction'[1] where they argue we are at a similar juncture in AI. We find ourselves in 'The Between Times', where there is plenty of enthusiasm while we await a truly game-changing application.

At Man AHL, we observe somewhat similar trends. Generative AI has certainly not yet replaced researchers or portfolio managers, or generated a whole new system for delivering market beating performance. What it has done, however, is boost productivity, allowing quantitative analysts ('quants') to spend more time focused on alpha generation. In this article, we showcase four examples of generative AI making an impact. We also discuss the challenges and opportunities of generative AI for the future of quant research.

Why the sudden uptick in AI hype?

The current focus is predominantly on generative AI. This leap allowing users to interact with models using human language and generate new outputs has been a significant driver of the recent excitement. Generative AI is a subset of machine learning, which is a subset of broader AI (Figure 1, below).

Figure 1. Subsets of Artificial Intelligence



Schematic illustration.
Source: https://www.researchgate.net/figure/A-comparative-view-of-AI-machine-learning-deep-learning-andgenerative-AI-source_fig1_373797588

For interested readers, the evolution of generative AI is covered in detail [here](#).[2] Machine learning techniques are already also well documented in asset management, with success enhancing asset predictors, improving risk management and driving down costs of execution.[3] We have been using machine learning techniques at Man AHL[4] for over a decade and are early adopters of generative AI.

Four ways we are using generative AI today:

We have a feeling generative AI will scale more quickly than the lightbulb of 1879. Our CIO recently detailed the adoption rate at Man Group[5] (spoiler, it's more than 70% of employees) while our Group CEO also discussed the efficiency gains here.[6] Below we show four ways generative AI is making us more productive.

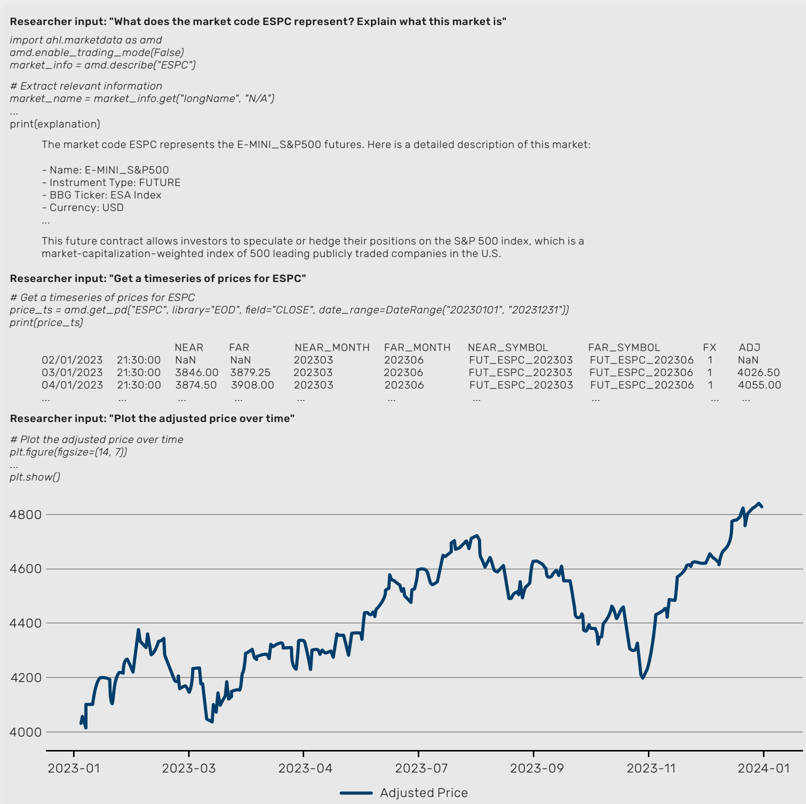
1. Coding with Copilot

One of the most effective use-cases of generative AI is assisting with coding. Tools like GitHub Copilot can accelerate the development of prototypes and initial research results by predicting code continuations, reducing development time. It also facilitates knowledge sharing, as developers can ask the AI to explain various parts of code written by others.

The challenge and the opportunity lie in training these tools to understand proprietary code. We have extensive code libraries for tasks like market data acquisition and running simulations. Off-the-shelf AI models lack knowledge of these specialised repositories.

We are developing chatbots with the capability to comprehend our internal code. For example, one chatbot can identify where to find metadata for a market code and retrieve prices, specifying the correct libraries and fields. It is a meaningful challenge which requires significant work to get useful outputs, but this capability enhances our efficiency and leverages our proprietary knowledge (Figure 2, below).

Figure 2. Copilot plotting a timeseries of S&P 500 E-Mini Future, using our internal libraries



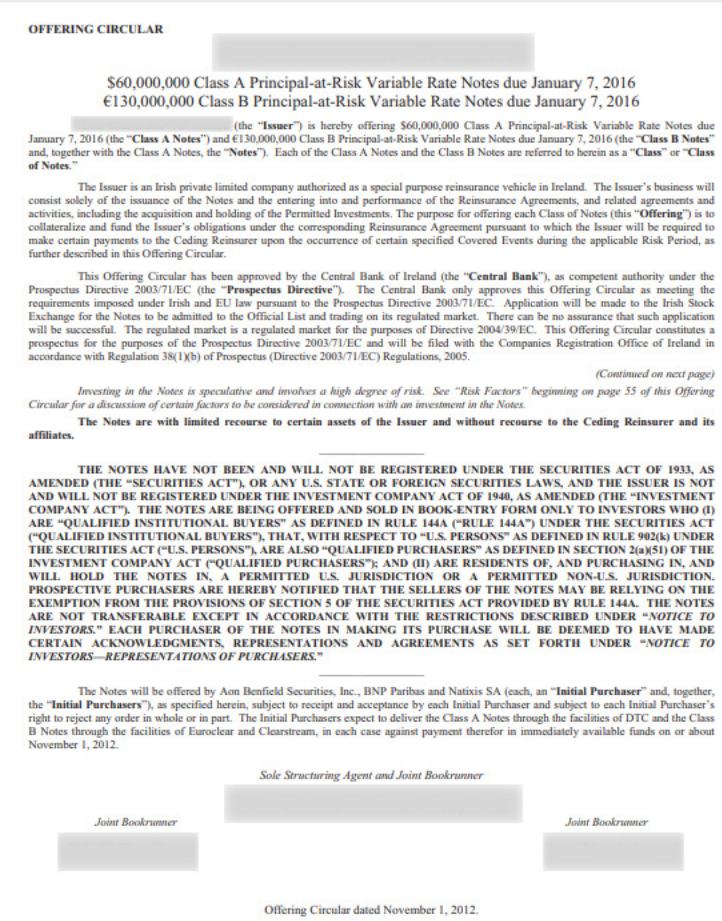
Schematic illustration

2. Extracting information for trading catastrophe bonds

Man AHL was founded as a commodity trading advisor (CTA) trading futures contracts. Futures are highly standardised and liquid, making them easy to trade for a systematic investment manager. However, as we've grown and diversified our business, we increasingly trade more novel and exotic instruments.[6]

One example is catastrophe bonds, debt instruments designed to pay out when a pre-specified event occurs, typically a natural disaster. Each catastrophe bond has unique features which need to be clearly understood before investment and, unlike interest rate or credit default swaps, do not have standardised terms. This process involves reading the offering circular, which is done by a human analyst, and a second check of the extracted data, again by another human analyst. As these documents run to 200 pages, this can be a considerable amount of time (Figure 3, below).

Figure 3. Catastrophe bond offering circular



OFFERING CIRCULAR

$60,000,000 Class A Principal-at-Risk Variable Rate Notes due January 7, 2016
€130,000,000 Class B Principal-at-Risk Variable Rate Notes due January 7, 2016

(the "**Issuer**") is hereby offering $60,000,000 Class A Principal-at-Risk Variable Rate Notes due January 7, 2016 (the "**Class A Notes**") and €130,000,000 Class B Principal-at-Risk Variable Rate Notes due January 7, 2016 (the "**Class B Notes**" and, together with the Class A Notes, the "**Notes**"). Each of the Class A Notes and the Class B Notes are referred to herein as a "**Class**" or "**Class of Notes**."

The Issuer is an Irish private limited company authorized as a special purpose reinsurance vehicle in Ireland. The Issuer's business will consist solely of the issuance of the Notes and the entering into and performance of the Reinsurance Agreements, and related agreements and activities, including the acquisition and holding of the Permitted Investments. The purpose for offering each Class of Notes (this "**Offering**") is to collateralize and fund the Issuer's obligations under the corresponding Reinsurance Agreement pursuant to which the Issuer will be required to make certain payments to the Ceding Reinsurer upon the occurrence of certain specified Covered Events during the applicable Risk Period, as further described in this Offering Circular.

This Offering Circular has been approved by the Central Bank of Ireland (the "**Central Bank**"), as competent authority under the Prospectus Directive 2003/71/EC (the "**Prospectus Directive**"). The Central Bank only approves this Offering Circular as meeting the requirements imposed under Irish and EU law pursuant to the Prospectus Directive 2003/71/EC. Application will be made to the Irish Stock Exchange for the Notes to be admitted to the Official List and trading on its regulated market. There can be no assurance that such application will be successful. The regulated market is a regulated market for the purposes of Directive 2004/39/EC. This Offering Circular constitutes a prospectus for the purposes of the Prospectus Directive 2003/71/EC and will be filed with the Companies Registration Office of Ireland in accordance with Regulation 38(1)(b) of Prospectus (Directive 2003/71/EC) Regulations, 2005.

(Continued on next page)

Investing in the Notes is speculative and involves a high degree of risk. See "Risk Factors" beginning on page 55 of this Offering Circular for a discussion of certain factors to be considered in connection with an investment in the Notes.

The Notes are with limited recourse to certain assets of the Issuer and without recourse to the Ceding Reinsurer and its affiliates.

THE NOTES HAVE NOT BEEN AND WILL NOT BE REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), OR ANY U.S. STATE OR FOREIGN SECURITIES LAWS, AND THE ISSUER IS NOT AND WILL NOT BE REGISTERED UNDER THE INVESTMENT COMPANY ACT OF 1940, AS AMENDED (THE "INVESTMENT COMPANY ACT"). THE NOTES ARE BEING OFFERED AND SOLD IN BOOK-ENTRY FORM ONLY TO INVESTORS WHO (I) ARE "QUALIFIED INSTITUTIONAL BUYERS" AS DEFINED IN RULE 144A ("RULE 144A") UNDER THE SECURITIES ACT ("QUALIFIED INSTITUTIONAL BUYERS"), THAT, WITH RESPECT TO "U.S. PERSONS" AS DEFINED IN RULE 902(k) UNDER THE SECURITIES ACT ("U.S. PERSONS"), ARE ALSO "QUALIFIED PURCHASERS" AS DEFINED IN SECTION 2(a)(51) OF THE INVESTMENT COMPANY ACT ("QUALIFIED PURCHASERS"); AND (II) ARE RESIDENTS OF, AND PURCHASING IN, AND WILL HOLD THE NOTES IN, A PERMITTED U.S. JURISDICTION OR A PERMITTED NON-U.S. JURISDICTION. PROSPECTIVE PURCHASERS ARE HEREBY NOTIFIED THAT THE SELLERS OF THE NOTES MAY BE RELYING ON THE EXEMPTION FROM THE PROVISIONS OF SECTION 5 OF THE SECURITIES ACT PROVIDED BY RULE 144A. THE NOTES ARE NOT TRANSFERABLE EXCEPT IN ACCORDANCE WITH THE RESTRICTIONS DESCRIBED UNDER "*NOTICE TO INVESTORS.*" EACH PURCHASER OF THE NOTES IN MAKING ITS PURCHASE WILL BE DEEMED TO HAVE MADE CERTAIN ACKNOWLEDGMENTS, REPRESENTATIONS AND AGREEMENTS AS SET FORTH UNDER "*NOTICE TO INVESTORS—REPRESENTATIONS OF PURCHASERS.*"

The Notes will be offered by Aon Benfield Securities, Inc., BNP Paribas and Natixis SA (each, an "**Initial Purchaser**" and, together, the "**Initial Purchasers**"), as specified herein, subject to receipt and acceptance by each Initial Purchaser and subject to each Initial Purchaser's right to reject any order in whole or in part. The Initial Purchasers expect to deliver the Class A Notes through the facilities of DTC and the Class B Notes through the facilities of Euroclear and Clearstream, in each case against payment therefor in immediately available funds on or about November 1, 2012.

