

AIMA JOURNAL

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start-ups and the evolution of their
relationship with single managers
Haynes Boone

Succession planning:
Handing over the reins
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and more...

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Contents

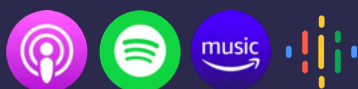
- 03 The Long-Short, Perspectives:
Industry leaders on the future of the hedge fund industry
- 04 Message from AIMA's CEO Jack Inglis
- 05 AIMA Events
- 06 K&L Gates
- 07 Citco
- 08 RSM
- 09 Multi-managers: Their impact on UK start-ups and the evolution of their relationship with single managers - *Haynes Boone*
- 14 Worldwide mobility explosion and implications for financial markets - *Kroll*
- 20 Navigating change: How the European ABS market proves to be resilient through challenging times - *Cardo AI*
- 25 SFDR 2.0 - A time for evolution - *Maples Group*
- 28 The SEC's Private Fund Adviser Rules: Key considerations for non-US managers - *Dechert LLP*
- 33 Succession planning: Handing over the reins - *Larkstoke Advisors*
- 37 The coming of age for ESG data - *ACA Group*
- 41 Three trends in sustainable lending - *Close Group Consulting*
- 43 UK Qualifying Asset Holding Company tax regime - *PwC*
- 47 Credit outlook pulse check - *Blue Owl Capital*
- 52 The rise of hybrid funds - *Simmons & Simmons*
- 57 Hong Kong taps into Asia Pacific growth - *KPMG China*
- 62 State Street data opportunity study: The growing importance of human capital in data operations - *State Street*
- 66 Alternatives: Becoming mainstream in India asset allocation - *Nuvama Asset Services*
- 70 2023: A compliance odyssey - *Torq Capital Management*
- 73 Empowering hedge funds: How getting KYC and KYP right can transform the investor experience - *Aivia*
- 76 Prime brokerage: Consistency, reputation & service are key - *TD Cowen*
- 78 Publication plan 2024
- 79 Contact us

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PERSPECTIVES

Industry leaders on the future of the hedge fund industry

Mark Wong
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Seth Fischer
CIO and Founder
Oasis Management



Jane Buchan
CEO
Martlet Asset Management



Message from AIMA's CEO

“

2023 has been a fascinating year for putting to the test many academic theories about how acute market conditions would impact various segments of the alternative investment industry. As we close 2023 with the final edition of the year of the AIMA Journal, contributors have naturally taken the opportunity to reflect on what we have learned.

One contributor observes how Europe's asset-backed securities market has remained resilient despite the higher interest rate environment we remain in. In fact, observations that certain sectors or whole markets have proved 'resilient' despite the challenging market environment is a recurring theme of this edition.

Staying in the EU, contributors note that the market's ESG market continues to evolve, partly driven by regulations such as SFDR, and the responsible investment market is now more clearly defined than it was previously and will continue to improve, with new products and services coming to market.

Not all regulatory change has been welcome, however. Another contributor addresses the important question of how the SEC's Private Fund Adviser Rules will impact non-US managers. This has also been a key area of focus for AIMA all year as we seek to ensure our global membership is aware of the stringent terms these new rules will bring globally.

The variety of articles in this edition focused on compliance with various regulatory frameworks around the world gives some indication of the scale of upheaval our industry has had to endure this year. And the signs are that the industry will have to endure further challenges over the coming year.

My thanks, as always, go to all the contributors to the AIMA Journal this year, who ensure it will continue to be one of our most popular and widely read resources going forward.

Sincerely,

Jack Inglis
CEO, AIMA



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RSM

Multi-managers: Their impact on UK start-ups and the evolution of their relationship with single managers



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What are multi-managers? Examples include Lighthouse, Millennium, Citadel, Schonfeld, Point72, Man GLG et al. They do it in different ways but, put simply, a multi-manager would hire, or otherwise engage with, portfolio management teams, which would become reasonably autonomous ‘pods’ within the firm. Each pod would have their own profit and loss (P&L), perhaps even manage their own fund, sub-fund or cell, but would be subject to the firm’s overall risk management and allocation policy and the firm’s strict risk parameters. In many ways, each pod is almost running its own hedge fund within the multi-manager.

I would recommend readers to the series of articles relating to multi-managers that have been in the FT recently.¹ Unfortunately, the FT has the rights to *multimanagerverse* so the title to this piece ended up being less superheroic as a result.

This article looks at the impact that multi-managers have had on hedge fund start-ups in the United Kingdom and considers the developing relationship between multi-managers and single managers (the term this article will use to distinguish hedge fund managers that are not multi-managers).

Starting up: single managers, multi-managers, regulatory hosts and going your own way

Broadly, a hedge fund start-up has a full spectrum of options (and there are a variety of different flavours for each option):

Option 1. Join an existing hedge fund manager – everything aside from portfolio management is done for you and you get access to the firm’s systems and infrastructure. You benefit from the firm’s brand and its capital raising efforts. You might even get your own fund to manage but you won’t get more than a personal brand. Ultimately, you are a cog in a much larger machine. You are not your own boss. Your performance will be assessed by the firm and the firm may decide to part ways if performance is not as expected.

¹ See, for example, “Hedge funds make it rain (for banks)” (Rupak Ghose, 21 July 2023); “Are hedge fund pioneers facing the end of a golden era?” (Harriet Agnew and Ortenca Aliaj, 24 August 2023); “Across the multimanagerverse” (Robin Wigglesworth, 24 August 2023), “Ken Griffin calls the top” (Harriet Agnew, 4 September 2023).

Option 2. Join a multi-manager - everything aside from portfolio management is done for you and you get access to the firm's systems and infrastructure. You benefit from the firm's brand and its capital raising efforts. You are able to develop more of a brand for your own business and you may get a fund (or, more likely, a cell in an umbrella segregated portfolio company), which may have your own business' branding.

You might even have your own entity that can build up its own brand to an extent. Ultimately, you are one of many pods. You are not your own boss. Your performance will be closely assessed by the firm and the firm may decide to part ways if performance is not as expected. This is much more likely to happen than under Option 1.

Option 3. Use a regulatory host - everything aside from portfolio management is done for you and you get access to the firm's systems and infrastructure. The firm may or may not be able to assist with capital raising but the onus is on you to raise the capital for your fund. You can set up your own fund vehicle (which may be independent of the host, or which may be provided by the host via a "fund out of the box" or a cell in an umbrella SPC platform). You are able to develop a brand for your own business and fund. You are your own boss (albeit working within the restrictions and parameters of the host). Your performance will be assessed by your investors. The host may decide to part ways, but this is much less likely to be on the basis of performance.

Option 4. Set up your own hedge fund management business - you need to make sure everything is done, and you need to build or buy in your firm's systems and infrastructure. The onus is on you to raise the capital for your fund. You can set up your own fund vehicle. You are able to develop a brand for your own business and fund. You are your own boss. Your performance will be assessed by your investors. We would note that getting FCA authorised from day one is not very common anymore, although we do still see it. Even the larger UK launches often use a regulatory host, if only to cover the FCA application period.

The lines are hazy between multi-managers and other hedge fund firms (particularly, multi-strategy firms), on the one hand, and multi-managers and FCA regulatory hosts, on the other. Some of the multi-managers are essentially a form of hybrid regulatory host...with some very crucial differences!

All these terms are certainly terms of art rather than science. The above options should be viewed as a simplification.

Impact on UK start-ups

Particularly in the last 5-6 years, the multi-managers have experienced outsized growth² as the barriers to entry for new managers remained high and the capital raising environment remained difficult (and the cash incentives of joining a multi-manager remained stratospheric).



The lines are hazy between multi-managers and other hedge fund firms (particularly, multi-strategy firms), on the one hand, and multi-managers and FCA regulatory hosts, on the other.

Some of the multi-managers are essentially a form of hybrid regulatory host...with some very crucial differences!

² Source: Goldman Sachs

The multi-manager model has certainly had an impact on the number of hedge fund start-ups in the UK and we have often been asked to advise teams proposing to join a multi-manager, where, for one reason or another, the teams have decided not to set up their own business. On the other side of the coin, we are often asked to advise teams that are leaving a multi-manager...

In the event of negative performance, capital can easily be taken away from your pod and your pod could even be closed and you and your team dismissed if performance thresholds are breached. This point cannot be overstated. The multi-managers have a reputation for being pretty brutal.

The barriers remain high for new entrants (particularly those choosing option 4, page 10) but option 3 (the regulatory hosting route) is very much alive and kicking. Q4 2023 and Q1 2024 are looking to be very active in the hedge fund start-up space in the UK.

Evolution of the multi manager model and its place within the ecosystem

The multi manager model is reportedly facing a number of issues (including the *hedge fund talent war*) but I would not say that they are (all) in trouble. They are a feature of the landscape and are here to stay.

They are possibly a victim of their own success in that they have large amounts of excess capital. Barclays estimates that at least 40% of multi-manager capital is allocated to external managers.³ In some respects, therefore, multi-managers could step into the capital allocation role that used to be dominated by the funds of hedge funds back in the day.

For a single manager, therefore, multi-managers are simultaneously competitors and potential sources of capital (for managed accounts, at least).

Can single managers compete with the multi-manager model?

Absolutely.

Single managers can compete with multi-managers with respect to each of the most common concerns levelled against multi-managers:⁴

Fees – when compared to the typical fee model of a multi-manager (i.e., pass through (almost all) expenses plus a performance fee), a good old 2 and 20 seems very attractive (provided the performance is there).

Technology – multi-managers have invested huge amounts in technology and systems, but outsourced technology is getting better and more affordable. Adam Davies, CEO and co-Founder of RSe, which aims to help single managers close the gap between them and their multi-manager cousins, says: *“There are 3 key problems that we identify in whether single managers can compete with multi-managers in the next few years. Problem 1: Does the investment industry best utilise Artificial Intelligence? Problem 2: How do small and medium-sized managers keep pace with the industry giants, who, with deep pockets, can spend millions on developing their own optimisation tools? Problem 3: SMA allocations continue to dominate, with non-pari passu often being the preference.”*

³ Source: Barclays, HFR, HFM, Pivotal Path, Capital Solutions

⁴ Source: Goldman Sachs

In order to sustain their profit margins amid fee pressure and costly resources for separately managed accounts, outsourced portfolio enhancement tools may be a key levelling factor.

Strategy – investors can invest in the strategy they want without it being diluted by the many strategies that a multi-manager may be running.

Liquidity – single managers should be able to offer better liquidity to investors. It is noted that most multi-managers are locking up capital, whilst sometimes seemingly taking a contradictory short-term view of pod performance.

Leverage - single managers should be able to offer tighter leverage restrictions to investors – multi-managers are infamous for the high levels of leverage that are used.

Transparency – single managers should be able to offer greater transparency than multi-managers.

Relationship – it should be possible to develop a closer connection and relationship between investor and portfolio manager.

Final thoughts

Multi-managers have very much become part of the equation in relation to both hedge fund start-ups and the flow, the management and allocation of capital in the hedge fund ecosystem.

The balance between multi-managers and single managers (both with respect to the number of start-ups and with respect to existing single managers) should be corrected in the short- to medium- term. The relationship between multi-managers, single managers and investors will continue to further evolve.

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Worldwide mobility explosion and implications for financial markets



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A new economic reality with high interest rates, high inflation and high asset price volatility is leading investors to desire more access to private investment products. As a result, certain limited partner investment structures are requiring more frequent and more timely valuations than the historical quarterly valuation paradigm. More frequent fair value estimates provide access to capital that would otherwise not be available. Investors can choose to move in or out of such vehicles when significant market movements occur, and more timely data allows for timely portfolio rebalancing and hedging. Outside of the macroeconomic changes, the world has been evolving with dramatic changes in the world of connectivity, which has and will continue to have greater impact on financial markets.

In this article, we will analyse both traditional economic indicators as well as alternative non-traditional data, including global mobility indicators—which also impact financial markets—and private equity investments. We will assess the impact on asset prices and how to practically incorporate the changes associated with macro- and sector-driven parameters on valuation of funds with portfolios of private equity investments as an example.

A new reality

In the past, the world was not as connected geographically, and events in one location only had a local effect. As such, investing in different geographies provided natural diversification. Is it still the case today? Not exactly.

A boom in connectivity and global mobility in the last 20 years reduced natural diversification. This can be observed by several metrics¹, including the number of passengers boarding planes each year, the development of high-speed trains (500% up from 2010 levels¹ and doubling since 2050), the worldwide motor vehicle production (up 30% from 2000 to 2022²) and the greater distances covered by railroads. See Figure 1, page 15 for more details.

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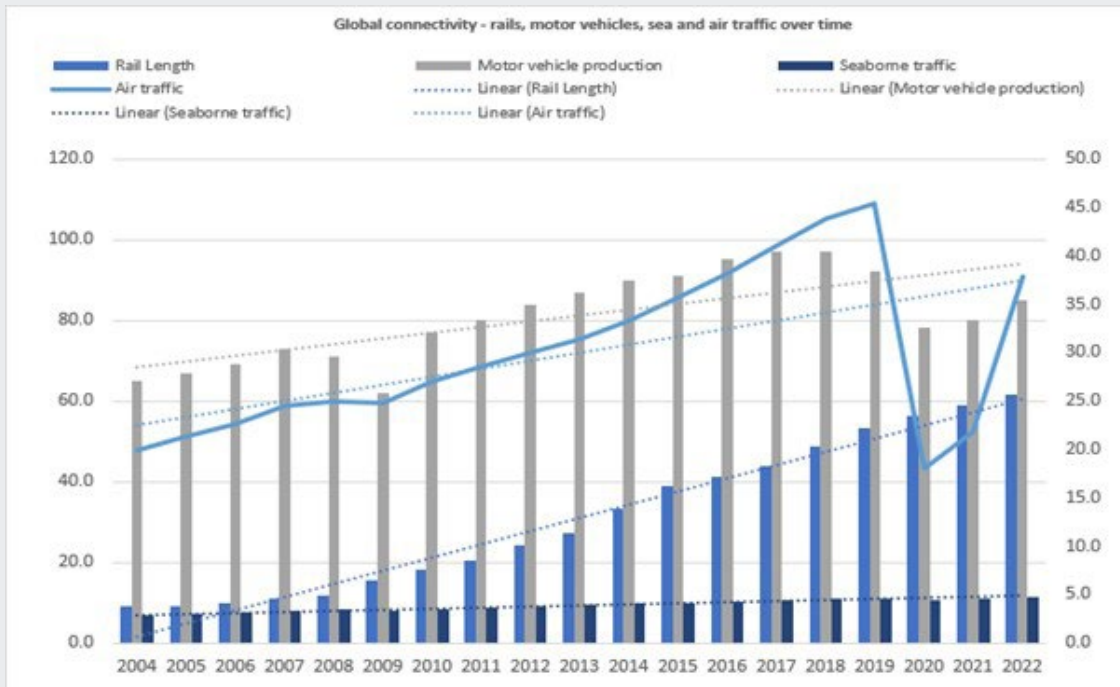
Is it still the case today?

Not exactly.