Sole Structuring Agent and Joint Bookrunner

Joint Bookrunner *Joint Bookrunner*

Offering Circular dated November 1, 2012.

Pages	200
Words	50,000
Expected human reading time	3 hours

Schematic illustration

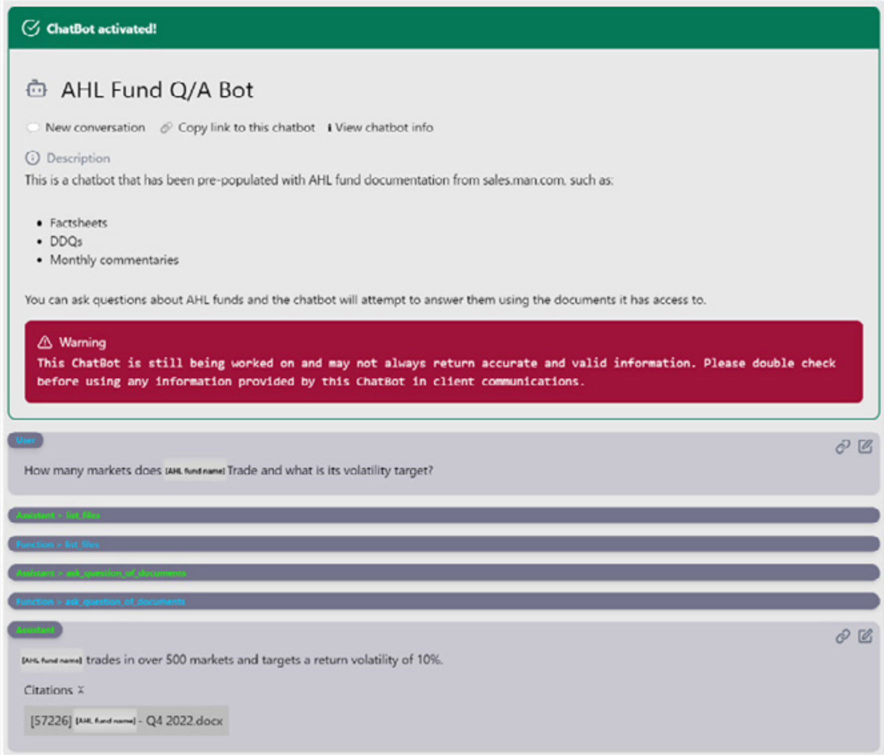
Today, this data extraction is done by ChatGPT, putting the relevant information in a systematic template for a reviewer to check. This frees up one analyst to focus on new research.

3. Chatbots assisting with research for investor queries

Man Group's Client Relations team assists with questions from clients on the firm's full suite of investments, including Man AHL's systematic investment strategies. Many questions rely on information from various investment materials, including factsheets, presentations, due diligence questionnaires, and investment commentaries. The team then crafts client-friendly responses. For example, a client might request information on fees, or the risk target of an investment strategy.

ChatGPT can automate several steps in this process (Figure 4, below). First, it can extract the required information from the relevant documents. Second, it can draft a response ready for human analyst review. This efficiency frees up time for the team to focus on higher-value tasks.

Figure 4. Screenshot of chatbot returning information



Schematic illustration

Improved efficiencies for data extraction are a general theme – we saw this in the catastrophe bond example – and other teams are reaping benefits too:

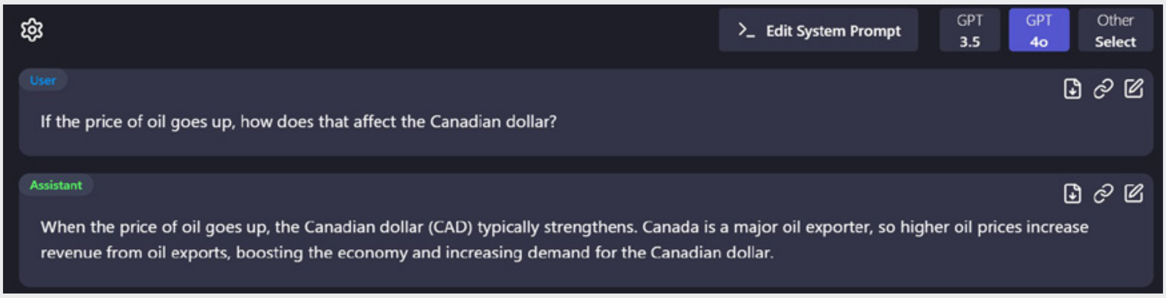
- Discretionary investment analysts extracting information from Regulatory News Service (RNS) announcements.
- Data science professionals extracting data information from vendor emails.
- Design professionals extracting underlying data from unformatted charts to convert to Man Group branding.

4. Producing simple macro hypotheses

ChatGPT is useful in quantitative macro research by leveraging its knowledge of fundamental macroeconomic relationships. One use-case is employing it as a hypothesis generator to suggest whether a particular economic timeseries has a fundamental relationship with a certain market. These hypotheses can then be tested using statistical back-testing methods.

While ChatGPT won't replace our macro research team in its current state, its understanding can be as good as a graduate researcher. The main difference being that a human researcher needs breaks, while ChatGPT can query thousands of relationships systematically.

Figure 5. ChatGPT explaining a simple macroeconomic relationship



Schematic illustration

We've focused on the opportunities until now. Below we highlight some of the key lessons from our experience with generative AI.

Hallucinations must be managed

ChatGPT's responses cannot be fully trusted. To help mitigate the impact of hallucinations, we use tools to highlight where information occurs in the original text, aiding human checking. It is a similar story for code, which is only a prototype and requires human verification.

Prompt engineering is crucial

If ChatGPT can't do a task well, it's often due to a misspecified prompt. Perfecting prompts requires significant resources, trial and error, and specific techniques.

Break tasks into smaller sub-tasks

ChatGPT can't logically break down and execute complex problems in one go. Effective 'AI engineering' involves splitting projects into smaller tasks, each handled by specialist instances of ChatGPT with tailored prompts and tools. The challenge is integrating these agents to solve complex problems.

Education is key for wider adoption

Understanding ChatGPT's capabilities and limitations is crucial. Sceptics should see its strengths, while enthusiasts need to learn its failures. Effective use requires learning how to interact with the model and understanding its training and functioning.

Be ready for the next best thing

Generative AI is already creating efficiencies in asset management, but users must be agile in taking on the next best model to reap the gains of this evolving technology. Progress has so far been swift, with GPT-2 released in 2019 described as 'far from useable'[7] versus GPT-4 which is already gathering multiple use-cases.

Conclusion

Electricity changed society but took 40 years to do it. AI can do the same,[8] but faster. Our analysts have already seen improvements in data augmentation, feature engineering, model selection and portfolio construction. We believe that in as little as a decade, those asset managers who embrace generative AI can help gain a competitive edge via a faster pace of innovation and superior performance.

It was 40 years from Edison's lightbulb until electricity changed the game for the masses. Perhaps AI hits that milestone in 10.

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Understanding AI and specific applications to commercial lending & structured finance

George Souri
Founder and CEO
AIO Logic

The rise of artificial intelligence (AI) has been one of the top stories in both the technology and business sectors over the past couple of years. The wide-ranging intrigue of AI can be attributed to its potential application in so many industries and unique situations. Executives seeking to achieve certain business goals, view AI and automation as a way to help their firm achieve those goals at levels that would not otherwise be possible.

While most of today's business executives have a general understanding of AI, their definitions are often either too broad or too narrow. In short, AI operates as a digital brain that can gather information, apply reasoning, infer conclusions, and make decisions. Essentially, AI is the 'thinking' aspect of automation that takes in information, decides on the correct process, and issues an action command. Once that command has been issued, automation is then used to perform the action and complete the task.

The challenge facing commercial lending

Generally speaking, industries with a higher level of complexity in their workflows have the potential to accrue greater benefit from implementing AI. The more complex the workflow, the greater impact that can be achieved by automating tasks in that workflow. Therefore, firms in the commercial lending and structured finance industry are prime examples of precisely who should be considering the implementation of AI.

Currently, the vast majority of commercial lending firms do not have technology that provides the level of functionality they need to operate effectively and efficiently. As a result, these commercial lending firms are burdened with time-consuming and error-prone manual processes, disparate systems that are both costly and inefficient, and data silos that make it difficult to perform insightful data analysis. Taken together, this leads to increased costs, increased risk, data fragmentation, data errors, and process errors.

This lack of sufficient technology presents real challenges to commercial lenders throughout the entire loan lifecycle, ranging from deal sourcing and deal management to loan origination and loan servicing. As a complex transaction lifecycle that is made up of several sub-processes, the loan lifecycle presents many complex workflows that can be difficult and inefficient if performed manually. Thankfully, AI and automation can help lenders streamline these workflows, allowing them to increase efficiency, reduce costs, and reduce errors.

How AI provides the solution

The level of complexity in the commercial lending industry allows for some very powerful applications where AI and automation can provide solutions to the challenges outlined above. In each case, AI plays a key role in building intelligent automations that can deal with the complexity of the commercial lending industry. The applications of AI to the commercial lending industry range across the entire loan lifecycle and vary in the level of benefit that they can provide the lending firm.

For example, some areas of the loan lifecycle where applications of AI provide particularly high benefits to commercial lenders include loan origination, financial analysis, risk monitoring, and reporting & analytics.

In the loan origination process, AI can automate the initial screening and validation of loan applications, reducing the time and effort required for manual processing. This increases efficiency which leads to reduced costs, while also reducing the likelihood of error. Additionally, the customer experience is also enhanced thanks to the quicker origination timeline.

Relating to financial analysis, AI can rigorously analyse vast amounts of data quickly and accurately to automate real-time underwriting and borrower financial health monitoring. Instead of relying on analysis and decision-making of humans, firms can base decisions regarding creditworthiness on real-time analysis performed by powerful AI. This allows lending firms to make insightful decisions on potential investment opportunities, thus mitigating credit risk.

Relating to financial analysis, AI can rigorously analyse vast amounts of data quickly and accurately to automate real-time underwriting and borrower financial health monitoring.

An area where AI has particularly powerful applications is risk monitoring. In this area, AI can predict potential risks and vulnerabilities in business processes, allowing organisations to mitigate them proactively. Specifically, AI can identify patterns and risk factors in financial, collateral, and loan data to proactively manage risk by identifying early warning signs. These capabilities combine to mitigate both process risk and default risk, which are key hurdles for lenders to overcome.

In an industry that is so reliant on analytics to make informed decisions regarding future investments, AI can be especially powerful in the area of reporting and analytics. For example, AI can provide real-time insights into operational performance, enabling firms to monitor key metrics and KPIs continuously. Additionally, AI can automate the generation of reports, providing accurate and timely information to stakeholders.

While there are many other potential applications of AI in the commercial loan lifecycle, these were just a few examples of the powerful ways in which AI can be applied to the commercial lending industry. In a complex and competitive industry such as the commercial lending industry, AI can be deployed as an extremely powerful tool to help firms achieve their business goals. The technology exists to solve the challenges that firms face, now it's just a matter of those firms implementing the powerful AI technology available.

Ready for your future?

For a majority of commercial lending firms, their current processes and technology are not optimal, leading to missed opportunities and competitive disadvantages. As they seek ways to improve processes and turn those disadvantages into advantages, implementing new technology will often be in the front of mind. While technological changes can be difficult to implement, especially in larger firms, the time is now to prepare your firm for a future that will undoubtedly feature heavy use of AI in commercial lending.

As the commercial lending industry continues to become more complex and competitive, the future benefit of implementing AI technology to automate your firm's processes will become increasingly significant. The good news is that this technology is no longer exclusive to firms with the largest budget.
If your firm is willing to embrace the implementation of AI, you will be positioned to be amongst those who will reap the rewards from it for years to come.

Visit [AIO Logic (aiologic.io)](aiologic.io) for more information.

AIO LOGIC

AI-powered solutions to automate, integrate, and optimize commercial lending and structured finance

End-to-End Scope

- AXIS natively handles every phase of the loan life-cycle creating seamless process & data flows

- AXIS can stand alone or integrate with 1,300 standard available 3rd party integrations

Robust Functionality

- Easily handles complex workflows and bespoke facilities

- Native handling for every commercial loan structure (amortizing, revolving, ABL, delayed draw, interest only, real estate, factoring, leasing, etc)

Advanced Automation

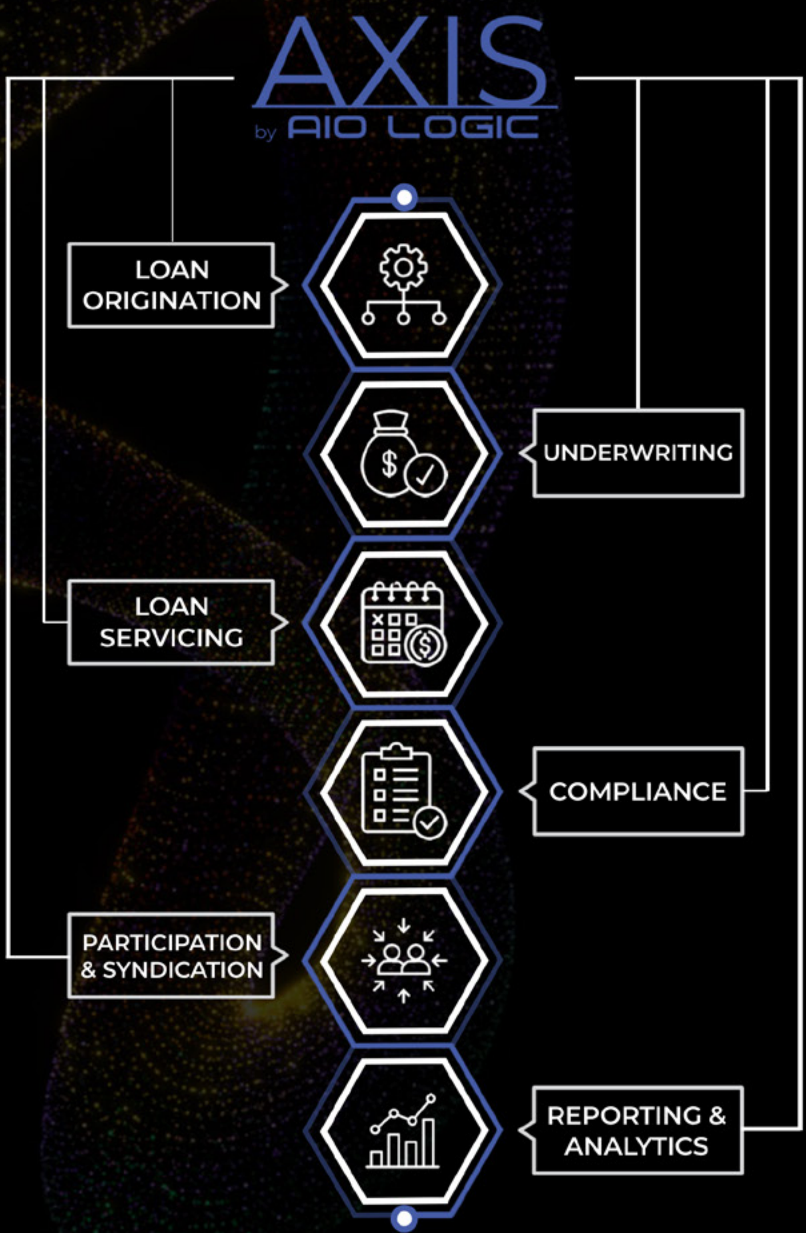
- AXIS features intelligent end-to-end automation that can handle complex workflows and diverse scenarios

- Automations are easily configurable

Powerful AI

- AXIS AI increases productivity and accuracy while reducing risk

- AXIS AI anticipates next best action and optimizes workflow paths



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Trust: The key to AI adoption in the asset management sector

Asset managers are keen to unlock the potential benefits of generative AI. But a lack of trust is getting in the way. Here's how the most advanced asset managers are building a foundation of trust for AI and driving adoption and value in the process.

Chrystelle Veeckmans
EMA Head of Asset Management
KPMG International

Benedikt Höck
Head of AI
KPMG in Germany

If you are like most asset management executives, you've probably been spending quite a bit of time talking about generative AI. You've likely seen dozens of potential use cases in the asset management space. And you are already well aware that 'gen AI' will soon become embedded right across the asset management value chain. Chances are, you see generative AI as a potential competitive advantage rather than a risk. But are you moving fast enough to seize that advantage?

According to a survey conducted in 2023 by KPMG in the US, 74% of executives think generative AI will be the top emerging tech to impact their business over the next year and a half.[1] And a global survey of CEOs shows that 70% are investing heavily in generative AI as their competitive edge for the future, with most (52%) expecting to see a return on their investment in three to five years.[2]

Yet progress adopting generative AI in the Asset Management space has been slow when compared to other sectors – even within the financial services industry. Some are now testing embedded AI features such as Microsoft's Copilot tools. Others are implementing platforms that allow employees to train their own assistants or to automate non-core activities (like office scheduling). Indeed, our work with leading asset managers suggests that the vast majority are still in the exploration phase.

What is slowing progress?

We believe it is trust – or a lack thereof. A lack of trust undermines confidence. It discourages exploration. It limits ambition. It creates massive challenges right across the value chain. And the root causes of the lack of trust are manifold.

In part, the lack of trust can be chalked up to the speed at which generative AI has burst onto the business scene. Within just 18 months, it has become mainstream. That's faster than many asset managers turn around an equity holding. And it's not a lot of time for managers to build up trust. They've seen edge cases where models didn't react as anticipated. Most would rather wait until the use cases are 100% reliable before they even consider embedding them into their businesses.

1 2023 KPMG Generative AI Survey, KPMG LLP
2 KPMG 2023 CEO Outlook, KPMG International

Many asset managers (rightly or wrongly) distrust the nature of the generative AI beast. Transparency is hard to find – the training data and models are often owned and managed by a third party (often Big Tech); the decision-making process is generally unexplainable (however correct the outcome may be); few, if any, people in the business really understand how this stuff works.

Then there are the use risks that keep asset managers up at night. They worry that their employees might use the technology in the wrong way, wrong context or wrong process, thereby creating reputational, financial and trading risks. They are concerned that their own internal data may not be reliable, leading to poor decisions. They agonise about the impact of future regulation, particularly as the EU member states move to adopt the EU AI Act and integrate it into their financial regulation systems.

Building trust

The key to driving generative AI adoption, value and innovation in the asset management sector, therefore, is trust. We believe those who are able to develop a foundation of trusted AI and then scale up will be the ones who are best placed to reap its competitive advantages. Those who leave trust as an afterthought will likely struggle to embrace AI and manage the related risks and challenges.

At KPMG, our experience reveals five key areas where asset managers will want to focus in order to better build trust in their AI.

- **Strategy.** The leaders have a clarity of vision about AI that unites their organisation and builds confidence about the future direction. The frontrunners have a strategy in place, supported by a clear story about how AI supports the overarching goals of the company. They have redesigned their operating models to reflect key aspects of AI – including things like technology impact, workforce optimisation and governance and controls. They understand the business priorities driving the adoption of AI and are aligning their technology spend and effort accordingly. And they are adapting and evolving their approach as their experience and AI capabilities grow.

- **Governance.** The leading asset managers are currently focused on ensuring that good governance is embedded as part of their AI strategy and target operating models. Those in the EU, in particular, are starting to implement measures to respond to key aspects of the EU AI Act, such as creating an inventory of use cases and related risk classifications. While governance should ensure that responsibility for AI flows from the very top of the organisation, great care must be taken to also implement controls and governance at an individual level across the organisation. Generative AI is rapidly spreading across the organisation – all three lines of risk management defence must be ready.

> "Generative AI is spinning out a range of exciting use cases for the Asset Management sector. Those able to selectively integrate these ideas and tools into their operations and trading will almost certainly enjoy a competitive advantage – but only if they put trust at the centre of their strategic decision-making."
>
> *Andrew Weir, Regional Senior Partner, KPMG in Hong Kong (SAR); Vice Chairman, KPMG China; and Global Chair, Asset Management and Real Estate, KPMG International*

- **Data and models.** There are two key inputs to every AI solution – the data and the models. Both must be trustworthy and reliable. With public Large Language Models (like ChatGPT, for example) it is often challenging to assess the quality of the underlying training data and foundational models. We are seeing a number of asset managers start to explore whether they can create their own smaller language models, particularly for higher risk applications, based on their own data. Those with a pre-existing data strategy and structured data layer are generally starting off from a better position; those without are struggling to catch up quickly.

- **People.** Getting your people comfortable with AI and helping them understand the risks and opportunities is key to driving trust within the workforce (we are working with one asset manager to deliver ‘AI boot camps’ for new managers, for example). Leading firms are creating safe spaces for employees to test ideas and become familiar with new AI tools and technologies rather than banning them completely. At the same time, it is also important to assess the workforce implications and to communicate the impacts clearly, particularly where people’s roles may be impacted. As a result, we are seeing the leading asset managers ramp up their change, enablement, communications and development programs related to AI.

- **Security**. In the KPMG 2023 CEO Outlook, 82% of leaders globally said they were worried that AI may provide new attack strategies for adversaries.[3] And we are already seeing a number of new attack strategies emerge – like, for example, ‘prompt injections’ where hackers feed the AI malicious prompts in order to fool the system into revealing sensitive information like customer accounts. The leading asset managers are reassessing their cyber defence and resilience strategies and capabilities in order to address and manage the new risks, vectors and tactics enabled by generative AI.

To find out more and to benefit from our experience, we encourage you to contact us to discuss your unique objectives.

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KPMG
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Integrating your digital assets technology stack with the traditional asset manager operating model

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Asset and wealth management firms have undergone profound changes to their operating model and technology stack over the decades – from the rise of electronic trading platforms in the 1980s and 90s, industry consolidation and globalisation of the 2000s, and now the expansion of digital assets. While firms have historically had fragmented technology stacks with point-to-point integrations, in recent years, there has been significant investment into consolidation of platforms across functions, asset classes, and regions to enable scale and efficiency.