¹ Source: International Union of Railways & IEA

² Source: Statista.com

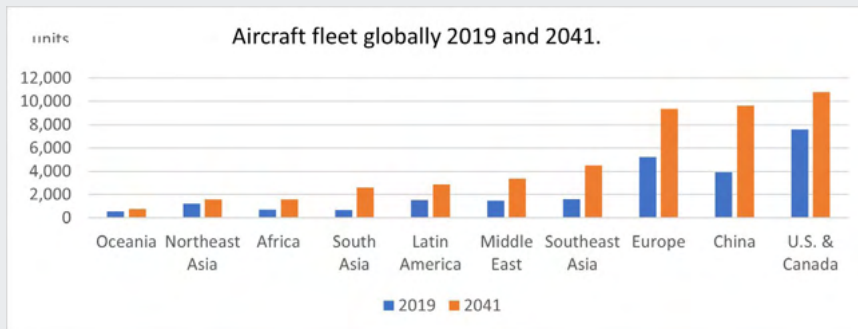
Figure 1 – Global mobility trends: Rail, motor vehicle and sea traffic



Source: Statista, Union of Railways, Kroll

Similarly, as shown in Figure 2, global aircraft demand is expected to grow further by 40% in the next ten years.³

Figure 2 - Size of aircraft fleets in 2019 vs. 2041



Source: Statista

The impact of greater mobility

With lower geographic diversification and higher interconnectivity, markets are moving faster, and it is becoming more and more important for all investments (including private and infrequently traded instruments) to be valued on a more frequent basis. The common cadence of quarterly or semi-annual valuation limits an investor's ability to hedge/rebalance timely enter/exit positions in a response to market movements and exposes funds to potentially significant financial losses.

As the need for more frequent valuations becomes evident, how would this work for illiquid private markets and associated reporting of fair value?

³ Source: [www.oliverwyman.com](https://www.oliverwyman.com/our-expertise/insights/2017/jun/paris-air-show/global-commercial-aircraft-fleet-to-grow-to-more-than-35000.html) - <https://www.oliverwyman.com/our-expertise/insights/2017/jun/paris-air-show/global-commercial-aircraft-fleet-to-grow-to-more-than-35000.html>

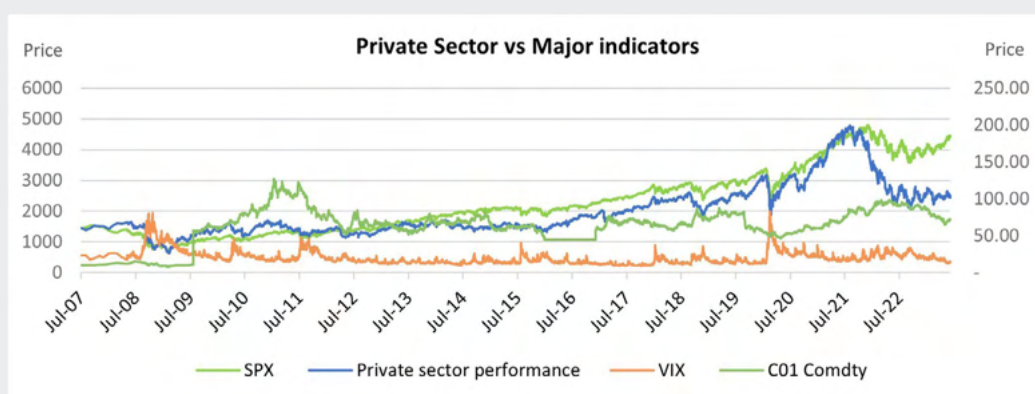
The link between private markets, major economic indicators and public markets

There have been discussions in the industry about the so-called denominator effect,⁴ which is when public market valuations move significantly, and private markets do not. These markets rarely move in-sync due to the impact of company-specific esoteric factors and since private markets tend to be less volatile. Nonetheless, private markets indeed follow the public markets and changes in macroeconomic indicators directionally, but with a lag.

We performed a regression analysis from Q3 2007 to Q3 2023 using daily observations of Foreign Exchange (FX) rates, interest rates, commodities, main equity indexes and to analyse movements in the private market (as evidenced by the valuation of companies with major exposure to private markets) and major economic indicators. We found that public markets provide a good fit in terms of directional movement, though not necessarily for the degree of magnitude.

As shown in Figure 3 below, private sector performance is highly correlated with the public market, but with a two to three-month lag. Private market performance has been negatively correlated with volatility, interest rates, inflation and oil prices and positively correlated with the equity markets.

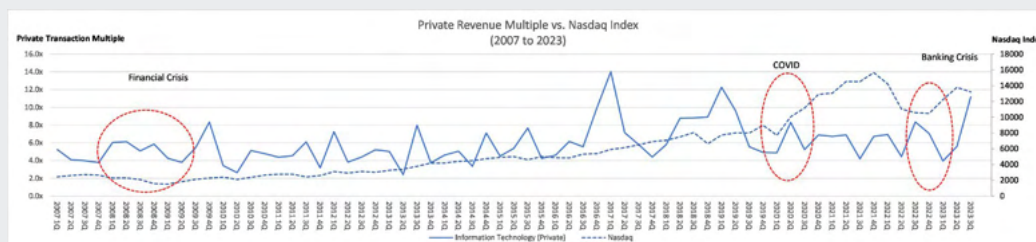
Figure 3 - Private sector moves in synch with major indicators



Source: Bloomberg, CapitalIQ, Kroll

We also looked at the private market performance as represented by the private sector transaction multiples since 2007. Using the technology sector as example, we can see that EV/revenue multiples for private companies in the financial sector moved in synch with the public markets, i.e., Nasdaq.

Figure 4: Private technology sector revenue multiples vs. Nasdaq



Source: Bloomberg, CapitalIQ, Kroll

We can see from Figure 4 above that major market dislocations (in both private and public markets) were linked to major world events.

⁴ The denominator effect occurs when the value of one part of a portfolio decreases substantially and decreases the overall value of the portfolio so that any parts of the portfolio that did not decrease in value now represent a larger portion of the overall pie. Source: www.benchmarkcorporate.com

Implications of mobility for financial markets

Apart from geopolitical factors, the latest and greatest shocks to financial markets were a result of the COVID-19 pandemic followed by the collapse of Silicon Valley Bank and the US banking crisis. However, these were not an isolated events as pandemics and recessions have been recurring.

World pandemics and recessions

Tremendous developments in global connectivity have made the spread and impact of pandemics and recessions faster and more global. While we note that pandemics and recessions have occurred throughout history—including three plagues, seven cholera pandemics, variety of flus, COVID-19 and four global recessions—the frequency of pandemics and recessions occurring globally could be linked with the increase in global connectivity. Therefore, considering the pace of mobility development may indicate an exposure to future market volatility. The next pandemic or local financial crisis could potentially spread from one isolated location to another as goods and people transfer faster and have a wider impact.

Overall, given the increased global mobility and the potentially faster spreading of pandemics and market volatility, tracking factors/indicators beyond traditional valuation inputs is becoming more crucial.

From quarterly to monthly and daily valuation

Marking investments daily has been a requirement and is already frequent practice for the sell-side market,⁵ but now some of the investors on the buy-side⁶ are interested in more frequent valuation.

However, how can this realistically be achieved when, in practice, the net asset value (NAV) for underlying portfolios are only available quarterly and with a time-lag?

As Partner Capital Account Statements (PCAPs) are provided on a quarterly basis, the reported NAV is used as the starting point for estimating the value of a fund interest at each subsequent monthly or daily valuation date. Afterward, adjustments for capital calls, distributions and the estimated changes in the fair value of underlying investments will be made. While for actively traded investments, the change in the fair value will be determined through the following: market price, a market adjustment factor based on a benchmark that is considered to be most representative of the portfolio (i.e., an index basket according to industry/size/rating) and a correlation coefficient, which will be estimated and utilised for the non-frequently traded investments to evolve the last reported NAV accordingly. Additionally, changes in cash and company-specific esoteric factors are considered.

The choice of indexes can be substantiated through back testing of the portfolio performance (through historical NAV statements) versus the movement in the publicly available benchmarks and index baskets. However, the results would be as robust as the starting NAV statements and additional deep dive analysis would be required on a periodic basis for private equity positions that require professional judgement. In addition, back testing review should be performed to redial the model.

5 The sell-side focuses on the **creation, promotion, and sale of stocks, bonds, foreign exchange**. (Source: Investopedia)

6 The buy-side refers to **firms that purchase securities**. (Source: Corporate Finance Institute)

And while the regression captures market factors, judgment needs to be applied concerning which idiosyncratic factors are relevant and how large of an impact they have. PCAP statements provide periodic feedback and indicate if adjustments are necessary.

While this process involves multiple steps, it allows the investment vehicle to provide fair value estimates to investors on a timelier and more frequent basis. Overall, it provides an advantage of being able to respond to world events and rebalance the portfolio much faster.

Summary

Global connectivity and mobility have caused our world to evolve, resulting in potentially more fluid/volatile prices across asset classes, including less frequently traded securities such as private equity. The next market shock or pandemic could now have a much greater affect as goods and people can move across greater distances faster than ever, potentially impacting cross dependency and connectivity of asset prices. Overall, this new world with greater world connectivity could pose more challenges for companies that do aspire to have more frequent valuation.

Updating the valuation for private equity securities is a combination of complex modelling coupled with qualitative analysis. Granted there would always be a large component of company-specific factors in private assets that requires professional judgement, the macro- and industry-specific factors could be considered more frequently. Most importantly, up-to-date valuation estimates provide a greater understanding of the portfolio and allow for more informed decision-making.



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Navigating change: How the European ABS market proves to be resilient through challenging times

The European securitisation market has been **navigating a very volatile year**, largely due to persistent geopolitical tensions, inflationary pressures, and increasing interest rates. This turbulence has had a negative impact on the issuance and placement rate of Asset-Backed Securities (ABS).

However, the second quarter of 2023 witnessed a **period of diminished volatility, even if it was still accompanied by some uncertainty**. The total issuance surged to €95.4 billion, marking an impressive escalation of 166% compared to the preceding quarter (€35.9 billion in Q1 2023) and a significant leap of 177% from the second quarter of the previous year (€34.5 billion in Q2 2022).

Shifting our attention to the Year-to-Date (YTD) volumes, the first half of 2023 witnessed a significant increase of 31.1% when compared to the latter half of 2022 (H2 2022), **resulting in a total of €131.3 billion**.

Notably, this exponential upswing can be largely attributed **to the BPMHL programme**, a massive €49.5 billion transaction focused on residential mortgage-backed securities, which was entirely retained. It's important to highlight that this substantial deal had a negative impact on the overall placed amounts in Q2 2023, constituting only 21.3% of the overall issuance volume.

Amidst these market dynamics and the complexities of securitisation products, it becomes evident that **data plays a crucial role in deepening our understanding of this ever-changing landscape**.

Securitisations are often complex products, making standardisation in terms of disclosure and performance analysis challenging due to their inherent complexity and the differences between transactions.

As a result, **investors must commit substantial effort** to conduct due diligence on potential securitisation investments and regularly monitor various factors that influence the performance of their holdings.

It is obvious that missing data stemming from the lack of transparency, as well as low quality or lack of standardisation, **hinders a proper overall assessment**.

To navigate these challenges, leveraging the right tools is paramount. For this reason, Cardo AI has designed a **market intelligence tool to empower investors with the data needed to**



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make informed decisions. Users can access powerful metrics, including delinquency rate, default rate, prepayment rate, collateral analysis, and risk metrics such as transition matrix, that provide deep insights with over 10 years of historical data. This invaluable resource equips investors with **the means to confidently assess and harness new investment opportunities while effectively managing risks in the securitisation market.**

The current state of the SME ABS market

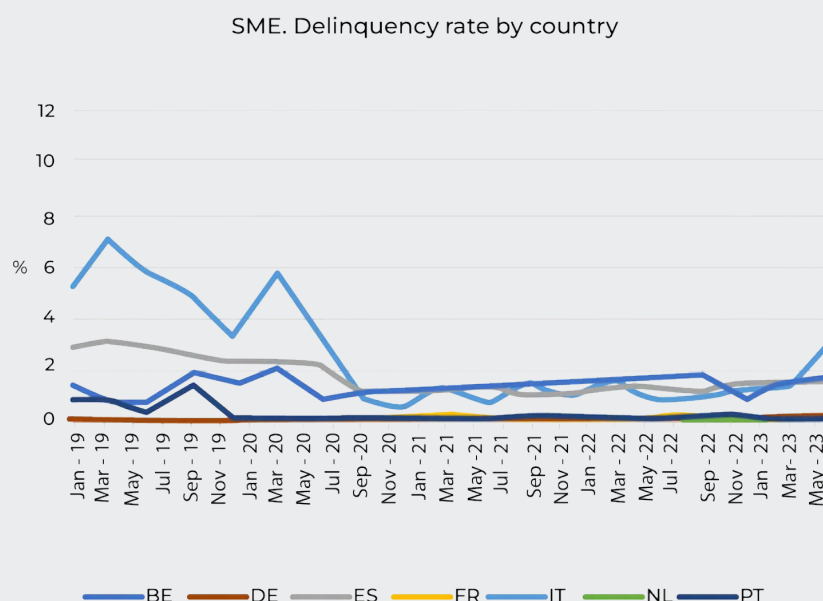
The SME ABS segment constitutes approximately 13% of the total market outstanding volume and has experienced significant growth over the years. The total outstanding volume has risen from €86 billion in Q1 2017 to its current level of €100 billion.

By analysing the evolution of the SME ABS market's composition over time, four key elements emerge:

1. **The SME ABS market has grown from €85 billion in 2015 to €110 billion at the end of Q2-2023.** Moreover, it has seen roughly 4 million new loans issued from 2020 through June 2023. This segment is, therefore, comprised of relatively young loans, on which the changes in macroeconomic conditions are yet to be fully reflected.
2. When looking at the three largest countries by lending amount, **Italy has the largest manufacturing sector as ranked by the NACE code**, Spain's largest sector is agriculture, and Belgium's is financial, professional, and administrative services.
3. The percentage of non-performing loans (i.e., delinquent, and defaulted loans combined) **has steadily decreased over the last decade**, from the heights reached after the great financial crisis (peaking at 12%) down to the current level of 5%.
4. **Defaulted loans and late-stage arrears have made up a relatively larger proportion of non-performing loans over time**, particularly before 2017.

Stable inflation levels and low-interest rates have provided **a solid foundation for the market.** Despite the current low levels of non-performing loans, key risk indicators reveal that in countries where moratoriums and other amortising techniques have been used, there is now a noticeable response to the surge in inflation and interest rates.