Traditional Finance (TradFi) vendors have responded to the operating model evolution by bringing 'front-to-back' investment management solutions to market, creating a one stop shop for front, middle, and back office as well as enterprise functions. These vendors have achieved this end-to-end functionality through a mix of acquisitions and partnerships, leading to increased competition for market share.

Asset and wealth managers looking to build an investment capability to gain exposure to digital assets must revisit their operating models – the people, processes, technology, data and governance that supports the manufacturing and distribution of investment products – as managing digital assets introduces nuances that do not exist in TradFi. For example, investing in digital assets requires safekeeping of assets via a wallet, which has been a central point of focus given market events such as FTX or 3AC. As a result, managers have increased their due diligence on counterparties and custodians, with counterparty and custody risk becoming a part of portfolio management decisions. In TradFi, managers typically outsource custody to a single third-party administrator, without as much concern for custody diversification and location of assets. However, custody for digital assets is paramount, with the selection decision and strategy requiring front office input. These operating model nuances have created market dynamics that have caused managers to focus their efforts on understanding how these nuances can be addressed in their existing model vs. how they need to augment existing capabilities, operating model, etc. to support their requirements.

Given the nascency of the asset class, we have seen an emergence of 'crypto-native' technology solutions. As opposed to the TradFi technology vendors, these crypto-native solutions were built to solve individual functional use cases. This has led to an increasingly fragmented vendor landscape, requiring managers to implement various solutions to meet their functional requirements. While the best-of-breed operating model affords managers with best-in-class functionality, it is antithetical to the consolidation they previously embarked on in their TradFi operating model. We have seen the crypto-native technology solutions start to broaden their functional use cases to support multiple functions within the operating model through internal development, acquisition, or partnerships, but we do anticipate that this will take some time to scale.

Given the nascency of the asset class, we have seen an emergence of 'crypto-native' technology solutions. As opposed to the TradFi technology vendors, these crypto-native solutions were initially built to solve individual functional use cases.

The question then arises of how managers can integrate the digital assets technology stack with their TradFi operating model, holding true to their guiding principles of consolidation and standardisation, while also being able to operationally satisfy their digital assets investment requirements. The first item to tackle is whether the TradFi investment technology incumbents have digital assets capabilities. TradFi vendors display diverse sentiments and levels of investment to support digital assets. We have seen most take the partnership approach, which allows for speed to market, flexibility, and reduced reputational risk. Others have attempted to build out their current product suite to support digital assets; however, we have seen different levels of success to meet the digital assets requirements, along with long lead times to deploy the necessary enhancements.

The good news for managers is that the crypto-native vendors have built their platforms to allow for open API integration, which has been previously lacking in TradFi solutions. This allows managers to employ best-of-breed digital assets solutions that will then integrate with their core TradFi investment platforms, enabling a firm-wide portfolio view for enterprise portfolio management, risk, and reporting.

We anticipate that asset and wealth managers will struggle to adapt to these digital assets nuances if these operating model considerations are not brought forward when defining their digital assets strategy. Ensuring that the inclusion of digital assets does not jeopardise the investment and transformation journey of the TradFi operating model requires upfront planning and design. Defining the digital assets operating model and selecting the right vendor partner are integral to success when building the capabilities to invest in digital assets due to the fast pace of change within the ecosystem.

Managers will need to partner with providers that can adapt with changes in market dynamics, support scale as complexity increases and can integrate seamlessly with the TradFi operating model.

Blockchain technology: Powering the transformation of asset management

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Blockchain technology is reshaping asset management, offering unprecedented levels of transparency, efficiency, automation, and security. By fundamentally changing how assets are handled, tracked, and transacted, blockchain enhances asset management processes, unlocks liquidity for illiquid investments, opens new avenues for distribution, and improves supply chain traceability. Financial service providers increasingly regard blockchain not merely as an innovative practice but as a critical strategic tool for maintaining a competitive edge in an era of immutable digital transformation.

The impact of blockchain technology on asset management

Transparency and trust

Blockchain fundamentally operates as a decentralised ledger system that maintains a record of transactions across numerous computers, thereby ensuring the integrity and transparency of data. In the context of asset management, this means that every asset's history and transaction details are recorded in an immutable and verifiable manner. Such a level of traceability provides exceptional trustworthiness, enabling asset managers to verify an asset's authenticity, track its entire transaction history, and confirm its legitimacy, all without relying on intermediaries.

Improved security

Advanced encryption techniques ensure that all asset-related data on the blockchain remains secure and tamper-proof, effectively reducing the risk of unlawful access. Stringent access control mechanisms are implemented to regulate who can view, modify, or interact with asset information, which enhances both security and privacy. Blockchain's transparent and immutable ledger plays a critical role in preventing security risks by reducing the likelihood of fraudulent activities and thereby enhancing the integrity of asset management processes. Furthermore, the decentralised nature of blockchain technology reduces single points of failure, thereby lowering the risk of cyber-attacks.

Improved liquidity

Blockchain technology improves liquidity and market access by facilitating quicker and more efficient asset trading, which enhances overall market liquidity. It also addresses regulatory challenges by managing compliance and jurisdictional issues, thus broadening market access. Additionally, blockchain reduces access restrictions by providing a transparent and decentralised platform for managing assets globally. This technology helps break down barriers, encourages cross-border investments, and supports financial inclusion on a global scale.

Enhanced regulatory compliance

Blockchain improves regulatory compliance by offering increased transparency, allowing regulators real-time access to transaction data, which helps mitigate fraud and ensure regulatory adherence. Additionally, the use of smart contracts to automate compliance processes ensures that transactions consistently meet regulatory standards, while the secure and immutable nature of blockchain data enhances audit efficiency, resulting in cost savings and improved overall compliance.

Operational efficiency

Blockchain technology is rapidly transforming asset management by significantly improving transaction efficiency and record-keeping accuracy. By using smart contracts and decentralised ledgers, blockchain streamlines transactions, making them more seamless and transparent while reducing reliance on intermediaries and reducing errors. This approach enables real-time settlements, cutting down transaction times from days to minutes, and enhances trust, security, and improved liquidity. The transparent ledger allows all parties to track transaction history, while the immutable nature of blockchain ensures accurate and tamper-proof records. Smart contracts further automate and refine record-keeping, boosting operational efficiency and reducing discrepancies.

Global reach

Traditional asset management is often constrained by geographic limitations and regulatory complexities. In contrast, blockchain operates on a global scale with minimal restrictions. This technology enables investors from around the world to participate, fostering a more inclusive and

Blockchain improves regulatory compliance by offering increased transparency, allowing regulators real-time access to transaction data, which helps mitigate fraud and ensure regulatory adherence.

diversified market. The removal of geographical barriers also opens new opportunities for asset managers to tap into a broader pool of investors.

Potential challenges for blockchain technology

Despite its potential, blockchain in asset management faces several challenges. The changing regulatory landscape necessitates clear guidelines that distinguish blockchain technology from the risks associated with cryptocurrencies, fostering a supportive environment for innovation while ensuring investor protection. Such frameworks should consider financial instruments based on their nature and function, regardless of the underlying technology (DLT or otherwise), focusing on the assets rather than the specific technology used to represent or transact them.

Security remains a critical concern, requiring robust measures and privacy protections to safeguard sensitive data and assets. Additionally, interoperability is essential for seamless asset transfer and management, demanding consistent protocols for smooth integration of blockchain technology with existing financial systems. Finally, scalability poses a challenge as transaction volumes increase, necessitating efficient solutions to manage the growing load, particularly in large-scale asset management scenarios.

The changing regulatory landscape necessitates clear guidelines that distinguish blockchain technology from the risks associated with cryptocurrencies, fostering a supportive environment for innovation while ensuring investor protection.

Blockchain technology ushers in a new era

Heralding a new era in asset management, blockchain technology leverages decentralisation, tokenisation, and smart contracts. It offers significant opportunities such as enhanced transparency, improved security, greater operational efficiency, and real-time settlement. These benefits extend across multiple industries, including supply chain management, finance, and real estate, showcasing the broad applicability and advantages of blockchain in asset management. While there are challenges, the potential benefits far outweigh the hurdles. Blockchain is not just a technological advancement; it is a strategic imperative for asset managers aiming to stay competitive in a rapidly transforming digital landscape.

The adoption of distributed ledger technology (DLT) solutions and fund tokenisation for managing fund orders and distribution is increasingly seen as a key component in the broader digitalisation of the fund industry. This modernisation effort will likely involve updating legacy systems, settlements, operations, distribution, and forms of collateralisation to leverage new networks and increase assets under management (AUM).

Why use a fractional Chief Marketing Officer?

Kate dos Santos
Founder and CEO
Lacewing Media

Achieving sustainable growth while efficiently managing all aspects of day-to-day operations can be challenging. As firms continue to adapt to the latest ideas and new ways of working, traditional roles are evolving to better meet modern demands. One role experiencing notable change is that of the Chief Marketing Officer (CMO). Nearly half of senior marketers report their role has changed over the past two years while 53% are spending significantly more time on digital marketing channels.

The role of the CMO has traditionally been heavily administrative and reliant on constant interaction between sales and business development functions. This often required a full-time, in-house presence with traditional skills to drive marketing strategies, oversee brand management and ensure effective customer engagement.

There has been a noticeable shift in how firms and individuals take an increasingly nuanced and sophisticated approach to their marketing efforts. We have seen an increased focus on the following areas:

- **Agile marketing strategies:**
  Digitisation has presented an opportunity for firms to really understand what their clients and prospects want to hear or are engaged with. Data in marketing, like most other business areas, is key to understanding what works for your business and more importantly, what does not.

- **Increased proficiency in digital marketing:**
  Digital marketing is a minefield of best practice, both for personal posting and as a business. Those who get it right are fast tracking their brand recognition above that of their competitors.

- **Increased competition:**
  Brand marketing is increasing in our sector. Impactful and purposeful messaging to your audience can help keep firms ahead of their competition, but it is a serious commitment particularly for small to mid-sized firms to take on an all-encompassing marketing strategy.

The increased complexity and variety of marketing, encompassing the required digital literacy and skillsets, has placed additional pressure on the traditional CMO model. Firms are now looking to teams who are proficient in a wider range of skills. This shift has resulted in alternative solutions to traditional marketing leadership strategies being tested and ultimately found to be successful, therefore bringing about the rise of the Fractional Chief Marketing Officer (FCMO).

The role of the FCMO

The FCMO has gained considerable traction within the sector emerging as a solution to some of the challenges faced by the typical CMO role. It might be a 'buzz phrase' but it does describe very well the model firms are starting to turn to, to revamp or begin their branding and marketing initiatives. This role provides scalable executive marketing leadership without the long-term financial commitment of a full-time executive, making it particularly advantageous for small and medium-sized firms. The FCMO model allows companies to tap into high-level expertise on a part-time or project basis, thereby better aligning marketing efforts with budgetary constraints.

The concept of fractional leadership is not entirely new. It has been shown to be successful in other areas such as finance and IT, where companies have long utilised part-time CFOs and CIOs. However, its application in marketing is relatively recent and gaining momentum. The FCMO model is particularly beneficial for businesses in growth and scaling phases, where they require strategic guidance that needs to be married with fee constraints. It provides a cost-effective solution while ensuring that the business has necessary resources to drive marketing efforts.

Key benefits of working with FCMOs

- **Access to advanced talent solutions**

  FCMOs will join your business with experience, yes, but also an innovative approach, knowledge of new tools and market trends and often a support team behind them. An FCMO may have worked with a variety of industries, bringing a depth of strategic insight and a proven track record of successful campaigns and initiatives that can translate into successful branding and marketing outcomes for your firm.

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It provides a cost-effective solution while ensuring that the business has necessary resources to drive marketing efforts.

- **Accelerated implementation**

  An FCMO will hit the ground running. They will require less time to understand the market landscape and internal processes, which means they can quickly develop and implement strategies that align with business goals. This acceleration is particularly beneficial during critical growth phases, product launches, or when quick pivots are necessary in response to market changes.

- **Objective perspective**

  As external consultants, FCMOs can provide an unbiased viewpoint that internal teams might find it difficult to see. This objectivity can be invaluable for identifying and addressing blind spots, offering honest feedback on existing strategies, and suggesting innovative approaches that an in-house team might overlook. Their external status also allows them to navigate differing viewpoints more effectively, focusing solely on what is best for the business's marketing efforts.

- **Flexibility**

  FCMOs offer the flexibility to be engaged for specific projects and in critical periods, such as brand redesigns, updates, mergers, acquisitions and other significant marketing events or campaigns. They will also offer longer term solutions to support internal teams or be able to bring their own team to support fee earners on an ongoing basis.

- **Cost**

  An outsourced FCMO allows for resources to be allocated more effectively. It is a scalable project based on longer term solution that can adapt as the market or your firm changes. A recent survey concluded that 82% of businesses implementing outsourcing strategies experienced significant cost savings, highlighting the financial benefits of the FCMO model.

A recent survey concluded that ***82%*** *of businesses implementing outsourcing strategies experienced significant cost savings, highlighting the financial benefits of the FCMO model.*

With so much to offer, the impact of an FCMO on a business can be substantial. 27% of professional services business report an increase in marketing efficiency when using an outsourced model when compared to those relying on in-house teams.

Implementing a FCMO

Successfully implementing an FCMO into your organisation involves a few vital steps to achieve the desired effect. First, clear communication is essential. Client communication skills are a crucial factor in success. Establishing goals and the pathway to achieve those goals is imperative at the outset for both parties. This applies to all third-party relationships, so is nothing new to the asset management sector.

Clear expectations are also important. This includes defining the relationship's scope, timelines, budgets, roles & responsibilities. When expectations are well-established, both the organisation and the FCMO can work more effectively towards common goals, supporting the necessary requirements for third party governance as a regulated firm.

Maintaining collaboration between the FCMO and your firm is also key in ensuring the stability of the ongoing relationship. Collaboration leads to more informed decisions, successful strategies, increased productivity, and higher quality output. Establishing this type of partnership ensures that both parties are working towards the same objectives, allowing knowledge transfer and a unified marketing approach.

Challenges with a FCMO

Of course, as with any other role, FCMOs can present a series of challenges. These issues often arise because of the difficulties involved with the integration of a third-party service provider.

- **Resistance from in-house staff** can lead to uncertainty, affecting the result of collaborations. These issues are easily overcome by an experienced FCMO.
- **Disconnect between team vision** can come about when FCMO strategies are not properly aligned with a company's long-term goals. This is solved by positive and consistent communication.
- **Limited availability** is only an issue if early conversations aren't informed and clear. Working with an FCMO that has access to their own team negates this issue.
- **Onboarding** with a new FCMO requires a structured approach, so both parties align quickly and effectively for a successful start to the relationship. The FCMO will be able to lead this discovery phase, based on previous experience.

The future of the FCMO

Integration of more technology is expected to play a significant role in the fields of brand and marketing. As businesses increasingly recognise the value of flexibility, cost efficiency and diverse expertise, the demand for FCMOs is likely to grow.

Technological advancements further enhance the appeal of FCMOs, as the ability to make use of advanced data analytics, artificial intelligence, and machine learning to drive more effective marketing strategies becomes essential to measurable success. This integration of recent technologies will not only improve marketing outcomes but also provide deeper insights into customer behaviour and marketing trends. The flexible nature of the role will also allow companies to better adapt to the new challenges and opportunities presented by technology. This will be a key advantage for businesses working with an FCMO.

Integration of more technology is expected to play a significant role in the fields of brand and marketing.

As the concept of fractional leadership continues to gain traction market wide, we may see the emergence of more specialised fractional roles across various functions within organisations. This will enable firms to access a broader range of expertise on a flexible basis, further enhancing their ability to adapt to changing market conditions. Our experience shows an upward trend in FCMO popularity, as it emerges as the most flexible, practical and cost-effective option in the asset management space.

Resources

- ttps://digitalmarketinginstitute.com/blog/the-evolution-of-the-cmo-whats-next
- https://medium.com/@webbtechy/the-outsourced-cmo-advantage-elevate-your-business-strategy-2eadc927424f
- https://www2.deloitte.com/us/en/pages/operations/articles/global-outsourcing-survey.html
- https://databox.com/benefits-of-hiring-fcmo

Optimism & opportunities: Hedge fund launches are on the rise

Jack Seibald
Global Co-Head of Prime Services
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Marex

2024 is shaping up to be a strong year for hedge funds, with an impressive revival in the launch environment. The rise we have been seeing in the number of talented fund managers setting up new funds, coupled with increased interest from allocators in wanting to invest in managers with strong pedigrees, paints a positive picture.

This is echoed in the Ones to Watch 2024 report, produced by Hedgeweek with support from Marex, which suggests that this year could see more than 40 new launches by managers coming from US$1 billion+ hedge fund firms. This level of activity would be welcome at any time, but it is all the more impressive given how lacklustre the past few years have been.

The current economic climate is undoubtedly fuelling the improved allocator sentiment, with expectations that interest rates will ease after their sharp surge. From a fund manager perspective, the easing of interest rates means that managers have a lower hurdle to clear in terms of beating the risk-free rate.

We are also seeing the improved environment reflected in the equity market performance, with the Dow Jones Industrial Average surpassing 40,000 – a further indicator of just how much sentiment has picked up.

Key trends

The Ones to Watch 2024 includes a list of the 20 most notable hedge fund launches. The report reveals some interesting trends:

1. **Quality and quantity**
   It's not just the number of big launches that highlights the strength of the industry's revival. It's also the quality. We are seeing major launches in the pipeline from managers formerly with high profile, billion-dollar hedge funds. In the Ones to Watch report, the founders of many of the Top 20 launches have truly top-tier backgrounds.

2. **Increased appetite from private wealth channels**
   Hedgeweek's research revealed that, over the last year, family offices and high net worth individuals were more likely to have shown interest in start-ups than institutions. This increased appetite from private wealth is a trend that we are continuing to see. In our experience, allocators are very much engaged in new idea flow and potential additions to their rosters of managers.

   Interestingly, the research highlighted that 70% of emerging managers believed wealth managers were showing more interest in investing in emerging funds compared to a year earlier. The pickup was particularly pronounced in Europe, where nearly 90% of emerging managers reported greater potential interest from the sector.

3. **Equity strategies dominate but multi-strategy trends are rising**
   Equity strategies were the most represented and featured in seven of the Top 20 most discussed launches in the report. However, this is a decrease from 15 in last year's report. Multi-strategy funds trends are now shaping the launch market, as well as individual macro and credit strategies. It's worth noting that investor appetite towards long-short equity has also rebounded after years of outflows.

4. **Allocators have a wide range of geographies to choose from**
   Another notable change from last year's Top 20 is the increase in launch activity outside the US. In last year's Top 20, 60% were US. This year it is half, with seven European and three in Asia-Pacific. We are definitely seeing LP interest in global opportunities.

5. **Outsourcing is on the rise**
   The research highlighted that the current break-even point for an emerging manager is widely seen as sub-US$100m: 32% say $50m or less and 55% say US$50-100m. Keeping costs low is a priority for funds of all sizes, but particularly for start-ups. Interestingly, across the board, for funds with asset under management (AUM)'s below US$500m to those above US$5bn, around 50% of respondents said that they are either planning or considering outsourcing more business functions to keep costs down. According to Hedgeweek, the use of outsourcing is likely to increase.

Launching a fund in today's climate is not without its challenges but the launch market is undoubtedly more buoyant than it has been in recent years, and industry confidence is growing worldwide. 2024 looks set to be a record year.

Demystifying the SEC's upcoming Treasury Clearing Mandate and its implications for market participants

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The upcoming Treasury Clearing Mandate will have significant impact on the methods by which the hedge fund and alternative investment community – as well as the broader buy-side – access and create incremental value from the Treasury repo market.

The United States Securities and Exchange Commission's (SEC) Treasury Clearing Mandate – announced on December 13, 2023 – will require a significantly larger portion of US Treasury cash and repo activity (both bilateral and triparty) to be centrally cleared through an SEC-regulated covered clearing agency.

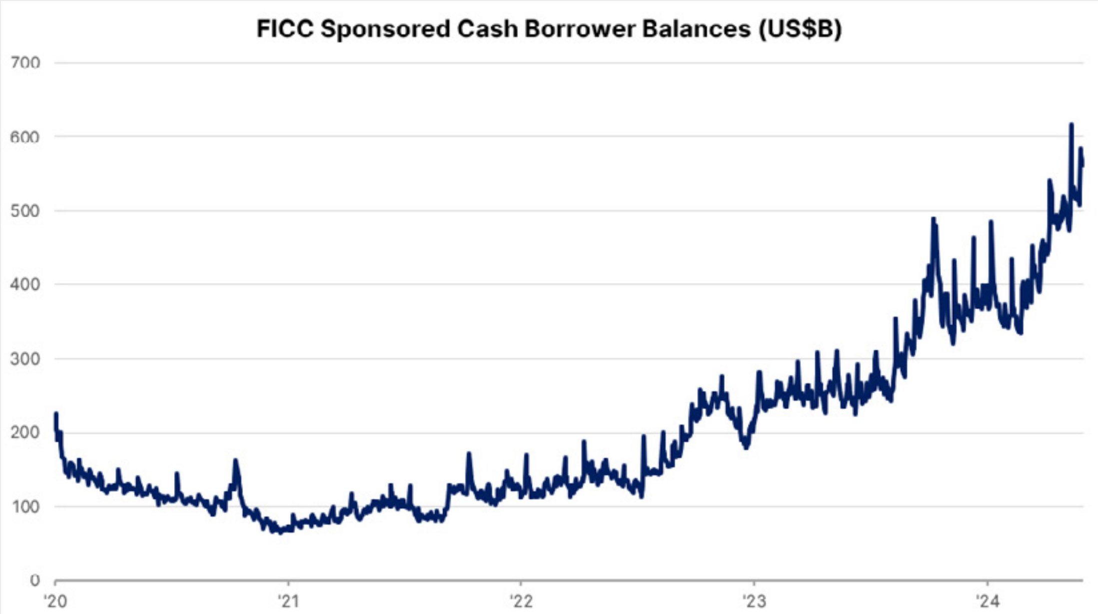
The Fixed Income Clearing Corporation (FICC) currently serves as the only central counterparty (CCP) for US Treasuries. Therefore, Treasury repo activity cleared by FICC is expected to increase significantly. Eligible trades are any secondary market US Treasury cash or repo transaction where at least one counterparty is a FICC Netting Member (direct member). While the final rule won't be enforced until December 31, 2025, and June 30, 2026, for eligible cash and repo transactions, respectively, migration to cleared activity will ramp up quickly as market participants move to become compliant. The cash mandate beginning in 2025 will exclude the hedge fund and alternatives community, whereas the 2026 repo mandate will expand the scope of eligibility – from the broader buy-side to the inter-dealer community. Both mandates include key exceptions for transactions with certain affiliates and sovereign entities. Firms can become FICC direct members to submit their eligible trades; however, eligibility terms are strict and not all buy-side firms may qualify or be willing to support the associated expenses. Alternatively, firms can have their access to the FICC facilitated by a direct member via several indirect access models.