Figure 1

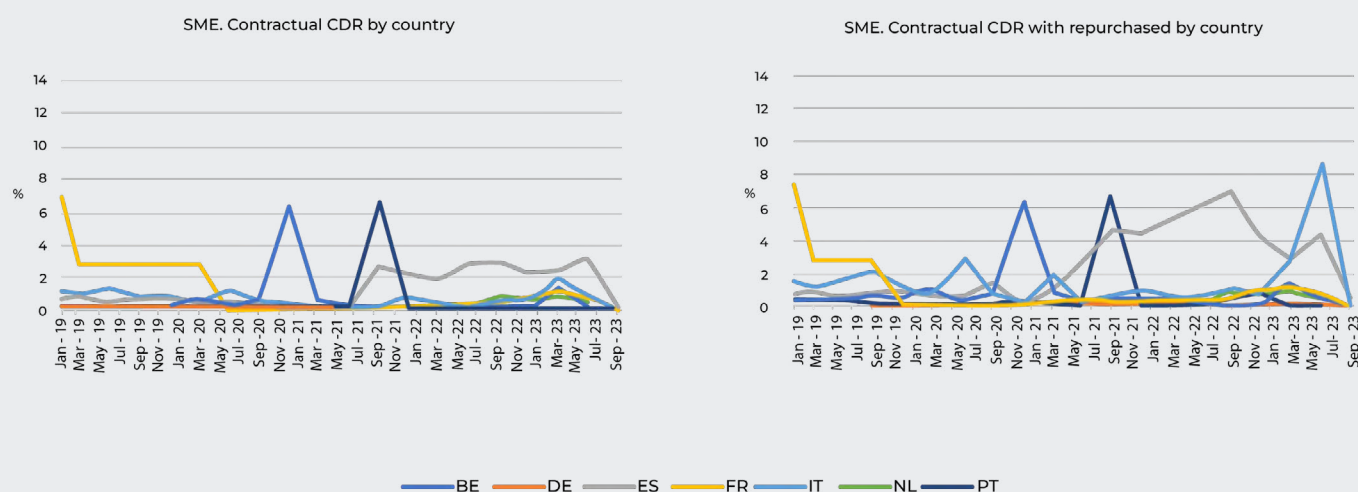


In Italy, for instance, a substantially stable trend is observed from COVID-19 to January 2023. **This stability can be attributed to various measures put in place to mitigate the effects of inflation and the pandemic.** However, when we examine the data for Q2 2023, we notice that the mitigating effect is diminishing, with delinquency increasing by about 1%, and there is a potential for further increases.

Following the Constant Default Rate (CDR) analysis, when comparing the two charts below, the second of which reclassifies as default those loans that have been repurchased (assuming this as a strategy to avoid impairing statistics and triggers), **it is possible to assert that some countries have implemented a proactive repurchase strategy to control the growth rate of CDR.**

For example, Italy shows a difference of about 5% between the first and second charts, suggesting a significant level of repurchases during that time. This strategy has been predominantly employed in countries like Italy, Spain, and Belgium. During the last quarter, Belgium and Italy extensively utilised this approach to counteract the impact of inflation.

Figure 2



The current state of the RMBS market

Starting from 2015, with nearly 800 transactions and a total outstanding amount of €460 billion as of Q2-23, **our dataset enables us to comprehensively analyse the main trends and features of the European Residential Mortgage-Backed Securities (RMBS) market, including the UK.** An added value to our dataset is the opportunity to perform highly detailed, loan-by-loan level analyses on the most significant metrics. Furthermore, the dataset are constantly updated, including the latest data, enabling timely analyses on key market trends.

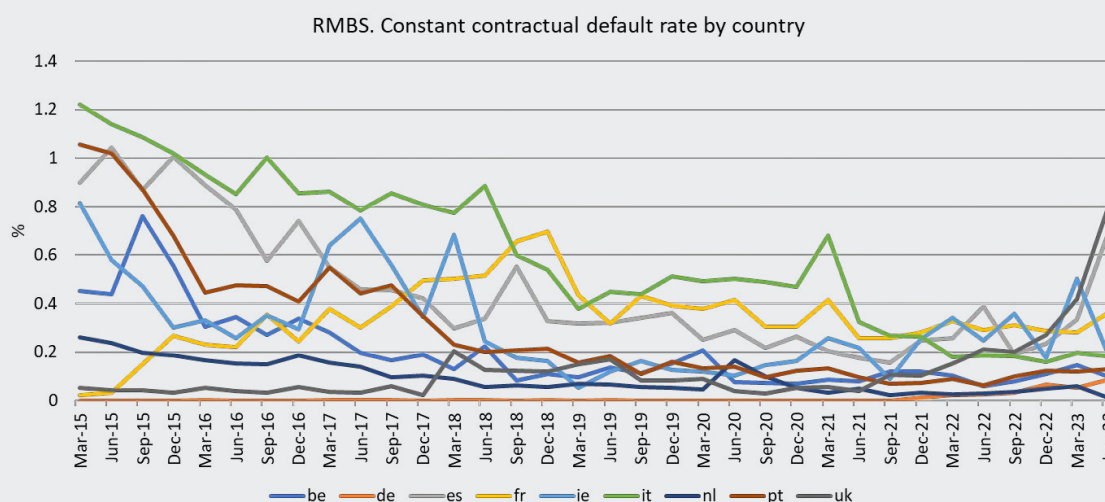
To better understand the impact of inflation, **we have used the CDR as the primary metric for evaluating this asset class.**

Figure 3 below displays the CDR per country from the beginning of 2019 to June 2023, according to the contractual definition. It provides insights into how the default growth rate has behaved over this period.

When examining the data from Q2 2023, it becomes evident that both Spain and the UK exhibited the most pronounced reactions to inflation. Both countries witnessed an increase of approximately +0.5% in June 2023, effectively returning to the levels observed before the COVID-19 pandemic.

On the other hand, countries such as Italy, the Netherlands, and Portugal continue to show a stable trend.

Figure 3



Q2 2023 and future outlook

DBRS Morningstar has revised its securitisation issuance forecast upwards. In January 2023, the forecast ranged from **€185-195 billion**. However, by June 2023, this projection was further adjusted to **€195-200 billion**. The adjustment can be primarily attributed to a significant surge in the issuance of RMBS in both France and the UK.

With the impending maturity of substantial amounts of central bank funding, specifically Targeted Longer-Term Refinancing Operations (TLTRO), **securitisation is poised to assume a pivotal role in the funding strategies of European banks**. This potential stems from its ability to counterbalance the anticipated reduction in central bank funding and enhance the diversification of funding sources, considering that 75% of European bank funding is derived from deposits.

However, a contrasting observation emerges from the **Funding Plan report issued by the European Banking Authority (EBA)**. This report encompasses the funding plans of 159 banks that have submitted forecasts spanning from 2023 to 2025. While securitisations have the potential to play a substantial role in banks' funding strategies, they do not appear to feature prominently among the main funding sources that respondents intend to prioritise in 2023. **This might also be explained by an increasing preference among market participants for private transactions**, which allows for a more tailored approach to investor needs while providing a shield from market volatility.

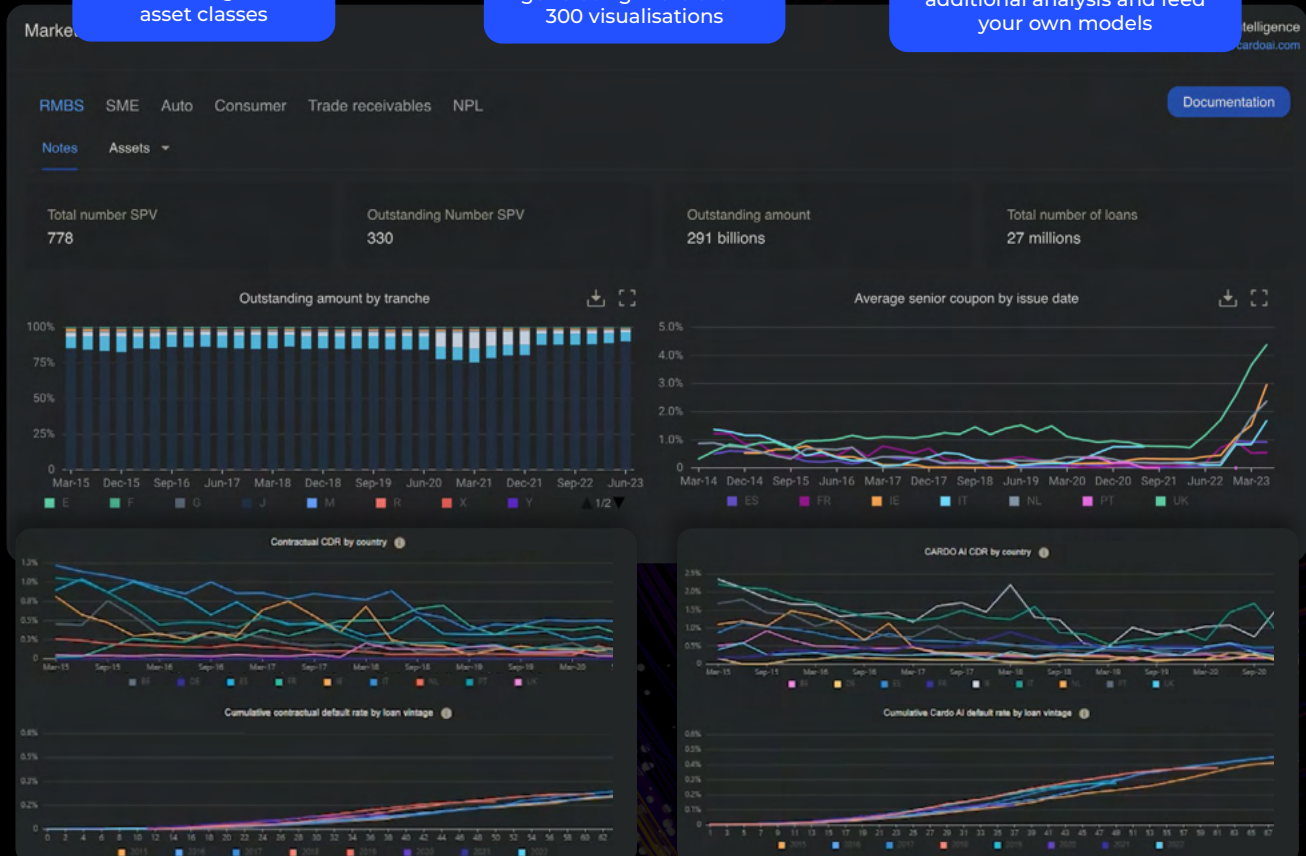
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SFDR 2.0 – A time for evolution

On 14 September 2023, the European Commission launched a public and [targeted consultation](#) on the implementation of Sustainable Finance Disclosure Regulation (SFDR) (the Consultation). The Consultation seeks to assess the SFDR framework (identifying any potential shortcomings) whilst also focusing on the usability of the regulation and its ability to play its part in tackling greenwashing.

The Consultation is ambitious and wide ranging, and seeks feedback on the costs, disclosure and data associated with SFDR compliance as well as how SFDR interacts with other sustainable finance legislation. But perhaps what is of most interest is the Consultation's questions in respect of the development of *"a more precise product categorisation system"*.

The European Commission acknowledges in the Consultation that SFDR is already operating as a de facto product labelling regime. Specifically, the Consultation asks for respondents' view on the statement that *"SFDR is not used as a disclosure framework as intended, but as a labelling and marketing tool"*. Rather than seeking to re-focus SFDR as a disclosure regulation, the European Commission has proposed two possible approaches in the Consultation for repurposing SFDR 2.0 as a product regime.

The first approach put forward is to *"build on and develop the distinction between Articles 8 and 9"* and the existing concepts embedded in them (such as environmental/social characteristics, sustainable investments and do no significant harm), complemented by additional minimum sustainability criteria that more clearly define the products falling within the scope of each Article.

The second approach is to establish a new product categorisation system based on the product's investment strategy. The Consultation has proposed four sustainability product categories, namely:

1. Products investing in assets that specifically strive to offer targeted, measurable solutions to a sustainability related problem;
2. Products aiming to meet credible sustainability standards or adhering to a specific sustainability-related theme;
3. Products that exclude activities and/or investees involved in activities with negative effects on people and/or the planet; and
4. Products with a transition focus aiming to bring measurable improvements to the sustainability profile of the assets they invest in.

Firstly, it must be recognised that publication of the Consultation is timely and represents a positive step by the European Commission.

The challenges presented by the phased implementation of SFDR have been well documented. So the opportunity for industry to provide feedback to the European Commission, particularly so soon after its full implementation, is extremely welcome.



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Looking at the two approaches proposed in the Consultation, we would be supportive of the first approach - to build upon and enhance the existing SFDR framework, as opposed to potentially starting again with entirely new sustainability product categories. We would contend that, rightly or wrongly, the ship has sailed on SFDR being purely a disclosure regulation. In reality, it is being used as a de facto labelling regime. Industry (at both the market participant and investor level) has adopted the three categories of sustainability funds identified within SFDR as product labels. The concept of an Article 6 fund, an Article 8 fund and an Article 9 fund have all now entered into the asset management lexicon. There is growing understanding of the basic distinctions between each of these categories. We would also contend that, in addition to SFDR no longer being a simple disclosure regulation, the way in which it is being implemented by EU regulators (in particular, the oversight role of the depositary) has seen it already transform into a quasi-product regime.



We believe introducing minimum sustainability criteria will be key, not only from distinguishing between Article 8 and Article 9 funds, but also between Article 6 and 8 funds.

SFDR remains in its infancy and is still evolving. However, as we observed in our [SFDR Impact Analysis](#), SFDR has already had a significant positive impact on the European funds space. Assets in European sustainable focused funds have exceeded €5 trillion. Over 40% of all new funds established in the European Union are seeking categorisation as either Article 8 or Article 9 funds. Even at this early stage, all signs suggest that SFDR is indeed contributing towards the objectives of the European Green Deal to reorientate private capital towards the transition to a climate-neutral, green and inclusive European economy. It would perhaps be a step backwards if the categories of Article 8 or Article 9 funds were, as the Consultation phrases it, to “disappear altogether from the transparency framework”. Rather, we believe that the European Commission should embrace how SFDR has developed to date, and focus its efforts on the areas which need enhancement or further clarity.

We would also be supportive of the Commission building on the distinctions between Article 8 and Article 9 funds. We believe that introducing minimum sustainability criteria will be key, not only from distinguishing between Article 8 and Article 9 funds, but also between Article 6 and 8 funds.

SFDR currently does not apply any minimum sustainability criteria or thresholds for what constitutes an Article 8 fund. As a result, the Article 8 category has become quite a broad church. We have seen plenty of what could be described as *strong* Article 6 funds demonstrating more ESG credentials than a *weak* Article 8 fund. The theme of Article 8 funds currently capturing wide-ranging and varying degrees of sustainability is a theme echoed in the feedback and guidance being issued by regulators across Europe in recent months. Regulators have warned that the Article 8 category should not in and of itself be relied upon as reflecting distinct levels of sustainability, and that managers should therefore not be using SFDR categorisations as sustainability labels. Regulators have similarly queried whether such an approach meets the spirit of SFDR.

Introducing minimum sustainability criteria would address these issues. Establishing a baseline of what constitutes an Article 8 fund would also provide investors with more certainty about its ESG credentials, whilst also affording them the reassurance to compare Article 8 funds with greater certainty.

Looking at the second approach proposed, while encouraging the creation of these types of products is laudable, it would be our view that these types of products are already being established as either Article 8 or Article 9 funds in the existing SFDR framework. Removing the existing Article 8 and Article 9 categories entirely, and replacing them with the proposed four new types, would likely lead to another lengthy implementation period for the industry. In turn, this would potentially entail significant new implementation costs being borne by asset managers, the funds and most importantly, investors. The Consultation acknowledges (and is seeking to further examine) the impact that SFDR compliance has had on both initial and recurring annual costs. It would therefore seem at odds with that view if SFDR 2.0 was to be an entirely repurposed regime.