To promote compliance, the FICC reviewed its various methods for access and is in the process of proposing rulebook changes. As the deadline approaches, the alternative investment and broader buy-side community will need to evaluate how these changes will affect market sizing, methods for access, economics and concentration.

Market sizing

Over the past few years, the hedge fund and alternatives community has become increasingly involved in the FICC cleared repo market. Repo cleared by the FICC serves as a liquid outlet for firms to borrow cash against US Treasuries at flexible terms in order to finance broader strategies. Firms can be sponsored as indirect members by existing direct members – which allows them to access cleared repo without needing to satisfy all the requirements of becoming a direct member. Sponsoring direct members submit trades to the FICC, guarantee performance of their client's trade, and generally contribute margin and clearing fund requirements to the FICC on behalf of indirect member clients. Moreover, direct members can offer additional value-adds (e.g., haircut reduction) when recognising synergies through support of other cleared products (e.g., exchange-traded derivatives) on behalf of the sponsored client.

The alternatives community can also participate on the other side of the trade, investing cash via reverse repo for incremental return. In the second quarter of 2024, FICC sponsored repo cash borrower balances – dominated by the hedge fund and alternatives community – averaged around US$390 billion (see **Figure 1**, below), up significantly from about US$80 billion in the first quarter of 2021, exhibiting a 70% compound annual growth rate. It is clear that demand for access to the economic, risk and operational benefits of cleared liquidity while retaining potential for cross-product synergies has driven increased adoption of FICC sponsored repo. The mandate is expected to exacerbate this trend and further expand FICC balances. FICC's 2024 survey of market participants suggested that overall volumes (cash, repo, and reverse repo) could increase by more than US$4 trillion. As the market becomes increasingly crowded, firms will need to consider all accessible options.



Source: Depository Trust and Clearing Corporation (DTCC)

Access models

The FICC's sponsored model through its delivery versus payment and general collateral tri-party services is the current standard for indirect clearing access. In the sponsored model, the client contracts with the FICC as an indirect member, enabling them to clear trades through a direct member without the additional cost and considerations of becoming a direct member. Indirect client trades executed with their direct member novate to the FICC as the CCP (i.e., the FICC becomes the client's ultimate counterparty), reducing overall market exposure for participants. Direct members typically contribute margin to the FICC on behalf of their clients, which is a set of payments determined by the FICC's internal stress modelling to maintain their default fund and other risk management factors. The FICC is currently updating its rulebook to promote broader adoption of its other indirect access model, agent clearing (formerly correspondent/prime broker clearing), which has seen very limited utilisation.

Under the agented model, a direct member still submits trades to the FICC on the client's behalf. However, the client has no legal relationship with the FICC and, therefore, the client's exposure ultimately remains with their direct member rather than with the FICC. The direct member is liable to fulfil all obligations resulting from their client's trade. Under both the sponsored and agented models, indirect members have the flexibility to use their direct member as an executing counterparty and clearing agent (done-with trading) or execute with another FICC member and leverage the direct member as the clearing agent only (done-away trading). Indirect members also have the option to contribute margin directly or have the indirect member contribute it on their behalf. It's currently unclear how the buy-side will optimally leverage this expanded optionality to access the repo market, given that these changes are still being digested and interpreted by market participants.

Margin

A key consideration for firms deciding between FICC indirect access models will be their willingness or ability to contribute margin. When a client contributes margin into a segregated customer account, their contribution is excluded from any loss mutualisation derived from FICC member defaults and their direct member's margin obligation to the FICC will be considered on a gross basis (not netted across all customer accounts). The FICC is jointly pursuing cross-product margin recognition with the Chicago Mercantile Exchange (CME) for indirect clients who have a common clearing intermediary for futures, Treasury cash and repo activity.

This segregated customer margin model will be a requirement for clients and their associated direct members to recognise potential cross-margin benefit. If a client does not contribute margin, the direct member will contribute into a non-segregated, omnibus margin account on behalf of its clients. Under this model for agented cleared trades, the direct member will have its margin requirements calculated across clients on a net basis, significantly reducing or eliminating requirements altogether. Direct members will not be able to realise the same benefit under the sponsored model, which will have margin calculated on a gross basis due to the legal relationship between the FICC and indirect members.

Rates/Spreads

Increased activity expanded access models and changing margin requirements all play into spreads and liquidity available in the market. Non-FICC member sell-side firms currently intermediating US Treasury transactions will need to become FICC direct members, which includes the associated cost of onboarding, as well as the ongoing cost of clearing and margin requirements. Sell-side firms intermediating FICC activity will need to consider which indirect access models to offer to clients and how to handle optionality within these structures (e.g., margin contribution, 'done away' activity). These considerations will play into the rates passed along to the buy-side. Under the sponsored model, direct members typically pass along the cost via a spread. Currently, it's unclear how direct members will seek compensation under the agented model, particularly when supporting 'done away' trading. The opportunity for direct members to net down contribution requirements in the agented model may reduce costs. However, it's uncertain how this will compare to sponsored pricing for buy-side firms. Cost considerations will also need to be weighed against non-economic factors that are crucial to client's decision-making (e.g., exposure to direct member in agented model, rather than FICC).

It should also be noted that an omni-margin agented model that provides margin benefit potential to direct members would exclude the respective indirect member transactions from any future FICC-CME cross-margin benefits. Given the significant trade-offs under each model, it's possible that direct member firms may choose to support several offerings under different models, depending on client needs. The buy-side will need to weigh these options pursuant to their ultimate goals and better understand how different sell-side providers will position themselves in a changing market.

Uncleared alternatives

In the midst of understanding methods for cleared Treasury repo compliance, buy-side firms may also consider uncleared repo alternatives that are not currently in scope for the mandate – like peer-to-peer (P2P) repo. P2P effectively removes intermediaries from the repo process. Buy-side firms negotiate terms directly and a third-party guarantor may provide its guaranty of the cash borrower's performance. P2P models may also offer support for expanded collateral types beyond US Treasuries, from agency mortgage-backed securities to corporates. Under the current rule, P2P transactions between two non-FICC direct members are not in scope for the mandate.

While the June 2026 mandate date may seem distant, the buy-side's comparative analysis of compliance options may prove to be intensive, with key considerations yet to be fully fleshed out. As the market becomes increasingly crowded, buy-side firms with an in-depth understanding of available options will be the most prepared.

How to attract the attention of the regulator

Michelle Zak
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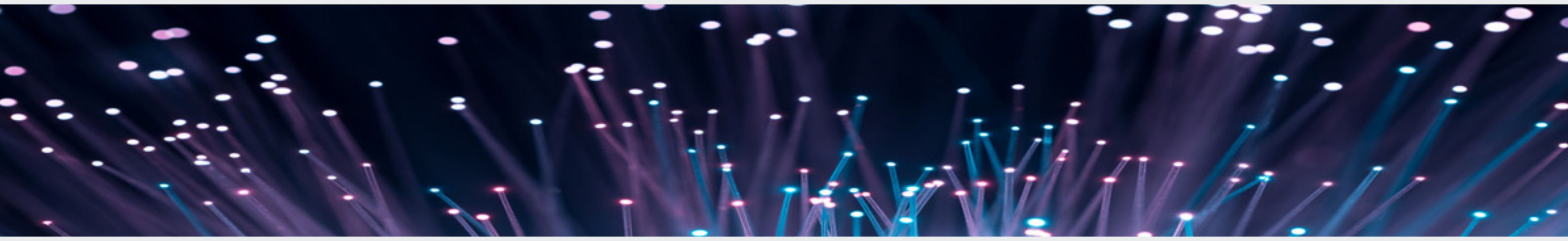
Qomply



Over this past year, there has been a notable increase in regulators approaching firms about the quality of their Markets in Financial Instruments Directive (MiFID) transaction reports. It starts innocently enough with a gently phrased email from the regulator inviting the recipient investment firm to have a look at a specific area of their reporting.

The email may seem harmless—perhaps suggesting that a particular field or area in the report wasn't quite right. There's no immediate sense of urgency in its tone or phrasing. Most firms might interpret it as a gentle nudge, signalling that something may have gone slightly off. The firm's initial response might be, *"How thoughtful of the regulator to reach out,"* followed by a casual response like, *"We'll take a look,"* or even, *"Thanks for letting us know."*

A critical mistake would be to respond with a tone that conveys a lack of urgency, or intent to thoroughly review the specific field or the entire reporting scope. The real misstep would be omitting clear timelines and concrete actions from the reply. That would be the nail in the coffin.

More often than not, the firm will go off, correct that "one little issue" in their reporting, communicate with the regulator that the corrections are on their way, and consider the job done.

That's when things escalate. The regulator, sensing a relaxed attitude towards simply correcting that one area of reporting, may re-approach with another tap to the firm. *"Maybe the firm would like to look at this other area of their reporting"* might be the next email. And so, it goes on.

This is how the rapport set by the regulator and the response of the firm sets the scene for how things escalate.

If the firm does not take things seriously from the point of initial contact, if an internal investigation isn't launched into the quality of reporting and internal controls, and if communication to the regulator is sparse and vague, then eventually there will be the proverbial 'phone call' from the regulator that conveys, in no uncertain terms, that a more formal review is ensuing.

Our firm sits on the other side of that phone call.

Transaction reporting and market surveillance represent two of the weakest points of entries for a regulator to approach a firm. The very nature of a transaction report being submitted daily to the regulator invites trouble if the house is not in order.

Over the course of the last few years, we have had a front row seat into regulatory activity mostly because we are approached when things go wrong in reporting.

Whilst there are a number of reasons a regulator may get in touch, the below are the best ways to attract the regulator's attention:

Not regularly requesting data from the regulator's MDP portal

This one is incredibly simple to resolve yet we still see issues. Evidence released by the Financial Conduct Authority (FCA) suggests that three years after Go LIVE, firms were still not conducting periodic reconciliation of their data.

How did they know? Simple- they were monitoring their Market Data processor (MDP) portal for activity. If there was no activity from your firm, it is a strong indication that you are not fulfilling one of the core MiFID transaction reporting obligations- periodic reconciliation. After all, if you haven't made periodic requests for the MDP file, then you are not conducting reconciliations. Low-lying fruit for a regulator.

Firms appear to have caught on to this – mostly because those firms were contacted directly by the regulator about their reconciliations. In fact, we see firms routinely requesting the regulator's data and storing it until they are ready to conduct a reconciliation just to hedge against any uninvited consequences.

Counterparty LEI Is a different counterparty than the one you've traded with

This particular item occurs quite frequently and if you are one of the unlucky reporting parties, then you understand how this could trigger a lot of pain.

The scenario is that you onboard a counterparty, conduct Know Your Customer (KYC), capture Legal Entity Identifiers (LEIs) and notify the traders that they are good to trade. In heated moments, when keying in trade details, traders or front-office staff are swamped for choice of which LEI to choose as their counterparty appears to have numerous identifiers. The default behaviour appears to have been – "take a guess". This approach has not boded well for those firms.

The simple truth is that regulators have a view of the entire UK market and can conduct market surveillance with relative ease. Regulators routinely match-up counterparties across firm's reports. Therefore, if the counterparty that you said you traded with, in the report, doesn't appear in their report, then it gives the regulators a reason to follow the thread.

They then start cross-referencing other counterparties within your reports – maybe even follow more threads as they build a case to contact you.

Bottom line – the whole jumper can easily become unravelled. If your counterparties that were onboarded are not aligning with those reflected in the transaction reports, then you will have to trigger a complete retrospective investigation to ensure the LEIs shown to your traders are, indeed, the counterparties they are cleared to trade with them.