In examining how the existing Article 8 and 9 categories can be enhanced, the Consultation is asking the right questions. Evolving SFDR and the Article 8 and 9 categories would allow managers to build on its success to date, while also embracing its evolution into a product regime through more precise categorisation criteria.

The Consultation remains open until 15 December 2023 but the European Commission has not yet committed to a timeline for subsequent reforms. Managers should take comfort that any substantial changes to SFDR or the introduction of a new categorisation regime will take a number of years before entering into force.

Learn more about the Maples Group's [ESG Advisory Group](#).

The SEC's Private Fund Adviser Rules: Key considerations for non-US managers

Background

On 23 August 2023, the US Securities and Exchange Commission (SEC) adopted new rules (Final Rules) under the US Investment Advisers Act of 1940 (Advisers Act) that will significantly reform the scope of reporting, disclosure and other obligations imposed on investment advisers to private funds (Private Fund Advisers).

The Final Rules have five major components, with certain rules applying only to SEC-registered Private Fund Advisers (Private Fund RIAs) and others applying to Private Fund Advisers regardless of their SEC registration status:

- Requirements to distribute quarterly statements;*
- Annual fund audit requirements;*
- Conditions for adviser-led secondary transactions;*
- Restrictions on certain activities, including charging funds for certain types of expenses; and
- Restrictions on preferential treatment of investors.

* *Applies to Private Fund RIAs only*

The compliance date for the Final Rules will be staggered based on the Private Fund Adviser's level of private fund assets under management (Private Fund AUM) as defined in Form ADV and Form PF. Certain rules¹ will come into effect on 14 September 2024 for Private Fund Advisers with at least US\$1.5 billion in Private Fund AUM, with the remaining rules coming into effect on 14 March 2025 for all Private Fund Advisers. These implementation dates may be delayed, depending on the outcome of litigation regarding the Final Rules.²

General applicability to non-US managers

Although a large volume of material has been produced examining the implications of the Final Rules, most of the analysis to date has been from the perspective of US-based Private Fund Advisers.

Overall, the Final Rules will have limited impact on managers whose primary office and place of business is located outside the United States (Offshore Advisers), and this is the case even if the Offshore Adviser is registered with the SEC as an investment adviser (an RIA).



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Any commentary or opinions herein do not reflect the opinions of Dechert LLP.

¹ Private Fund Advisers with at least US\$1.5 billion in Private Fund AUM have a compliance date of 14 September 2024 for the Restricted Activities Rule, Preferential Treatment Rule and Adviser-led Secondaries Rule. The Audit Rule and Quarterly Statement Rule will have a longer transition period to allow Private Fund Advisers additional time to implement the necessary systems and negotiate with service providers. All Private Fund Advisers must comply with the applicable rules by 14 March 2025.

² Multiple industry bodies, including AIMA, have filed a lawsuit with the US Court of Appeals for the Fifth Circuit challenging the adoption of the Final Rules.

The SEC confirmed in the Final Rules' adopting release³ that with respect to the Final Rules the SEC staff will follow its longstanding position of not applying substantive provisions of the Advisers Act to Offshore Advisers with respect to their non-US clients (and a fund domiciled outside the US is a non-US client, whether or not it has US person investors in it).

The practical implication is that for most Offshore Advisers, the Final Rules will only apply to their US-domiciled private funds (e.g., Delaware funds). Nevertheless, several interpretive questions remain for Offshore Advisers, which we will examine briefly at the end of this note.

As a threshold matter, many Offshore Advisers are still grappling with how the Final Rules will apply to their business. There are various instances where an Offshore Adviser will come within scope of the Final Rules. Offshore Advisers may be able to determine that they are outside the scope of the Final Rules by asking three key questions.

1. Is the fund a 'private fund' covered by the rules?

The Final Rules apply to 'private funds' which is any fund that would be required to register under the US Investment Company Act of 1940 (1940 Act) but for the exceptions under Section 3(c)(1) or 3(c)(7) of the 1940 Act. Most investment funds that are privately placed in the US rely on one of these exceptions.

Funds that are not required to rely on one of these exceptions, either because they are not offered or sold to US person investors, or because they can rely on a different exception (such as certain real estate funds relying on Section 3(c)(5)) are not subject to the Final Rules. In addition, funds that are registered under the 1940 Act (also known as "registered investment companies") are not subject to the Final Rules. The SEC also provided a carve-out for securitized asset funds (such as CLOs), which will not be subject to the Final Rules, even if they otherwise meet the definition of a private fund.

2. Where is the fund domiciled?

An Offshore Adviser is only subject to the Final Rules with respect to its US clients. Under the Advisers Act, a fund is the adviser's client (not its underlying investors), so a fund domiciled in a non-US jurisdiction is not a US client for these purposes, even if it is offered to US person investors. Absent other extenuating circumstances (see discussion below), an Offshore Adviser will generally not be subject to the Final Rules with respect to such a fund.

3. Is the Private Fund Adviser an RIA?

Certain Final Rules are only applicable to RIAs. If the Offshore Adviser is not an RIA (e.g., it is operating as a foreign private adviser under Section 203(b)(3) of the Advisers Act or an exempt reporting adviser (ERA) under Section 203(l)-l or 203(m)-l under the Advisers Act), then it will not be subject to the Audit Rule, the Quarterly Statement Rule

³ See *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Release No. IA-6383 (23 Aug. 2023) (Adopting Release) at footnote 126 and accompanying discussion.

or the Adviser-led Secondaries Rule. The only rules that such an Offshore Adviser would potentially be subject to are the Preferential Treatment Rule and the Restricted Activities Rule.

Below is a chart illustrating how the Final Rules will apply to Offshore Advisers in certain common circumstances:⁴

| Fact Pattern | Annual Fund Audit | Quarterly Statements | Restricted Activities | Preferential Treatment | Adviser-Led Secondaries |
|--|-------------------|----------------------|-----------------------|------------------------|-------------------------|
| Non-US Registered Investment Adviser (RIA) + US Private Fund | ✓ | ✓ | ✓ | ✓ | ✓ |
| Non-US RIA + Non-US Private Fund (with or without US investors) | | | | | |
| ERA or Foreign Private Adviser + US Private Fund | | | ✓ | ✓ | |
| Non-US ERA or Foreign Private Adviser + Non-US Fund (with or without US investors) | | | | | |

Other considerations for non-US managers

In addition to the initial question of determining whether an Offshore Adviser is subject to the Final Rules, Offshore Advisers should consider potential nuances in the application of the Final Rules, including the following:

1. Does the Private Fund have a US-domiciled sub-adviser?

The appointment of a US sub-adviser could bring a non-US fund within scope of the Final Rules. If an offshore fund has a US sub-adviser and is privately placed in the United States (as discussed above), that Private Fund will be subject to the Final Rules. If the US sub-adviser is an RIA, all five components of the Final Rules will apply; if the US sub-adviser is an ERA or otherwise not registered with the SEC, only the Preferential Treatment Rule and the Restricted Activities Rule will apply.

2. What if the Final Rules apply only to certain feeder funds within a Master-Feeder Structure?

Offshore Advisers to certain fund structures (such as a single master-feeder structure offering US and non-US feeder funds as different entry points for investors) may find that the Final Rules apply to a US feeder fund but not to other non-US funds within the structure. Offshore Advisers will need to consider how to treat investors across the different entry points within the single master-feeder structure, taking into account legal requirements in the home jurisdictions of the Offshore Adviser and the master and feeder funds and the development of market practice on this topic over time.

⁴ Note that this chart does not cover more nuanced fact patterns, such as a private fund that is sub-advised by a US-based RIA. These types of complex situations will need to be examined on a case-by-case basis.

There is also a possibility that investors will come to view the Final Rules as a baseline requirement, and the market may evolve so investors will expect managers to comply with the Final Rules even if a Private Fund Adviser is technically out of scope with respect to a particular vehicle.

3. *Potential conflicts between the Final Rules and home jurisdiction requirements for Offshore Advisers and non-US Funds*

As Offshore Advisers become familiar with the details of the Final Rule, they may identify potential conflicts between the Final Rule and local requirements of the home jurisdictions of the Offshore Adviser and/or the Private Fund. Offshore Advisers will need to consider how the specific requirements of the Final Rules – for example, the requirement to disclose preferential treatment/side letter terms given to certain investors in a fund to all investors in that fund, or the requirement to calculate performance information in the quarterly statement in accordance with specific guidelines – can be reconciled with compliance requirements under local law.

We expect more detailed analyses on the interplay of the Final Rules and various local requirements for Offshore Advisers and funds to be undertaken in the near future, and Offshore Advisers subject to the Final Rules should be on the lookout for these issues as they are identified.

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An aerial night view of a city skyline, featuring several prominent skyscrapers. Overlaid on the image are numerous glowing white arcs that connect different points across the city, symbolizing global connectivity and cross-border collaboration. The overall color palette is a deep blue with bright white highlights from the city lights and the glowing arcs.

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Succession planning: Handing over the reins

The effective leadership of a business is paramount to its success and strategic direction. Succession planning ensures continuity of leadership and owners should plan succession well ahead of time to protect the business. Planning involves time and effort from owners, senior management, professional advisors, and investors.

The hedge fund industry has grown rapidly in the past couple of decades. Managers who have been in operation from the beginning of this period may now find themselves in the mature phase of their life cycle needing to consider options and planning to pass on leadership roles. Hedge Fund managers often have a 'keyman', who is typically the founder/owner, and their name is usually attached to the business. When the 'keyman' eventually retires, continuity (and survival) depends on a smooth succession process. This article highlights some planning options available to owner/managers and key considerations for each option. The comments in this article are general in nature and not intended to be advice.

Passing to family – a *simple* option is to pass ownership to children/spouse or other family. This option may be beneficial from a tax perspective, with potential reliefs and exemptions for both Capital Gains Tax (CGT) and Inheritance Tax (IHT) - conditions apply. However, the unique nature of the asset management business, requires the successor to have the relevant skills, technical knowledge, and experience to carry on the leadership role. Alternatively, the successor family member may choose to retain ownership and appoint another individual to the management role. In either situation, the outgoing owner may hold a non-executive or advisory role after retirement to ensure a smooth transition.

Third party sale – the owner may sell to an external third party. For a successful business that can negotiate a fair price, this option could yield the maximum value. The sale of the business will be subject to CGT and any reliefs will have to be considered. Asset management businesses tend to have internally generated goodwill that is not on their balance sheet as an asset. Asset managers are a people business and their ability to generate income is linked to the individuals in the business, who are the key assets. A buyer is likely to retain key individuals to retain the brand value. The cost of this may be reflected in the price and it is likely that the owner can only step away gradually.

Rather than selling the business outright, a buyer partly invests in the business, and the existing owners dilute their holding over time.

Management Buy-Out (MBO) – here the management of the business buy the business. Whilst this could be an ideal option for an owner to secure the future of the business, it depends on the ability and willingness of the management team to take on the pressure and responsibility that comes with ownership, the unity of the management



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team and their ability to agree a realistic price with the owner. Private equity and debt are common ways that MBOs are funded. Other options include employee ownership trusts (EOT) (which could result in a tax-free sale) or awarding employees with incentive share options during their time in the business.

Having management personnel take over the business, may provide peace of mind to the owner and make their exit smooth in terms of handing over the business and keeping the legacy intact. The owner may be able to step away from the business sooner and may feel more comfortable with the management already knowing the business well and providing continuity.

The tax implications under this option will depend on how it is structured. Employees must consider the Employment Related Securities rules and the owner likely being subject to CGT, unless selling to an EOT.

Bringing in new talent – the owner may bring in new talent to take the business forward with a view to preparing them for future leadership. Planning for this usually starts well in advance as finding the appropriate person to bring into the business can be a lengthy process. More commonly, owners' mentor someone within their business with a view to promoting them and taking over the business once they eventually step down.

The owner may retain ownership of all or part of the business to later pass down to family, to a third party or new management in due course. The tax implications under this option would depend on the course of action taken.

Voluntary liquidation – where the owners do not want to run the business anymore and it is not viable to pass on the ownership to family members or third parties, it may be preferable to voluntarily liquidate the business. The assets and liabilities of the business are reviewed for this process to make a declaration of solvency stating that the company is able to pay its debts. This is followed by the shareholders passing a resolution for voluntary winding up and appointing a liquidator to complete winding down process, settling liabilities and distributing remaining assets to the owners. The tax implications of this option would depend on the tax profile of the individual shareholders / owners, the structure of the business and the availability of reliefs.

Going public – a less common option is to take the business public and make it a publicly traded and owned entity. Whilst this option is usually considered when raising capital for the business, it can also serve as an exit strategy allowing the owner to realise part or all of the value they have built up in the business. To be viable, the business requires a strong management team with a track record of strong performance to attract public investors with a sufficient return on investment. There are significant costs associated with the floatation process along with legal, accounting, and regulatory considerations that makes this option more time-consuming and expensive than others. There are also further considerations relating to the choice of stock exchange, valuation of the business and other administrative and statutory burdens that may dissuade owners from pursuing this option despite the ease of raising capital and increasing the company profile.



Having management personnel take over the business, may provide peace of mind to the owner and make their exit smooth in terms of handing over the business and keeping the legacy intact.

Further considerations

It is important to document provisions relating to leaving, disposal, winding up, dissolution, etc. in a business's constitutional documentation/shareholders agreement/partnership agreement as appropriate and have a clear path to follow when any such event occurs. Businesses may also choose to have a buy-sell agreement in place stipulating what will happen with the business if something were to happen to the owner / owners and providing limitations on how the owners can transfer or sell their stake in the business. Having documentation in place at the outset ensures certainty towards the future of the business when an owner chooses to retire or there is an unexpected event such as disability or death and provides reassurance to stakeholders in these circumstances.

Tax is a key area to be borne in mind when considering the exit strategy for a business. When passing down the ownership of a business to family, it is important to consider whether the conditions for gift holdover relief are met to defer any CGT charge until the shares are ultimately sold. Another vital consideration upon the sale of a business is the availability of business asset disposal relief (previously known as entrepreneur's relief), that reduces the CGT charge to 10%, subject to conditions and limits. For IHT purposes, the timing of passing down shares to family needs to be borne in mind. There may be no charge if Business Relief applies, or the donor survives for 7 years following gifting the shares. It is also possible to use a trust structure to protect assets for beneficiaries. Consideration should also be given to the different tax implications for a partnership vs a corporate structure.

The exit considerations will ultimately be dependent on the type of structure used by the business and may significantly change the succession planning options available to the owners. Given the complexity of legislation applicable to different structures, the tax implications for each case need to be considered in detail and professional advice needs to be sought based on the specific facts and circumstances.

Whilst several succession planning options may be available to asset managers, the preferred course of action will depend on their individual needs or circumstances and take into account both personal and commercial factors. A well-planned exit strategy will also entail detailed consideration from a tax, accounting and legal perspective whilst ensuring the maximisation of wealth to the owners/future generations and keeping the legacy intact where intended. Finally, it is important to note that it is never too early to start the succession planning process as it may take equally long to be able to exit a business as it took to build it.



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The coming of age for ESG data

Environmental, social, and governance (ESG) data has been around as a consumable product since the early 1990s. The first ESG index came in 1990, and its initial company risk data arrived at the end of the decade. The biggest players of today began over this timeframe, and the ESG data product ecosystem took nearly 20 years to begin to ramp up, which happened in earnest in the late 2010s.

While the explosion of ESG data over the last five years has garnered both enthusiasm and criticism from different corners of the investment community, the wild west character of the data environment is fading – giving way to a market that is more robust, reliable, and regulated. The crucible of interacting investor demand, regulatory scrutiny, industry competition, and stakeholder (insert your favorite politician or pundit) criticism is giving ESG data a facelift. Investment professionals are getting more purpose-built data products that fit their investment use cases.

Usage

In the early days, investment professionals were less accustomed to data usage implementation methodologies, and as such, there was frequent volume buying across the industry. Managers would purchase suites of data and figure out how best to use it as a later step. Many large managers would build their data solutions by constantly adding new datasets to achieve the broadest possible coverage universe. Managers and other consumers of ESG data, such as Limited Partners (LPs), have become more sophisticated and directive in their usage of ESG data. They are also facing increased regulatory and investor pressure to implement and monitor ESG data across multiple strategies. This has led to more specific use cases, such as deeper climate physical risk data, coverage of private markets, and solutions for fixed income and alternatives.



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Quality

Until recently, data quality programs have been focused on internal research procedures. Data providers could only focus on assuring quality in procedures they have control over. However, the most important quality issue for any data customer is whether ESG data accurately reflects reality for any underlying name.

The vast majority of ESG data, particularly for public issuers, consists of voluntarily reported information – and data providers have only been in the position to accept this information, with limited ability to check the data's veracity.

With improved data from sources other than firms (such as geospatial/satellite), AI-based data collection and validation, an increase in independent data auditing, and improved statistical modeling across ever-growing datasets, providers and consumers alike are empowered to measure and control the quality of ESG data.

Regulatory infrastructure

Financial regulators in multiple jurisdictions have zeroed in on ESG practices for enhanced scrutiny and rulemaking over the past three years, and this regulatory pressure is creating rules of the road for ESG data providers and users.

Aggressive regulation in the EU, and more recently the UK and Asia, have shown the US to be the laggard in this space. While the SEC has heightened its ESG focus in recent exams and is currently deliberating over potential rulemaking for the US, regulatory bodies in states across the country have attempted to take their own stands on the implementation of ESG data and analysis in how their state's money is managed, creating quasi-regulated environments.

This is in contrast to current and proposed regulation in the EU, such as the proposed legislation on the transparency and integrity of ESG ratings activities, announced in June of this year.

Red herrings

Several undercurrents in the ESG ecosystem have created misleading conclusions about ESG data. For example, detractors of ESG data frequently cite the lack of correlation in ESG scores between data providers as evidence for the idea that ESG data is somehow inherently flawed. In fact, it is precisely the wide variety of investment and research use cases that makes ESG data both useful to many managers and other consumers of ESG data, and difficult to compare.

The data being compared (such as scores from different ESG data providers) are made up of different constituent parts for different audiences with different goals, and thus will continue to struggle to correlate. Scores that focus on physical climate risk will not correlate well with scores that focus on controversy or reputation risk, for example, but both are useful in different contexts.

Similarly, vocal critics of individual ESG scoring methodologies can misunderstand, and as a result misinterpret, ESG scores (as seen most notably in tirades on ESG from certain public intellectuals in the news), thus amplifying false characterisations of ESG data (and indeed of ESG more broadly). Despite the opinions of pundits, investors everywhere are consuming ESG data to improve investment decision-making.

Our expectations

Over the next five years, we can expect to see the following developments in the ESG data market:

- Given the constant need to improve data sources and methodologies, we will continue to see innovation in data sourcing, reaching universal data coverage and expanding data types. While climate tech investing in PE/VC slowed over 2023, the pipeline for data technology remains strong and will likely continue to grow.
- The trend of combining directly measured data with voluntary disclosures will accelerate. For certain types of companies, there will always be a dearth of information. As methodologies to measure ESG directly without contacting the company improve, the data picture will continue to fill in.
- Data assurance will create another inflection point for the industry. The majority of data in use today is not assured, and demand for assured data is nascent. However, a vended data assurance system is the finish line for ESG criticism, and the market will get pushed there over time. When it does, it will usher the Big 4 and other assurance players, significantly increasing the market size and distributing additional costs across the system.
- The association between regulations and data will weaken in proportion to investor demand. The sense that regulations create the market for data (see recent developments in Europe) will fade, as we will see softening of proposed regulations in the EU and UK and possibly no significant regulation in the US (the net effect of political pushback, the coming 2024 election, inflation, and continued elevated interest rates).

Taken in combination, it's clear that ESG data is established, maturing, and here to stay. Firms can benefit from working with third parties that can help leverage their data in a new way to help develop and monitor their ESG programs to mitigate risk, make informed choices, combat greenwashing, and grow profitably and sustainably in the process.

But where does it go from here?

While the turmoil of the last two years may have called ESG's longevity into question, it appears to have instead worked to improve the ecosystem. Reporting consumers (investors) have focused demand over time, data providers have developed better sources, methodologies, and tailored products, and data users (asset managers) are finding better ways to monetise the analysis. Only time will tell just how big it will get.



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Three trends in sustainable lending

Having worked with a multitude of private credit funds and LPs on environmental, social, and governance (ESG) strategy and due diligence in Europe, the UK and North America, we've seen the full spectrum of ESG integration. From managers asking us what ESG stands for, to strategies that are finding new and innovative ways to incorporate sustainability risks into covenants and credit scores. Lately we have seen LPs become increasingly demanding of their private credit GPs, as they understand that systemic risks like climate change and idiosyncratic ESG risks not only create financial and investment risks but can also create existential risk to their core businesses, such as ensuring secure retirements or comprehensive insurance offerings for beneficiaries. From discussions and our work with global credit funds and their LPs, we have identified the following trends to watch out for as the market evolves:



Harry Schmidt
Senior Associate
Close Group Consulting

1. Increased scrutiny on ESG integration practices leads to "ESG due diligence 2.0".

Leading private credit GPs include ESG as a core part of due diligence, both from a credit risk perspective and to ensure no unforeseen regulatory or reputational risks arise during the life of a loan.

Climate change impacts have historically not been a significant part of most private credit ESG due diligence programmes usually due to a lack of data from mid-market companies and a general view that these risks are longer term in nature. However, with record temperatures broken on a yearly basis, and conversations rapidly turning to adaptation from mitigation, a company's ability to raise long term capital will now depend on adapting business models in the face of multiple climate-related risks. The impacts go beyond the transition and physical risks of climate change as well, to encompass resource scarcity, biodiversity, and societal impacts both directly and throughout companies' value chains.

As investors assess their total portfolio risk 10+ years into the future, private credit managers can expect increased scrutiny from investors into how they are adapting their ESG due diligence programs to account for both the current and future risks of climate change as well as the follow-on ESG impacts from changes in business models. Climate change risks will become a core requirement in ESG due diligence of borrowers.

2. In a restrictive capital environment, ESG becomes a key requirement for sponsored loans.

In a tougher economic environment, private credit lenders want to ensure their borrowers will continue to be supported by their private equity owners. As PE firms feel the pressure from a more restrictive capital environment, they need to identify the portfolio companies that they will continue to support financially and strategically. In today's volatile markets, coupled with complex geopolitical factors and an uncertain macroeconomic environment, capital will seek, now more than ever, those high quality, resilient companies that can maintain strong financials irrespective of the economic cycle. Private credit lenders understand that the sustainability profile of a company serves as a proxy for many resiliency factors and will ensure their sponsored loans are to those portfolio companies that have high sustainability and ESG profiles as they will have better chances of being supported by their private equity sponsors.

With a more restrictive environment for capital flows, private credit managers will double down on ESG assessments of borrowers to identify those that are successfully managing their ESG and sustainability risks, will continue to be supported by their private equity sponsors and will be the resilient companies of the future.

3. Private lenders operating as agents for change.

The increased interest in ESG across private markets is leading to closer collaboration between stakeholders, driven by the common objective to enhance ESG outcomes. The traditional view that it is not the place of lenders to provide support for corporate ESG strategies is changing. Private lenders are increasingly incorporating ESG into debt packages, either by requiring borrowers to fix ESG weaknesses as a precondition for lending or by introducing ESG margin ratchets into loans, i.e., rewarding firms hitting KPIs relating to ESG through debt margins. With the growing importance of ESG to the private debt investment case, actors are increasingly involving themselves in due diligence processes, with private lenders enjoying more access to management teams, company ESG research, and conversations around how to support and increase the company's ESG maturity.

Leading debt providers are also ramping up their ESG due diligence on private equity sponsors. Aligning themselves with sponsors that share the same level of ambition and that will encourage companies to meet ESG objectives is a growing priority. This alignment not only maximizes the influence of investors over corporate ESG programmes but is also positive for borrowers as the support from multiple stakeholders allows them to make sustainability a core part of their strategic and capital allocation decisions.

As the drive to produce tangible ESG outcomes continues, communication between sponsors and lenders will be key to ensuring objectives are aligned and management hears "one voice" on ESG from their financiers. As the penny drops, expect the debt and equity relationship to draw closer still.

UK Qualifying Asset Holding Company tax regime

We are now over 18 months on from the introduction of the UK Qualifying Asset Holding Company (QAHC) tax regime in April 2022.

The QAHC legislation was intended to address the tax road blocks which previously prevented the use of a UK company to act as an intermediate holding company within an alternative investment structure and to facilitate the flow of capital, income and gains between investors and underlying investments. The regime seeks to allow investors to be taxed (broadly) as if they had invested in the underlying assets directly and for the intermediate asset holding companies to pay no more tax than is proportionate to the activities they perform.

Whilst there has been increasing engagement from many alternative investment managers and institutional investors, of all sizes and across all of the asset classes, regarding the potential use of UK QAHCs for future investment structures, the focus has definitely centred on the use of the regime by those players within the private credit sector.

Recap of the regime - What are the key benefits of the QAHC for Private credit?

Perhaps the key benefit of the QAHC regime in the private credit space specifically, relates to the amendments that it makes to the UK's existing interest restriction rules, allowing for interest and other finance costs on debt funding of the QAHC, including profit participating and convertible debt, to be (in principle) deductible on an accruals basis. As a result, the QAHC is effectively only taxed on an arm's length margin (typically 10 - 25 basis points for a direct lending strategy).

Additionally, we note that the regime introduces two simplicities to the ordinary UK tax rules, which allow for certainty in modelling investments, including:

- The removal of the requirement to deduct UK withholding tax on interest payments made by a QAHC (matched by the fact that the UK already does not impose withholding tax on dividends); and
- An exemption for gains on the disposal of shares or other qualifying equity interests (other than shares which derive 75% of their value from UK land), with no minimum holding period (a common problem when equity kickers are provided in a private credit transaction).

Finally, as a UK resident company fully subject to UK corporation tax at 25%, a QAHC should also be able to benefit from double taxation treaty relief to minimise withholding taxes on underlying investments. Specifically, we would expect that the matching of the location of the asset holding company with the key decision makers for investments



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where there are UK based investment managers, should further support applications for double tax treaty and certain domestic reliefs against a backdrop of increased scrutiny by tax authorities in this area.

These major changes, linked with the UK's position surrounding gains on debt instruments qualifying as equivalent to interest, allow the QAHC regime to act as a credible alternative to other European lending platform structures, which to date have primarily been located in Luxembourg and Ireland.

How many QAHCs are there now?

As at the end of October 2023, HMRC confirmed that over 275 QAHCs have elected into the regime. We estimate that c.30 - 50% of these elections were from managers within the private credit sector.

Typically, QAHCs are being used as either a single-investment vehicle or as a GBP denominated investment sleeve as part of a wider fund structure. However, there is a wider movement towards private credit managers exploring a UK QAHC platform under their new fund launches (which echoes the position taken across other asset classes).

What are the key points to consider?

The eligibility criteria

One of the key requirements to elect into the regime is the need to meet various eligibility conditions, focused around UK tax residence, ownership of the QAHC, activity of the QAHC, investment strategy and not being a UK Real Estate Investment Trust, UK securitisation company or a listed company. We note that the key condition to be considered relates to the ownership of a QAHC, which essentially requires that the QAHC must be held by at least 70% Category A (good) investors.

Specifically, the rules aim to limit the application of the regime to certain 'qualifying funds' or other institutional investors (i.e. sovereign wealth, pension or insurance funds). Whilst we would expect that the majority of players within the alternative fund industry should be able to meet this condition, the rules, most of which have been repurposed from existing UK tax legislation, are somewhat complex. Realistically, this may be seen as being no different to other countries' tax regimes and there is simply a learning curve to be tackled.

One concern that was originally raised within the private credit sector related to HMRC's position regarding the activity condition, which requires the entity to primarily undertake an investment business. We note that there is little statutory guidance as to the meaning of a 'trade' and the 'badges of trade' are based on a body of case law. However, following discussions with industry stakeholders including the Alternative Credit Council, HMRC have helpfully included some helpful guidance (in the form of examples located within the Investment Funds Manual at IFM 40260) which should help to provide some comfort for those private credit managers seeking to meet the activity condition.

One of the key requirements to elect into the regime is the need to meet various eligibility conditions, focused around UK tax residence, ownership of the QAHC, activity of the QAHC, investment strategy and not being a UK Real Estate Investment Trust, UK securitisation company or a listed company.

What to consider for a new fund?

Whilst certain managers may not be ready to adopt QAHCs at this moment in time, we have found that many are interested in *future-proofing* new fund structures to allow themselves the optionality to use a QAHC in the future. Here, the 'key' consideration will be ensuring that wording is included within the fund's marketing documents to investors (specifically its Private Placement Memorandum (**PPM**) or other offering document) which (i) makes reference to the various entities within the fund; and (ii) satisfies the genuine diversity of ownership (**GDO**) requirements (one of HMRC's tests to satisfy as a Qualifying Fund - a Category A investor).

Specifically, Condition A of the GDO rules requires that the documents made available to investors contain (i) a statement specifying the intended categories of investor, (ii) an undertaking that interests in the fund will be widely available and (iii) that the fund will be marketed widely in a manner appropriate to attract the intended investors.

Based on our experience, whilst a PPM does generally specify the intended type of investor that the fund is being marketed to, it does not typically state that the Fund will make an undertaking that interests in the fund will be widely available or that they will be marketed and made available in order to reach the intended categories of investors, and in a manner appropriate to attract those categories of investors.

New fund documents should therefore, wherever possible, be drafted with the objective of meeting these requirements. There are other approaches to meet the ownership condition that can be taken but we consider the up-front GDO test as part of the Qualifying Fund approach to be the most straightforward.

What are the specific considerations for private credit?