Sloppy trade capture systems or relaxed mechanisms for capturing execution times means that you are effectively notifying the regulator that you are trading on a venue when it's closed.

Counterparty personal sensitive data is not expressed correctly

Erroneous construction of identifier data pertaining to individuals was a real problem when MiFID went live. So much so, the regulator's posted a MarketWatch to remind market participants how to concatenate identifiers or which identifiers to use – passport versus national identifiers. Then, after Brexit, less-than-vigilant regulatory reporting teams forgot to audit UK and EU nationals to adjust for the new expectations in using identifiers. This still haunts firms and we routinely see back-reporting exercises undertaken to correct the pesty legacy of Brexit.

The timestamp for executing a trade on a venue reflects a time when venue is closed

Sloppy trade capture systems or relaxed mechanisms for capturing execution times means that you are effectively notifying the regulator that you are trading on a venue when it's closed.

This can also occur twice a year when adjustments to the clock aren't accounted for. Easy to catch, annoying when it happens, yet surprising how it continues to occur across the industry.

You aren't sending all transactions to the regulator

This effectively means you are under-reporting transactions. When means, the regulator does not have a full view of market activity and will impede their ability to conduct effective surveillance. Therefore, this should be taken seriously.

A common reason for under-reporting is that a 'flag' has been 'ticked' somewhere which is stopping transactions from flowing downstream into the daily reports. Believe it or not, this occurs frequently. Certain Trade Capture Systems have a nifty MiFID Reportable Flag which, when ticked, will exclude all transactions that come its way.

We see it sting firms from time-to-time and many firms only discover it when contacted by the regulator. It is a big clue to the regulator that systems & controls need tightening. Definitely want to ensure you are conducting reconciliations (see point above) to close this gap.

To stay off the regulator's radar, ensure your internal controls are robust, you are conducting routine reconciliations, you are capturing accurate details and are training your staff to do the same. Remaining vigilant always helps but greasing the wheels with formal procedures makes it a whole lot easier to execute daily.

Better together: The powerful synergy in public and private debt strategies

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Synergy—the combination of two or more elements to produce a combined effect greater than the sum of their individual parts—has given the world Lennon and McCartney, fish ‘n’ chips, and Dolce & Gabbana. In the realm of investing in stressed and distressed credit, investors have tended to favour private credit funds over public debt. Yet, I will argue that by including both strategies in a portfolio, investors are better able to leverage the strengths of each— and potentially enjoy superior performance.

Despite the longest period of yield curve inversion, surpassing the 1978 record of 624 days,[1] we are in a Goldilocks’ period where a recession has been avoided so far, business activity remains solid, balance sheets appear resilient, and the US distressed debt ratio, at 6%, is at nearly half its long-term average and close to its lowest level since mid-2022.[2] Spreads are exceptionally narrow, with single-B-rated corporate bonds and leveraged loans hovering at their lowest levels since 2006.

The tight spreads indicate that credit markets seem relaxed about the prospect of corporate defaults. Amidst this benign backdrop, market participants may be overlooking several important factors: 1) the lag effect between rates and defaults; 2) the current fraught geopolitical and environmental landscape, where an exogenous shock could suddenly and severely challenge business conditions as it did in March 2020; and 3) upcoming debt maturities that may necessitate the selling of assets or undergoing distressed exchanges to reduce leverage. With spreads this tight, it would not take much to upset the apple cart in corporate debt markets.

1 https://www.reuters.com/markets/rates-bonds/us-treasury-key-yield-curve-inversion-becomes-longest-record-2024-03-21/
2 https://www.fticonsulting.com/en/canada/insights/articles/distressed-debt-levels-very-disconnected-from-default-activity-thats-first

While larger enterprises may be better able to weather tighter liquidity, small-to-medium-sized corporate borrowers typically have shorter-dated loans that need to be refinanced more frequently. They are considered riskier bets than larger and better capitalised firms. During the past few years these smaller enterprises have encountered a much tougher refinancing environment. Among stressed and distressed companies, tighter spreads and dwindling cashflows present a negatively skewed risk-to-reward ratio. To attract lenders, stressed and distressed borrowers have had to offer high rates (14%+) and stronger covenants.[3]

A closer look reveals cracks in the façade. For example, the current weakness in pockets of the commercial real estate sector has the potential to spread contagion and sour investor appetite for credit. This is because commercial real estate impacts credit conditions more broadly due to the involvement of banks and institutional investors. Following a halcyon period of solid returns, the tighter interest rate regime has led some private credit strategies to experience drawdowns with no line of sight to a bottom.

In this environment, what advantages could an allocation to a stressed and distressed public credit strategy provide? Terms like stressed, distressed, restructuring, and bankruptcy are not often music to the average investors' ears. However, the numerous 'hairs' on this asset class obscure the highly attractive, and asymmetric risk-to-reward opportunities on offer.

Publicly traded debt provides investors with the liquidity to take advantage of market dislocations or to exit a position with relative ease. This is where active managers can generate alpha by being able to quickly respond to changing market conditions and idiosyncratic opportunities. In contrast, private credits may involve potentially long lock-up periods making it impossible for investors to access their capital until the terms of the loan have been met or it has reached maturity.

Secondly, public companies vary widely across size, sector, and geography compared to private companies which are often small-to-mid-sized, special situations, and niche businesses making them harder to access. Public companies can respond more rapidly to changes in the economic and policy landscape compared to private firms that tend to be less market sensitive.

Thirdly, being subject to regulatory requirements, public debt markets are more transparent and usually the businesses and debt structures are simpler making resolutions faster and more predictable. Investors in public market debt have access to company financial statements, analyst and rating reports and other information about the issuer and its prospects compared to private credits which are opaque and based on undisclosed agreements. For example, in situations where negative company news is forefront in investors' minds, by being able to dig into balance sheets and understand the scope of liquidity, it is possible to determine the margin of safety and lean in with a larger position.

Investor preferences determine the relative allocation to the price-to-model and price-to-market mix. The price-to-model fund gives access to a private network of debt underwriting whereas the price-to-market fund may offer similar returns with the advantage of transparency and secondary market liquidity.

In my view, both strategies are relevant and provide suitable diversification in the credit market. By including an allocation to both private and public credit strategies in the portfolio, an investor can optimise the risk/reward equilibrium and be well-positioned to benefit from a range of market, economic, and geopolitical conditions.

3 https://www.penderfund.com/pender-credit-opportunities-fund/

Private credit: A global perspective on market developments

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With the continued global expansion of the pool of private credit, what does the future hold? Will the boom times continue, or will enthusiasm be dampened by the resurgence of syndicated bank loans and the return of CLOs? The private credit market over the past few years has expanded exponentially but this has been against the backdrop of a very subdued Broadly Syndicated Loan (BSL) market.

Clifford Chance looks at the impact of the return of the BSL market on private credit, the options for private credit in the short term and what developments are expected in the future.

Overview of market dynamics

In the first four months of 2024, more than US$13.2 billion of private credit owed by US companies has been refinanced in the BSL market (according to data prepared by PitchBook). It is a similar picture in Europe. Private credit had stepped in to fill a funding gap in 2023 but, with the return of the BSL market, borrowers are looking for (and finding) cheaper debt. To avoid borrowers going out to the BSL market, an increasing number of private credit providers are agreeing to reprice transactions. On new money deals, sponsors are often running 'dual-track' processes where papers for both an underwritten TLB and a private credit club solution are being prepared concurrently.

In parts of APAC, investment banks continue to have a lot of appetite for sponsor-backed financings/ senior syndicated deals. It is difficult for credit funds to compete on pricing so a lot of them are more focused on bilateral direct lending opportunities. These deals are often highly structured, and they sometimes involve convertible instruments and warrants. The nature of some of these deals can make it difficult for them to be refinanced in the BSL market, where arrangers typically expect more standardised terms to facilitate syndication.

The ‘new normal’, at least for the foreseeable future, is increasing competition amongst lenders. In face of this, providers of private credit may look to maintain borrower friendly terms and agree to items that would often be ‘flexed’ out in the BSL market. Private credit providers also have the advantage of being able to provide bespoke flexible financing solutions in the form of hybrid capital. This will be another option for them as they look to compete in the market. The growth of the asset class will push certain private credit lenders to focus on larger cap deals and/or to diversify their investment strategies.

Refinancings and distressed loans

Given the rise of interest rates and tougher economic conditions, there has not been the wave of restructurings which might have been expected in the London market. Instead, borrower and lenders are agreeing to ‘amend and extends’, covenant waivers, additional equity injections and similar transactions.

By contrast, it is a mixed picture in Continental Europe. While a covenant holiday combined with some form of PIK interest and, potentially, a smaller equity injection was considered sufficient to stabilise the borrower group in many cases, this has not been universally successful, with some borrowers struggling with the increased debt burden arising from the PIK which can no longer be dealt with by a simple waiver process. There have been several cases where the shares were fully or partially handed over to the lenders on a consensual basis and, in rare cases, borrowers even ended up in insolvency.

In APAC, two main trends have emerged: the first is the increased use of insolvency and enforcement processes which is presenting opportunities for credit funds, particularly in the Hong Kong and mainland China real estate space, to buy out existing bank debt and look to execute credit bids or debt for equity plays for key assets in receivership or liquidation; and the other is second or third rounds of restructurings - deals that were done throughout COVID and in the year or two after are now starting to come back for another round, given the changing landscape for businesses post-COVID.

Deployment of ‘dry powder’; flexible financing solutions

Private credit providers have the ability to provide flexible, bespoke financing solutions and, for the right businesses, the use of hybrid equity instruments - such as convertible notes, vanilla preferred equity and convertible preferred equity investments - in resized capital structures is key. These instruments are attractive to investors, as they provide sizeable risk-adjusted returns along with protection against downside scenarios.

In the US, use of these junior capital instruments tends to be most common in situations where a borrower is looking to reduce leverage at an operating company level, minimise cash interest payments or address immediate liquidity concerns. Outside of these scenarios, special situations dynamics, requiring more tailored solutions unique to a specific capital structure, are where there is increasing activity.

In APAC, hybrid equity instruments are typically used in circumstances where the borrower cannot take on more debt and is looking for liquidity. Structuring these can be challenging depending on the jurisdiction – ensuring that it is not treated as debt but has debt-like protections is a key aspect of any investment using this structure. This is typically only done for the larger players where confidence can be taken from the various underlying businesses and where other investors have done something similar and funds can get comfortable with the regulatory risk.

Credit funds are increasingly innovative and willing to engage in different debt structures. In the London market, there have been examples of a convergence of senior and junior debt, with an opco financing provided by banks sitting alongside a Holdco PIK provided by private credit lenders. APAC is also seeing bespoke transactions where sponsors are looking for an extra bit of leverage. In a challenging exit environment, sponsors may see value in doubling down on their investment and unlocking the last bit of value in a portfolio company. The additional capex spend is being funded through Holdco PIKs or additional pieces of subordinated debt that sit behind a senior financing (whether it be a syndicated unitranche or senior bank debt). Many private credit funds have special opportunity strategies to allow them to fund either higher up in the structure or into potentially more volatile businesses and/or provide a combination of debt and equity.

Although a subdued M&A market has suppressed financing opportunities, the scale of 'dry powder' in both debt and equity funds will add pressure for managers to put funds to work and generate returns for their investors (via the traditional route rather than dividend recap transactions, an area where there has not been the increased activity that might have been expected in a slow M&A market).

Recent developments

A (comparatively) recent development has been banks setting up their own debt funds. Across Europe generally, several banks have set up their own (off-balance sheet) debt funds which are operating successfully in the market, and others have made strategic tie-ups with asset managers to get a foothold in the private credit industry. Similar trends have been observed in APAC.