Whilst not QAHC specific and non-tax related, one of the regulatory points that has been highlighted by those adopting the use of QAHCs in lending platform structures relates to the requirements for a UK entity that is originating debt to register with the FCA for anti-money laundering and combating the financing of terrorism purposes as an 'Annex 1 financial institution'. These rules have historically applied in respect of UK financing companies, however given the increasing take up of the QAHC regime in the private credit sector, this is becoming more commonplace. Based on our experience, we understand that the majority of the requirements that come with the registration are often considered at the fund manager level. However, where QAHCs are used in transaction structures, it is important to ensure that the necessary registrations are undertaken in line with transaction timelines.



The other point highlighted relates to the UK anti-hybrid rules, which (save for Chapter 3 of Part 6A of the Taxation (International and Other Provisions) Act 2010) still apply to a QAHC. Specifically, whilst the amendments to the UK anti-hybrid rules made as part of Finance Act 2021 allow for an investor in a transparent fund which holds less than a 10% interest to be ignored for determining whether a hybrid restriction will arise, the additional measures included within Chapter 7 (Deemed Hybrid Entities) have caused some concerns.

Specifically, there are concerns it may not be possible to use a QAHC under certain fund entities (i.e., Luxembourg RAIFs, Irish ICAVs or Cayman master funds) which are treated as transparent by some of their investors, as these entities would be Deemed Hybrid Entities. This is something to consider and may require appropriate structuring when utilising a QAHC.

Are there other considerations?

As with any change to the market, we would expect that over time (and as the QAHC structures become more commonplace) the market will adapt to accommodate the use of the QAHC regime.

Additionally, whilst not necessarily a showstopper, some managers have expressed concerns about the additional level of public disclosure that arises when using a UK holding company and the filing requirements at UK Companies House.

There have also been some other concerns surrounding the current UK political landscape and uncertainty on the EU response to the QAHC regime. In this respect it could however be argued that the QAHC regime is a tax accretive regime for the UK and so may not be brought into focus to the extent there is a change in Government following a UK General Election in 2024.

However, the simplicity and certainty over some of the QAHC regime's benefits, including the removal of withholding tax on interest payments and of capital gains tax on the disposal of qualifying shares, has proven to be extremely popular across the industry. We await to see what the next 18 months of the regime will bring but our expectation is that the number of QAHCs across the industry is set to accelerate further.

Credit outlook pulse check



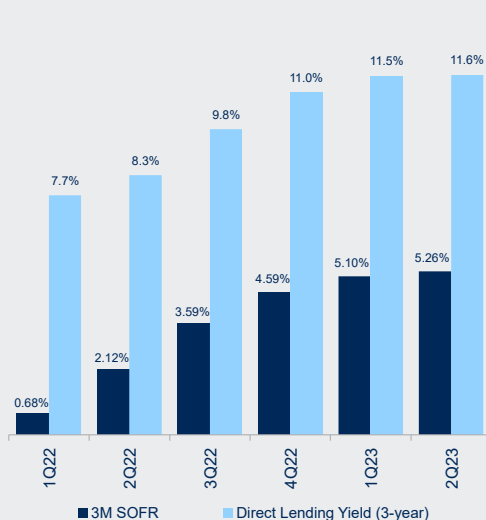
Craig W. Packer
Co-President & Head of Credit
Blue Owl Capital

The first half of 2023 was a conflicting storyline of optimism and uncertainty as investors navigated a global picture in transition on several fronts.

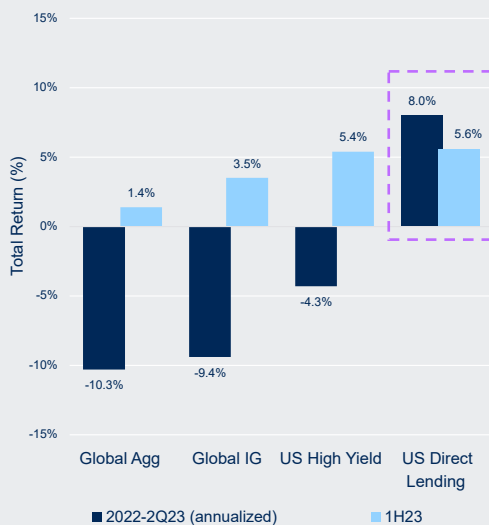
Indeed, we were cautious about the outlook for the US economy as we entered the year but have been pleasantly surprised by its resilience. Company fundamentals are strong, as consumer and industrial demand have held up despite higher interest rates and slowing growth. As inflation moderates, many businesses are exhibiting improved profitability and margin profiles. Risk assets have generated attractive investment returns and direct lending portfolios generally continue to perform well. For direct lenders, elevated rates have widely continued to benefit earnings profiles, evidenced by significantly higher loan asset yields and increasing dividend rates. Though a 'higher-for-longer' rate regime still poses a threat to the macro backdrop, we believe upper middle market borrowers are well-positioned even if the economy were to modestly weaken in 2024.

In this piece, we revisit some of the themes shared in our 2023 Direct Lending Outlook published earlier this year. Rather than offering entirely new perspectives, we have provided updates on the topics continuing to define our market.

Earnings power has risen alongside base rates¹



Direct lending's outperformance this hiking cycle²



- ¹ Sources: Bloomberg, Cliffwater as of March 31, 2023. Federal Funds Effective Rate (ticker: FEDL01 Index). Direct lending yield represented by Cliffwater Direct Lending Index 3-year takeout.
- ² Sources: Bloomberg, Cliffwater for the period January 1, 2022 to June 30, 2023. Global Agg represented by the Bloomberg Barclays Global Aggregate Index, Global IG represented by the Bloomberg Barclays Global IG Corporate Index, US High Yield represented by the ICE BofA US High Yield Index, US Direct Lending represented by the Cliffwater Direct Lending Index.

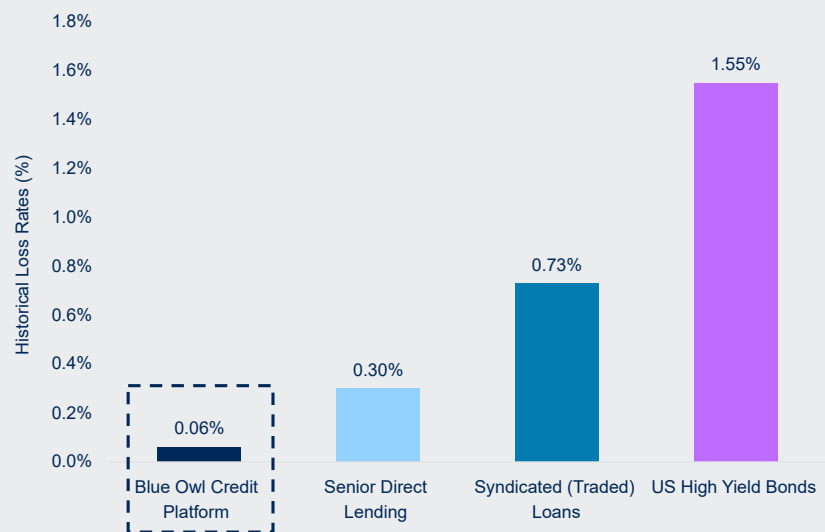
Navigating the macroeconomic conditions that lay ahead

So far this year, direct lending portfolio returns across the asset class have been buoyed by stable credit quality, as well as rising spreads and benchmark rates. We have not observed any signs of broad-based erosion in credit fundamentals or a material uptick in defaults or non-accruals in our portfolios. We have been particularly focused on the impact of higher rates on interest coverage ratios, which, as we expected, have come down moderately in recent quarters in line with the higher rate environment. Our current expectation is that interest coverage will reach its lowest point in 1H24, albeit at an acceptable level for the vast majority of borrowers, and then increase thereafter as benchmark rates are currently expected to normalise in the back half of next year.

Our borrowers continue to see positive, though moderating, revenue and earnings before interest, taxes, depreciation and amortisation (EBITDA) growth and maintain reasonable liquidity to service debt. Businesses across many industries are proactively cutting costs to ensure sufficient cash cushions in this higher rate environment. In the select instances in which borrowers anticipate tight liquidity, sponsors have

demonstrated a strong willingness and ability to provide additional equity capital when needed. We remain vigilant on portfolio monitoring and believe any potential credit losses will be manageable and more than offset by the earnings increases from higher benchmark rates. We also believe private credit will continue to deliver lower default and loss rates relative to public markets. This reflects our enhanced diligence and underwriting process, ability to negotiate more comprehensive covenant packages, on-going dialogue with borrowers and sponsors, and in-house portfolio management and workout teams to support downside mitigation and capital preservation.

Direct lending can offer better downside protection compared to its public credit market peers ^{3,4}



One of the best investing environments for direct lenders

The investing environment is still very attractive for direct lenders, and particularly scaled managers. While the syndicated market has reopened somewhat this year, leveraged loan volumes are still light as direct lending comprises roughly 90% of leveraged buyout (LBO) financings so far this year. As noted in our 2023 outlook, we continue to secure compelling economics and 'lender-friendly' terms on deals. Direct lenders are still pricing newly originated unitranche at over 12% all-in unlevered yields, as a result of rising benchmark rates and credit spreads in the last year.

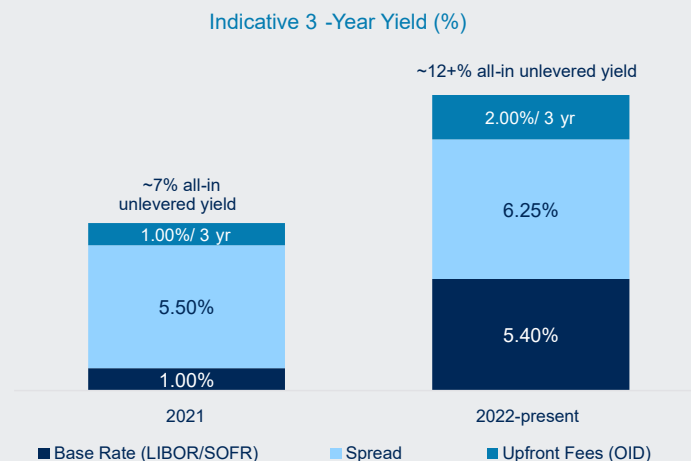
³ Average annual loss rate based on total annual net realised losses across Direct Lending strategies divided by the average aggregate quarterly cost of investments. The loss rate is based on the average loss rates in each year since inception from 2016 to 2Q23.

⁴ Source: SP LCD, Cliffwater, JP Morgan. Market loss rates calculated as average loss rates and defined as: for loans, based on SP LCD default rates for all loan \$ defaults as percentage of total outstanding and calculated as $\text{default} \times (1 - \text{average historical Recovery Rate})$ from 2016 to 2Q23; Direct Lending based on Cliffwater Direct Lending Index realised gains/losses from 2Q16 to 1Q23; High Yield Bonds based on JP Morgan Default Monitor annual defaults and calculated as $\text{default} \times (1 - \text{average historical Recovery Rate})$ from 2016 to 2Q23; Recovery rates for loans of range from 48-63% by year and 22-55% for bonds and are based on JP Morgan Default Monitor, July 5, 2023

While spreads have moderated in recent months as markets re-open and capital constraints within direct lending taper off, they remain at attractive levels and overall yields are well above historical levels.

Borrower credit quality also remains very attractive. The borrowers seeking capital in our market continue to skew very high quality. Also, these deals are frequently closing at lower leverage and loan-to-values as sponsor valuations remain high and lenders factor in elevated debt service costs in the financing packages they provide.

Higher base rates and wider credit spreads boosting all-in yields



Private equity deal activity is slower than last year, but picking up

Deal activity in the direct lending space has picked up over the last quarter after a slow start to the year. We are seeing a diverse mix of deal flow across a range of transaction types and company sizes. The most noteworthy change since the beginning of the year is the recent pick-up in traditional sponsor LBO activity. This is the 'bread-and-butter' of the leveraged finance markets but was largely dormant in the first quarter of this year and fourth quarter of 2022.

Aside from the recovery in sponsor-to-sponsor LBOs, we have primarily witnessed a continuation of trends from earlier this year. Add-on acquisitions for existing portfolio companies remain active. We view these transactions as particularly attractive because we have an in-place relationship with the sponsor and management team and thus have a keen understanding of the company's historical financial and operating performance. We can be very efficient in diligence, leveraging the competitive advantages of our incumbency and often securing above-market pricing given our unique positioning. We are also still seeing activity across corporate carveouts and divestitures as large conglomerates focus on streamlining operations and selling off non-core assets.

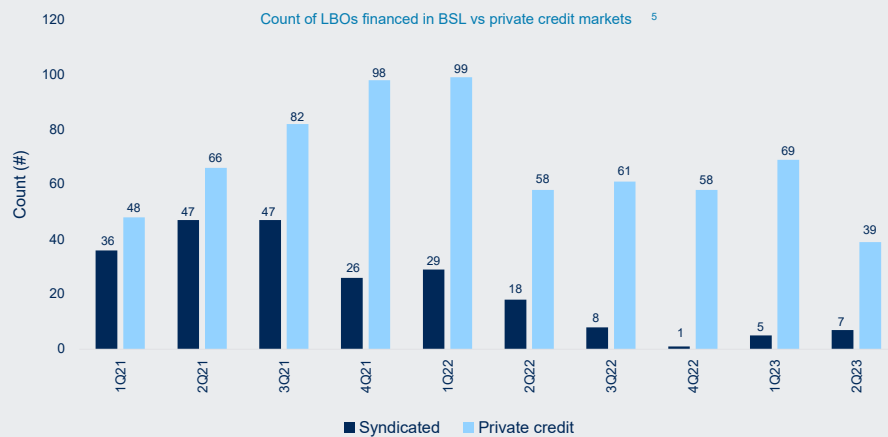
While 'take-private' transactions remain a source of deal flow, activity has been slightly less prominent versus late last year as public equity markets have rebounded. We continue to lead the vast majority of these deals in which we participate, typically driving negotiations and speaking for large size. Of note, the average size of these take-privates has come down relative to the 'mega-tranche' deals of 2022, as rising debt service costs inform smaller purchase prices and debt financing packages.

Finally, we believe there is significant pent-up demand from sponsors to sell mature assets and to deploy dry powder across the industry. This will likely lead to a welcome pick-up in financing activity as the rate outlook stabilises.

LBO volumes likely to pick-up after an 18-month slowdown...



...with private credit lenders expected to continue to play a key role.



In conclusion

We believe market dynamics will continue to favour the direct lending asset class. There is no denying that direct lenders have been uniquely situated to finance transactions and gain share from the investment banks amidst the volatile backdrop of the last few months, but we believe the opportunity set will continue to expand even after public markets reopen to normal levels.

This is part of an ongoing secular shift, rather than a cyclical one. Indeed, more sponsors today are familiar with direct lending and have seen first-hand the strong value proposition that a private solution can offer. Scale, certainty of execution and flexibility all provide borrowers and financial sponsors with a compelling alternative to the syndicated and high yield markets. As a result, direct lending is poised to gain further share from the public credit universe. After all, the asset class represents only 20% of the leveraged finance market today, and we believe has potential for further growth, representing up to 30% of the total market in the coming years. So, the opportunity set is expanding dramatically even as more capital enters the direct lending asset class and as public market activity normalises.

Looking ahead, we maintain a decidedly positive outlook for direct lending. We are able to be highly selective on the deals that we do and the terms at which we transact. Solid earnings potential, a manageable credit environment, and growing demand for our capital all point to a compelling opportunity set and risk-return profile to come.

Disclaimer

Please review the important disclosure information for this article at the link below: <https://www.blueowl.com/disclosure-information>

⁵ Sources: Pitchbook, LCD. As of June 30, 2023. Private Credit & Middle Market Report 2Q23.

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The rise of hybrid funds

Recently, the different categories into which an alternative investment fund fell (hedge, private equity, infrastructure etc.) have become less distinct and a new fund type – the hybrid fund – has emerged.

These offer greater flexibility in terms of, for example:

- The subscription and redemption terms and fees charged;
- Their suitability for investing in less liquid assets (e.g., private credit or distressed debt); and
- The wide range of strategies they can be used for.

By taking advantage of this flexibility, managers can launch hybrid funds which offer a 'best of both worlds' option, tapping into less liquid (but hopefully higher yielding) assets than most traditional hedge funds, while offering greater liquidity and better redemption rights than a traditional closed-end fund.

Hybrid funds, though, are not, in themselves, a panacea - the key is to ensure that the fund is established to reflect the underlying investment strategy to be employed and is suitable to meet the ultimate requirements of the investors.

In this article we provide a high-level look at the pros and cons of such funds, their key characteristics and the questions a manager needs to ask in order to select the appropriate structure.

What is a hybrid fund?

There's no single definition of what a hybrid fund is but, for this article, we're using the generally accepted view, i.e., a private investment vehicle that combines one or more elements of an open-ended fund structure with one or more attributes of a closed-end fund structure.

Hybrid funds offer investors the possibility of access to less liquid investments with (hopefully) higher returns while providing managers with the opportunity to develop a broader investment base than traditional open-ended funds (along with a more flexible structure). Investors can withdraw or to add capital at set intervals (unlike in a typical closed-end fund) – being able to tailor the fund's liquidity profile to the liquidity of the underlying investments makes a hybrid fund a more attractive proposition for sophisticated investors.



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Managing Associate
Simmons & Simmons

Main characteristics of hybrid funds

Liquidity

Although hybrid funds are bespoke structures, with differing investment goals and fund structures, they often share certain key characteristics, including:

Allowing longer-term investors to redeem existing investments (or add capital during the life of a fund) albeit on bespoke terms – such redemptions are usually on specified dates set at regular intervals or on the occurrence of certain, specified events.

As this entails the manager aligning lock-up periods with the fund's anticipated liquidity profile, relevant terms should be included in the fund's offering documents.

Alternatively, a hybrid fund could be structured to give investors a choice of liquidity options, allowing investors to select the one best suited to their investment goals.

Hybrid fund managers also have at their disposal a variety of liquidity management tools (e.g., redemption gates, lock up periods, side pockets, suspension) to ensure the fund suffers no significant liquidity mismatch. This can help avoid fire sales of the funds most liquid assets or excessive borrowing.

Valuation

A fund which permits ongoing subscriptions and redemptions must be able to determine its Net Asset Value (NAV) as at the permitted subscription and redemption dates.

Since a hybrid fund will likely hold illiquid and/or hard-to-value assets, for which market quotations may not be available, determining the NAV is a key challenge which must be addressed.

So, too, is agreeing the terms on which new capital invested in the fund will be accepted – for this, one of two alternatives will normally be used:

- The **'private fund model'** allows periodic new investment in tranches, with investors in the same tranche participating in future investments on a pro rata basis and without exposure to earlier investments;
- The **'hedge fund model'** allows investors to subscribe based on the fund's then current NAV (provided that this can be accurately determined on an ongoing basis).

Illiquid assets are typically valued at the lower of (i) cost and (ii) current value.

Fees

Hybrid funds allow a degree of flexibility over how to structure management and performance fees, with models based on either (i) the incentive fee (typically with a high water mark) seen in open-ended funds or (ii) carried interest, common in closed-ended funds. Variants or combinations of each model can also be used.

The most appropriate fee model will depend on the circumstances of the individual fund - generally, deferred incentive compensation structures will be more common when restrictions on investors' rights to withdraw their capital are stricter.

Additional capital contributions

Unlike traditional closed-end funds, hybrid funds can allow investors to make capital contributions (in full, drawn down over time from a committed amount or a mixture of the two) on an ongoing basis, outside the usual fundraising period.

Traditional closed-end funds can face an issue where the fund's portfolio value decreases significantly between initial and final closings, which is unattractive for investors having to buy in at cost. Hybrid funds, though, can avoid this by adopting a more typical hedge fund structure, which reflects the fund's underlying portfolio's fair market value as at the date of any later closings on which new capital contributions are accepted.

Tax considerations for hybrid funds

Structuring a hybrid fund gives rise to additional tax considerations compared to a typical open-ended hedge fund structure, including:

- Whether the fund's investment objective and approach will be treated as investing and not trading for tax purposes – if they are, meeting the conditions of the investment manager exemption (and equivalent exemptions outside the UK) may be less of a requirement;
- The potential to make use of carried interest arrangements, in place of more typical hedge fund incentive fees;
- Additional downstream structuring (including the development of a *below-the-fund* holding structure) will be needed to maximise returns from underlying assets;
- Ensuring that the hybrid fund structure enables investors to achieve a post-tax outcome equivalent to what would have been received had they invested directly in the underlying assets.

Hybrid funds allow a degree of flexibility over how to structure management and performance fees, with models based on either (i) the incentive fee (typically with a high water mark) seen in open-ended funds or (ii) carried interest, common in closed-ended funds.

Some pros of hybrid funds

Flexibility

Combining characteristics of both open- and closed-ended structures can give a hybrid fund a number of advantages over the traditional 'hedge' or 'private' fund model, including significant flexibility in how the fund is structured. This allows the manager to tailor terms to specific investment goals and time horizons.

Being able to invest in illiquid assets while, at the same time, providing for appropriate liquidity terms means that hybrid funds are well-placed to meet the needs of a wider investor base, for whom access to capital is important. This means they can, to some degree, square the circle of providing exposure to the potentially higher yield that alternative strategies offer while, at the same time, offering stable cash flows and more predictable liquidity.

Moreover, the ability to accept additional capital contributions through the fund's life allows the fund to be marketed on an extended basis rather than (as is more usual with closed-end funds) there being periods between closings when new capital cannot be raised.

Diversity

By combining elements from multiple investment vehicles, hybrid funds can invest in a more diverse range of asset classes than would be typical for a hedge fund (or even a private equity fund). This helps increase the opportunity to generate higher investor returns or to smooth cashflows.

Hybrid funds can, for example, offer exposure to (among other things) private equity, distressed debt, venture capital, private debt/credit, infrastructure, derivatives, real estate and public securities.

Liquidity management

Since they can be structured with greater liquidity management, hybrid funds can offer a happy medium when it comes to the holding of assets:

- Closed-end funds can be left holding assets when the fund's life comes to an end, which can mean the establishment of a costly continuation fund;
- Open-ended funds can face liquidity mismatch problems, which can lead to fire sales, the imposition of a gate or the suspension of redemptions.

Because of their increased flexibility on liquidity, ability to raise additional capital etc., hybrid funds are better placed to avoid such issues.

And some cons

There are, of course, also downsides to setting up a hybrid fund rather than a more traditional hedge or private fund.

These can include:

- Operational and valuation aspects of a hybrid fund can be relatively complex, for example, matching cash flows from subscriptions and redemptions with the underlying cash flows from investments;
- Being more complex, hybrid funds can face greater regulatory and compliance issues;
- Being highly bespoke, establishment and running costs can be greater than for more "plain vanilla" structures;
- Any secondary liquidity may remain somewhat illusory (for instance, in a listed fund scenario where shares are trading at a discount to NAV); and
- The manner in which managers are paid by hybrid funds may complicate how those managers then pay their own staff.

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Hong Kong taps into Asia Pacific growth

As the opportunities rise across the region, the city is strengthening its status as the region's hub for alternative assets



Darren Bowdern

Head of Alternative Assets
KPMG China

Hong Kong has long been the major hub in Asia Pacific for alternative asset management, with more assets under management and a higher concentration of industry professionals than any other jurisdiction in the region.¹ But there is no doubt that the sector was impacted by the COVID-related travel restrictions that remained in place long after most other jurisdictions had reopened. These rules made it difficult for asset managers to host or attend meetings and events. More broadly, they may have dented Hong Kong's reputation as a cosmopolitan and open city.

But since all the restrictions were lifted in early 2023 the city has fully returned to normal operations, and the Hong Kong SAR Government has emphasised that supporting the financial services sector is a priority. Besides the efforts to promote the city as a financial services hub, the Government has also introduced a number of initiatives and proposals that aim to directly benefit the alternative assets sector.

Growing opportunities

Supporting and promoting the alternatives sector in Hong Kong is important given the huge size of the opportunities. The financial services sector is the backbone of Hong Kong's economy, accounting for more than a fifth of the city's GDP,² and the alternative investment sector is a crucial part of the financial ecosystem.

1 SFC Asset and Wealth Management Activities Survey 2021 [AWMAS-2021_final_e.pdf \(sfc.hk\)](#)

2 Hong Kong Trade and Development Council Financial Services Industry Profile. [Financial Services Industry in Hong Kong | HKTDC Research](#)

At the same time, a considerable proportion of the growth in AUM globally is being driven by alternative asset classes³ and, within that, Asia Pacific's alternative asset class is growing faster than the rest of the world.

Hong Kong already manages most of the alternative assets in the region: it is the largest international asset management hub in Asia, the largest cross-border private wealth management and hedge fund centre in Asia, and the second largest private funds centre in Asia, after the Chinese Mainland, according to the Hong Kong Monetary Authority (HKMA),⁴ the city's de facto central bank.

In the past decade or so, as the alternative assets industry has grown rapidly, Asia-focused firms, talent and service providers have naturally based themselves in Hong Kong. The city has therefore built the specialist expertise and knowledge spanning tax, legal, administration and investment management to handle alternative assets, including niche strategies like impact investing.

The potential for further growth in the alternative assets sector in the Asia Pacific is still massive. The number of HNWI in Mainland China and across Southeast Asia continues to grow - from UHNWIs to the rising numbers of middle class - all of whom are seeking to preserve and grow their wealth. The number of UHNWIs in the Chinese Mainland grew by 19% in 2021 and by 14% in Asia Pacific, according to UBS, which also expects the number of US-dollar millionaires in China to double between 2022 and 2027.⁵

In addition, the attitude towards alternative investments is evolving. Investors in the region who formerly focused on more traditional forms of asset management and savings are developing a taste for alternatives as they seek to diversify and grow their investments.

Refining the local landscape

Hong Kong is well positioned to serve this huge and growing potential market, but the city cannot take its position as the major alternative asset management center for granted. The landscape for alternatives in Hong Kong must remain at least as attractive as other jurisdictions, including in the areas of tax and the overall regulatory environment.

To this end, the alternative assets management industry in Hong Kong has been in discussions with the government and regulators in recent years, which has resulted in the introduction of a number of incentives and initiatives.

Among the developments has been a series of measures to support the growing family office sector. In February's Budget Speech, for example, Financial Secretary Paul Chan allocated HK\$100 million (US\$12.8 million) to InvestHK, a government department, over the next three years to attract more family offices.

Earlier this year, the government also announced a family office tax incentive, which introduced a zero percent tax rate on profits for UHNWIs and their family members on qualifying transactions.

This tax incentive, in particular, has been widely welcomed by the industry and has already generated client interest from family offices globally.

³ [Preqin Global Report 2023: Alternative Assets | Preqin](#)

⁴ HKMA – Competitive International Financial Platform [Hong Kong Monetary Authority - Competitive International Financial Platform \(hkma.gov.hk\)](https://www.hkma.gov.hk/en/competitive-international-financial-platform)

⁵ [Global Wealth Report 2023 | UBS Global](#)

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Other incentives targeting alternative assets that have been introduced in recent years include the Open-ended Fund Company (OFC) and the Limited Partnership Fund (LPF).

Introduced in 2018, the OFC code was revised in 2020 to remove restrictions on the scope of investment, and again in 2021 to allow overseas funds to re-domicile in Hong Kong as OFCs. An OFC is eligible for profits tax exemption under the Unified Fund Exemption (UFE) regime, provided that the requirements under the Inland Revenue Ordinance are fulfilled. To encourage the use of OFCs, the government also introduced a subsidy that covers 70% of expenses paid to professional service providers (capped at HK\$1 million).

The LPF Ordinance was passed in 2020 with the aim of levelling the playing field for funds in the region, especially in comparison with the Exempted Limited Partnership (ELP) in the Cayman Islands. While there is no direct tax on the Caymans' ELPs, in Hong Kong, an LPF may also enjoy profits tax exemption, where the UFE conditions are satisfied.

In addition, the Tax Concession for Carried Interest Ordinance was introduced in 2021, where eligible carried interest allocated by the fund will be subject to a 0% tax rate. In the absence of the tax concession applying, the IRD's position on carried interest is that it represents a fee for services rendered and therefore liable for tax to the extent that it relates to services rendered in Hong Kong.

However, to date, the results of these initiatives has been underwhelming. This has been principally due to uncertainty over how the rules apply to certain asset classes and funds, as well as a lack of clarity with respect to the application of the rules.

To help ensure that Hong Kong remains competitive, it needs to be very clear and certain that the gains made on such investment holdings do not suffer any further incidence of tax in Hong Kong upon repatriation of such gains to the fund investors.

In addition, some of the licensing application procedures are onerous, and some procedures are complicated. The resulting uncertainty and complexity are discouraging asset managers from otherwise choosing Hong Kong as a fund domicile or investment platform location.

There is an expectation, however, that some of these issues may be ironed out. In his Budget Speech this year, the Financial Secretary noted the importance of the asset management sector to Hong Kong and said that the government would review the existing tax concession measures applicable to funds and carried interest.



To help ensure that Hong Kong remains competitive, it needs to be very clear and certain that the gains made on such investment holdings do not suffer any further incidence of tax in Hong Kong upon repatriation of such gains to the fund investors.

Since then, the industry has further engaged with the government to share more insights on the reforms that would best benefit the sector. The proposed changes include suggestions on reform of the UFE regime to provide more certainty on the tax exemption for investments managed from Hong Kong, and to make it clear that interest and other returns for private credit and debt funds fall within the UFC regime.

Other proposals include ways to address the issues that have prevented the carried interest tax concession operating as intended. In addition, the industry has also suggested that the Securities and Futures Commission reviews the current complexities in the licensing process so that the licensing regime better accommodates the private funds industry and how managers operate in practice.

Such reforms can help to ensure that Hong Kong remains a competitive jurisdiction for funds to hold and manage their investments in the region, and ultimately strengthen the wider financial sector in the city.

Looking ahead

The opportunities in Asia suggest Hong Kong's alternatives sector has a bright future ahead. But if it is to continue to grow and thrive, it should have a regime that is best-in-class, that will attract alternative asset managers to manage more funds in Hong Kong and use more structures in Hong Kong. Other jurisdictions, including Singapore, offer a good demonstration of how targeted incentives with clear conditions can be effective in attracting funds.