In APAC (particularly Australia), the latest trend is credit funds moving into the non-sponsor/ real estate space – i.e., more corporate-style financings which use other features such as back-leverage to achieve their return hurdles. Credit funds are also more focused on the asset-based lending market and structured securitisation-style products which help slice return/ risk.

Credit funds in APAC are increasingly going into new markets. A lot of focus has been centred on India, Indonesia and Vietnam.

Future outlook

Private credit is increasingly recognised as an alternative to the public markets beyond the mid-market. There has been an increasing convergence of terms between large deals in the BSL market and those being done by private credit providers, with a number of covenant-light club-style unitranche transactions emerging for strong credits and/or strong sponsors. This has been driven by competition among direct lenders, sponsor precedent and market liquidity during 2021-22. This trend is likely to continue as private credit providers look to compete with the BSL market and deploy the funds that have been raised over the past few years.

In the US, as well as in certain segments of the APAC market (particularly in Australia), focus on liability management is the main indication that there is a convergence between the large deals in the BSL market and those being done by private credit providers. Particularly in the big-ticket market, lenders are looking for new ways to tighten some of the customary lender protections, in light of, amongst other transactions, the recent discussions involving Pluralsight.

In conclusion, while the return of the BSL market may have led to an increase in competition, there remain significant opportunities for private credit across the globe as the funds adapt to the changes in the markets and the challenges represented by the different geographies and jurisdictions.

To read the full briefing, click here.

Certain aspects re: ELTIF for retail investors and illiquid and liquid assets combined in one investment fund

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Since 10 January 2024, the revised regulation on European Long Term Investment Funds (**ELTIF**), the so-called **ELTIF 2.0**[1] is applicable.

Undoubtably ELTIF 2.0 is an improved legal framework allowing, inter alia, in a much more efficient manner an offering of private funds asset classes to investors which qualify as so called "retail investors" within the meaning of Annex II of **MiFID II**[2] (**retail investors**), i.e. not qualifying as professional investors within the meaning of Annex II of MiFID II (**professional investors**). ELTIFs may of course be an interesting investment fund for professional investors – it is well noted that the requirements especially on the investments side are "lighter" for ELTIFs which are reserved for professional investors only. We would, however, focus here on ELTIFs which are open to retail investors and would need to comply with the requirements set for products allowing retail investor access.

An ELTIF 2.0 fund, offered to retail investors, needs, however, to ensure minimum investments in liquid (UCITS compliant) assets. Furthermore, such structures may need to ensure, to be able to effectively raise the interests of retail investors, reliance on the exemption in Article 18 of the ELTIF regulation as amended by ELTIF 2.0, meaning being able to handle and serve liquidity as per the applicable rules and to proceed in a prescribed manner for such potential redemptions. The recent positive developments - on 19 July 2024, the European Commission published its adopted regulatory technical standards as a delegated regulation (**RTS**) for ELTIF, please consult for details our Maples Group Industry Update on the topic (ELTIF 2.0 - European Commission Adopts RTS Delegated Regulation (maples.com)) – may, however, not take away on the one hand, the requirement to handle retail investor expectations/needs for their investment into an ELTIF and on the other hand,

1 **ELTIF 2.0**: Regulation (EU) 2023/606 of the European Parliament and of the Council of 15 March 2023 amending Regulation (EU) 2015/760 as regards the requirements pertaining to the investment policies and operating conditions of European long-term investment funds and the scope of eligible investment assets, the portfolio composition and diversification requirements and the borrowing of cash and other fund rules (Text with EEA relevance)

2 **MiFID II**: Consolidated text: Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast) (Text with EEA relevance) Text with EEA relevance.

the requirement to operationally handle illiquid assets and, to the extent required, liquid (UCITS compliant) assets within the same fund structure.

While this previously described situation is not entirely new, as a combination of illiquid and liquid asset classes in one fund has already been the case for ELTIF before ELTIF 2.0. Going back much further, has also been the case, at least to a certain extent, in multi asset class funds, e.g. in funds established for “family and friends”, for example as Luxembourg so-called **Part II Funds**[3] or as Luxembourg Specialised Investment Funds (**SIF**)[4] and, after 2016, as Luxembourg Reserved Alternative Investment Funds (**RAIF**)[5]. Now it is the new ELTIF 2.0 which represents a fund regime much more attractive for managers as it provides a legal framework allowing to attract substantial investment of retail investors in a fund structure, offering (partial) access to private funds illiquid asset classes.

Below are listed some - non-exhaustive - considerations in relation to items which may be relevant for the establishment and running of a fund combining liquid and illiquid asset classes and being addressed to retail investors and where checks before/at the beginning of a project may be useful in order to best minimise the risk of avoiding discussions/surprises at a later stage.

Legal structuring

The long existing Part II Fund (initial legal text in Luxembourg at the occasion of the implementation of UCITS I in 1988), being the retail investor eligible alternative investment fund as well as the RAIF and the SIF are the preferred fund regimes of managers for the establishment of an ELTIF.

With a Part II Fund all retail investors may be targeted, while in a SIF or a RAIF, even though legally possible, for practical reasons usually solely retail investors investing at least EUR 100,000, so-called well-informed investors (Well-Informed Investor) are effectively targeted.

With the aim of a constant improvement of the Luxembourg fund toolbox, the Luxembourg legislator anticipated, inter alia, the upcoming ELTIF 2.0 on 10 January 2024, and already updated in July 2023 numerous aspects in the Luxembourg fund laws, including the Part II Fund, the SIF and the RAIF rules.

Key improvements are the following:

- As in SIF and RAIF enhanced flexibility in the choice of the legal forms available to Part II Funds - added to previously SICAV only in the form of a public limited company (**SA** or **PLC**) possibility to establish SICAV as SCA, SCS or SCSp;
- As in SIF and RAIF enhanced flexibility for subscriptions – these are now possible not only at net asset value but also at fixed amounts, as the case may be;
- Extended time to reach legal minimum capital (SIF, SICAR, RAIF, Part II);
- Simplification and clarification of rules for proceeding in case of a Depositary mandate termination (SIF, SICAR, Part II);
- Simplification of RAIF establishment formalities if legal form established before notary;
- Exemption, inter alia, from subscription tax (taxe d’abonnement) for Part II Funds qualifying as ELTIF; and
- Well-Informed Investor definition (SIF, SICAR, RAIF): minimum investment threshold reduced from EUR 125,000 to EUR 100,000.

3 **Part II Fund(s)**: undertaking(s) for collective investment subject to part II of the Luxembourg Law of 17 December 2010 relating to undertakings for collective investment, as amended (the **2010 Law**)
4 Luxembourg Specialised Investment Funds (**SIF**): fund subject to the Luxembourg Law of 13 February 2007 relating to specialised investment funds, as amended (**SIF Law**)
5 Luxembourg Reserved Alternative Investment Fund (**RAIF**): fund subject to the Luxembourg Law of 23 July 2016 on reserved alternative investment funds, as amended (**RAIF Law**)

While the Luxembourg fund toolbox offers this large range of flexibility a structuring analysis would still need to take into account numerous aspects, for example the expectations of the targeted clients, especially if retail investors, operational needs considering these investors, legal security and process etc.

Marketing/distribution to retail investors

The marketing of a professional investor dedicated alternative investment fund structure to a usually manageable number of professional investors processing directly subscriptions in funds, often structured as Luxembourg partnerships (special limited partnership (**SCSp** or **SLP**), common limited partnership (**SCS** or **CLP**), or partnership limited by shares (**SCA** or **PLS**), follows neither the same marketing channels nor identical principles compared to the marketing of a retail investor alternative investment fund structure.

This applies regardless of whether the retail investor dedicated alternative investment fund structure may target retail investors only beyond a minimum investment of EUR 100,000, like a RAIF, or also below, like a Part II Fund.

Placement agents or partners for the marketing are rarely the same (or at least not the same teams within an entity) as for professional investors and subscriptions for retail investors more commonly happen through the use of nominees (which needs to be properly disclosed and addressed in the respective fund documentation) or approaches similar to it.

In addition to the forgoing retail investor access may require facilitating a clearing possibility for the acquired fund shares/units as retail investors much more often expect their “share/unit” to be “delivered” into an investment account at their usual bank. This may require carefully considering the type of issuance (shares or units instead of investor accounts) and their character (“registered” or “book entry registered”), which may at the same time have an influence on the legal structure to be chosen (see above). Due to the difference regarding the retail investor a clearing in a SIF or a RAIF, having Well-Informed Investor Private Investors, is processed slightly differently from a clearing in a Part II Fund, the latter being open formally to all retail investors.

A typical capital call structuring as is usual for professional investors may need to be additionally explained to retail investors or potentially adjusted if targeted retail investors marketing is expected not to result in a success, based on the experience that such investors are used to a “cash-in cut-off-time” subscription – and, if applicable, redemption - systematic (used especially in retail investor funds targeting below EUR 100,000 investment).

Registrar and transfer agent

Alongside a larger number of retail investors investing smaller amounts comes the need for a Registrar- and Transfer Agency service (in-house entity of an initiator or external service provider) which can handle, e.g. from the perspective of the number of its employees, processes, and IT-facilities, not only a range of 5-30 professional investor set-up, but potentially hundreds of retail investors, potentially holding registered shares/units.

This is not, as such, problematic but may be a challenging element for an entity not active in this retail investor sector. Initial checks before the beginning of a project and in any case through a proper due diligence selection process are required.

Asset management aspects

Besides the proper management of the illiquid part of the portfolio, the eligibility of assets as UCITS eligible assets would need to be checked upfront (so-called pre-trade compliance). Either a discretionary manager can ensure this itself (team competence and technical set-up) or chosen service providers would need to be able to do this.

Liquid assets management (UCITS eligible assets) needs to be undertaken and in case a discretionary manager may not be able to do this in-house due to lack of respective teams and/or technical set-up, delegated managers/service providers would need to be appointed to ensure that the entire range of assets which may be relevant is covered. Liquidity management is of particular importance if the ELTIF is open for redemptions (as mentioned previously).

Administration of liquid and illiquid asset classes in one fund structure

Experience has shown that administrative service providing of illiquid assets and liquid (UCITS compliant) assets is usually done on different operational platforms, as IT-setups and processes and generally needs between the two worlds diverge a lot.

In case the administrative part is ensured internally with an entity of the initiator, the competence of the relevant services, the processes and especially the IT-set-up, just to name some of the important elements, need be checked as to their readiness for both worlds. The same goes for the choice of an external service provider. Also here, initial checks before the beginning of a project and in any case through a proper due diligence selection process are required.

Valuation

As for the administration services, the valuation of the assets by the chosen AIFM will also need to be properly thought through from the perspective of the two diverging asset classes. A properly functioning system of own valuation by the AIFM or delegated valuation using a delegated valuer or through the use of appraisers is needed, in the latter case provided that the respective valuation competence for all asset classes is available at the required level at the relevant chosen AIFM itself.

Conclusion

ELTIF 2.0 is a milestone of new fund legislation and opens a broad range of legal possibilities. Addressing certain operational elements with respect to the ELTIF particularities, especially where retail investors are targeted, is useful and recommended as solutions are available.

Thank you for reading the Edition 139 of the AIMA Journal.

If you would like to contribute to future editions, please email Caterina Giordo.

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- **Q4 Edition 140**
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  Please note the deadline to reserve a spot for the Q4 edition of the AIMA Journal is 5pm UK time Friday 4 October.

Please note that availability is limited, and we cannot accept any additional contributions once all the spots have been filled.

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