Removing the uncertainty around some of the current incentives is an important step. More clarity about the scope of the incentives available and the conditions that need to be satisfied can address concerns of global asset managers about domiciling funds and SPVs here.

Such reforms to the current incentives will create more opportunities and potential benefits for the sector and beyond, including the supporting infrastructure and broader ecosystem of lawyers, administrators, accountants and other indirectly employed people that the alternative assets management sector supports.

There are reasons for optimism about the prospect for further enhancements to Hong Kong's alternative assets landscape. In February this year, Chief Executive John Lee, accompanied by other senior government officials and financial sector executives, visited the Middle East, followed by a similar visit to Southeast Asia in July. These high-level, high-profile trips were part of the campaign to promote the city's advantages as a finance and asset management hub, including as a center for family offices.

The new family office tax incentive and the commitment to review certain other incentives announced this year demonstrate that the government has clearly taken the concerns and proposals of alternative asset managers on board.

Moving into 2024, if the proposed further reforms to the asset management landscape are adopted, these can help to ensure that Hong Kong is in prime position to seize the growing opportunities across the Asia Pacific region.



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State Street data opportunity study: The growing importance of human capital in data operations



Cleyde Hazell
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Cross Product Client Solutions
State Street

Generative artificial intelligence (AI) across the industrial sectors including financial services is at the center of a long-running debate about the ability of emerging technology that automates several processes that were traditionally performed by individuals with specialised skills.

In this article, we focus on how generative AI is transforming the way asset managers in the alternatives space function and the impact it has on their clients.

Over the last two decades, technological developments have allowed institutions to store, process and analyse vast amounts of data electronically, enabling them to harness the power of data to make informed decisions across investment functions such as asset allocation and securities analysis, risk management, regulatory compliance, and product distribution.

The relationship between technology systems and humans, in terms of data management, has seen significant change. The global data quest is fast evolving and there are now high-performing technology tools available in the market with no shortage of new solutions.

However, institutions still face the challenge of having the right people and processes in place to maximise their investment in new technology and automation tools to deliver better outcomes for the clients they serve.

We see the 'human vs machine' paradigm shift taking place where certain tasks are moving to automation and leading to the introduction of new tasks and expanded roles. We have seen this happen in the past with the motor car - when blacksmiths became mechanics. However, the fear with AI goes beyond automation of existing jobs to include the jobs its expansive potential may create. However, this is not a pressing concern for today's institutional investors and alternatives managers, according to State Street's latest research. Respondents to the State Street Data Opportunity Survey are highly focused on acquiring data literate talent and have indeed created a highly competitive job market in this area that looks set to continue for several years.

Unsurprisingly, institutions were focused on a combination of workforce and technology (as well as partnerships with third party organisations offering them access to both), but more than a quarter (27%) of asset owners said talent was the area they were most focussed on to build their data capabilities. Among alternatives managers this figure rises to 29%.

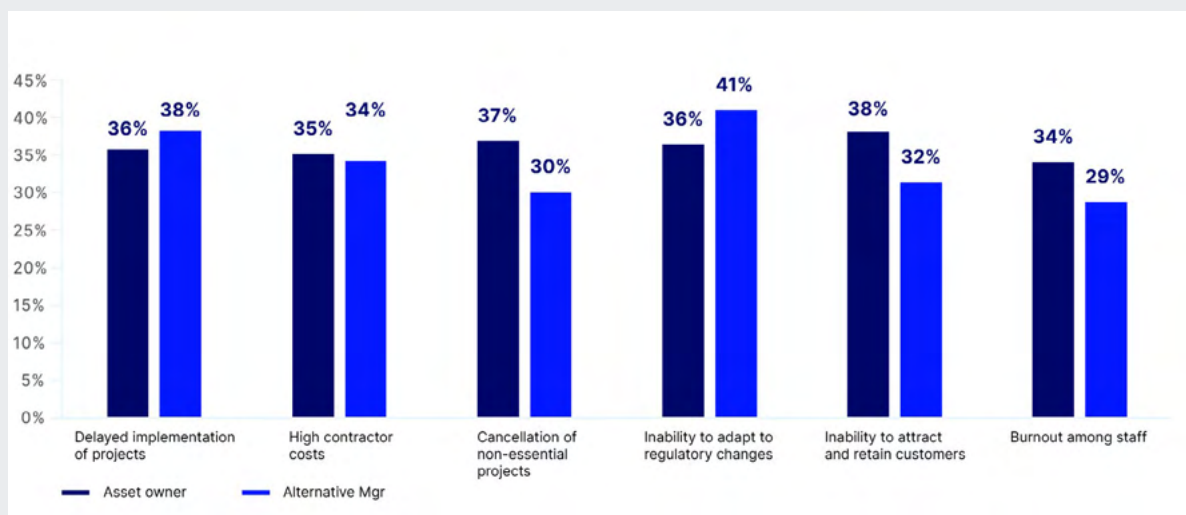
This is in alignment with institutional investors' ongoing approach to data and technology. They like to have capability in house, and to have highly sophisticated teams to manage their alternatives assets. Instead of growing these teams in headcount, investors are focused on leveraging technology to support their existing expertise to expand their investment strategies.

With the right balance of technology and skilled workforce, they can outsource operations externally, enabling the internal teams to manage oversight functions, thus prioritising upskilling, cybersecurity, and governance.

Significant proportions of both respondent types highlighted a large number of ways that a shortage of data literate talent in the job market was negatively impacting their organisations.

Among alternatives managers, it was primarily making it harder for them to adapt to new regulations and pushing back strategic project implementation. Asset owners found customer retention and their ability to focus on projects beyond the day-to-day essential functions of their organisations were the main areas that were impacted.

Fig. 1. Is a lack of talent negatively impacting your organisation in any of the following ways?

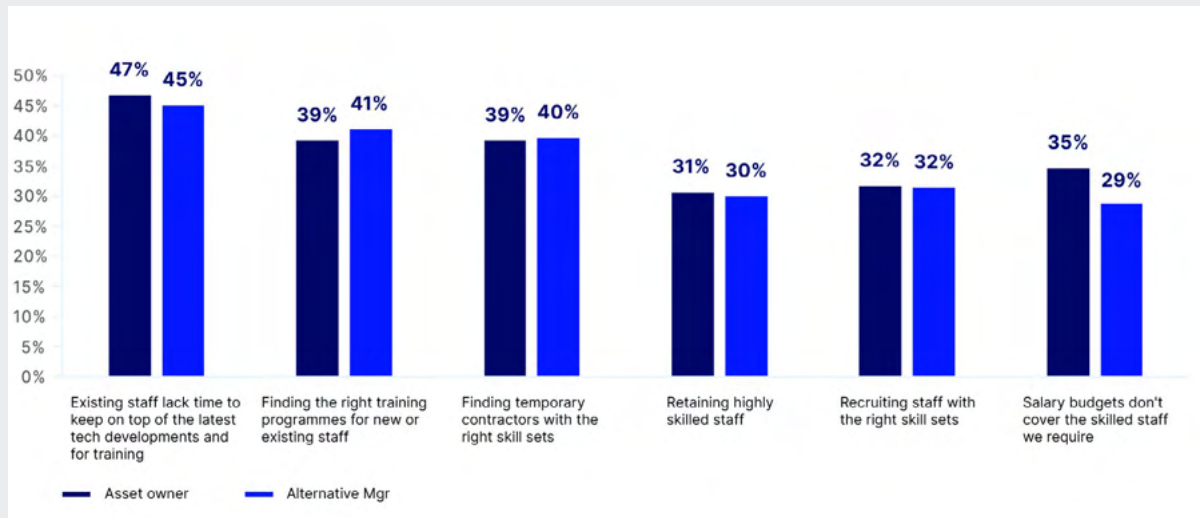


Our research also suggests, technology that facilitates greater speed and efficiency in data management through automation will continue to benefit workforces.

Nearly half of both asset owners and alternatives managers (47% and 45% respectively) said their biggest impediment in trying to address the shortage of adequately skilled staff was finding time for upskilling existing employees.

Institutions foresee a virtuous circle of automation and technology freeing up time to enable workforces to make better use of automation technology.

Fig. 2. What are the greatest challenges your organisation faces when developing data-literate talent who can unlock the potential of data?



According to our research, 29% of asset owners prioritise talent and skilled workforce to meet their data management goals as the most important area to invest in currently. When asked to consider the same list of priorities between two to five years from now, talent dropped out of the top three priorities (although it remained a top choice for 17% of asset owners).

Alternatives managers do not consider investing in human capital as a top three priority among their current areas of investment in data management. However, in two to five years, nearly a third of alternatives manager respondents said they anticipated it to be their top priority (second only to AI).

As technology continues to drive innovation in investment management, firms will need to look further into how their human capital working in tandem with innovative new tools will enable them to be dynamic and excel in a competitive market environment.

As times goes by, we tend to get a binary view of what the solution for today's data problems will be, with a common perception that automation is the only pathway to success. In reality, there are many things in parallel that the industry is doing well, through data collaborations, knowledge sharing and in-house investment in talent that will help all of us with our quest for holistic data integration.

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How are organizations evolving their technology and talent to capture the data opportunity?

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Alternatives: Becoming mainstream in India asset allocation



Vivek Sharma

Head of International Clients Group
Nuvama Group

India's robust economic growth has created new investment opportunities for both domestic and foreign investors. The country, the fifth-largest economy in the world, now has significantly more high-net-worth individuals (HNIs). Rising household savings due to higher per capita income and increased awareness of financial products has hastened India's transition into the financialisation of savings. This has sparked a desire to take risks and, also a search for unconventional investment vehicles.

Alternative investment funds (AIFs) have emerged as a robust alternate and are in high demand. Over the past ten years, AIFs have experienced rapid growth in India, improving the investment climate in the nation. It has grown ten times in the last seven years. AIFs were largely unknown a decade ago and were believed to be the sole property of foreign institutional investors.

AIFs are privately pooled funds that invest in infrastructure, hedge funds, private equity, venture capital, etc. They are typically only available to retail HNIs or ultra-HNI investors who can afford to invest at least ~US\$125,000.¹

Growth drivers

The AIF market segment in India is growing exponentially driven by micro and macroeconomic factors, a robust policy framework and relaxed taxation norms.

The country is one of the fastest growing economies in the world, compounded by expanding infrastructure, the third-largest startup ecosystem, and a thriving business environment, all of which contribute to the success of AIFs. India's thriving capital markets and the general decline in interest rates have made it a popular destination for investors. If HNIs want significant returns without taking on too much risk, AIFs present an alluring investment option.

Along with traditional investments in equity, gold, and real estate, investors are also looking into alternative investment opportunities. Investment options in bonds that support both public and private infrastructure are in greater demand. AIFs provide investors with a lucrative opportunity while bridging the supply and demand gaps. AIFs benefit from and contribute to the nation's economic development as a result. Little wonder, the AIF industry is finding new wings.

¹ This may vary as per US dollar to rupee conversion rate.

In a nutshell, the AIFs have seen a steady rise due to the following reasons:

1. A steadily growing economy;
2. Favourable regulatory framework;
3. There is no immediate connection to stock markets;
4. Unique opportunities and possibly higher investment returns;
5. Risk management and diversification;
6. Prompt investments in a portfolio of companies to increase returns;
7. Serve as a buffer during periods of market volatility or financial crisis;
8. Mainly invested in securities that are not listed or unlisted.

Data

AIFs in India have come of age and experienced an annual growth rate of 30% in FY23.

According to recent trends, AIFs are getting a lot of attention. By the end of March 2023, AIFs had committed a total of approximately (~)US\$100 billion, had a corpus of ~US\$44 billion, and had invested a total of ~US\$40 billion, according to cumulative data compiled by the market regulator Securities and Exchange Board of India (SEBI). Corresponding to annual growth rates of 30%, 16.49%, and 19% respectively.

According to the Indian Association of Alternative Investment Funds (IAAIF), the AIF industry managed assets worth a total of ~US\$84.3 billion. The industry is currently expanding thanks to a constantly growing pool of domestic investors. Domestic investors now provide 80–90% of the funds raised, as opposed to a decade ago when foreign investors made up the majority of capital infusions. According to current trends, the AIFs industry in India, which is estimated to be worth ~US\$554 billion, may be comparable in size to the mutual funds.

Favourable regulations

Indian AIFs, with 885 registered in FY22, offer customised products, flexibility, unique opportunities, experienced management, and strategic diversification, demonstrating the rapid growth of the AIF segment since 2020.

Favourable policy framework, statutory mandate and regulatory compliance pivot an industry's growth in an economy. Similarly, investor-friendly policies are providing the AIFs the stability they need to flourish. Some strategic policies merit a mention.

For example, early in June 2023, SEBI began implementing new rules, which include:

- i. Standardisation of the process for valuing investment portfolios;
- ii. Requirement for the dematerialised issuance of AIF units;
- iii. A framework for the liquidation scheme to help AIFs manage investments that become unsellable due to a lack of liquidity when the scheme is being dismantled.

The tightening of regulations has significantly increased investor confidence. SEBI has received more than 55 applications for AIF registrations between April and July; thirteen of these applications have been approved and are awaiting payment of the registration fees. This ongoing interest and regulatory vigilance indicate that the Indian financial landscape is a robust and responsive environment for AIFs.

Subsequently, in September 2023, SEBI reviewed its quarterly reporting format to improve compliance reporting, promote uniformity in compliance standards, and support regulatory and developmental goals. Starting December 2023, AIFs must submit revised quarterly reports electronically via the SEBI Intermediary Portal within 15 days at the end of each quarter.

Advantage India

AIFs typically have higher return potential than other alternative investment options. The sizeable aggregate gives the fund managers enough room to create flexible strategies aimed at maximising returns.

AIFs had accumulated commitments totalling ~US\$102 billion as of the June quarter, with investments crossing ~US\$42.1 billion for the first time. On an annual basis, the segment saw substantial growth of more than 20%. The total investment commitments for Category II funds as of June 30 totalled ~US\$84 billion. In contrast, ~US\$7.6 billion and ~US\$10.2 billion, respectively, were committed for Category I and Category III funds.

Investors typically commit to making these investments in tranches, which are reflected in the total amount of funds raised by the fund managers. A total of ~US\$45 billion had been raised as of the end of June, of which ~US\$33 billion came from Category II AIF contributions. Based on the available information, investments total ~US\$42 billion, or roughly a 4% progression.

Opportunities for global investors

According to Ernst and Young, AIFs have become extremely popular in India because they give investors a wide range of alternative assets, including infrastructure, real estate, and private equity. They provide diversification beyond conventional investment options such as equities, bonds, currencies, or gold.

AIFs give global investors the opportunity to invest into industries with enormous growth potential, like technology, healthcare, renewable energy, and infrastructure. Investors can ride the wave of India's changing economic landscape and potentially earn sizable rewards by investing in these promising sectors, and a scope to diversify their portfolio.

The different categories and the funds:

| Catgory I | Category II | Category III |
|---|---------------------------------|--|
| Venture capital funds (including angel funds) | Real estate funds | Funds that engage in many complex trading techniques, e.g., listed, or unlisted derivatives. |
| SME funds | Private equity funds (PE funds) | Hedge funds, private investment in public equity (PIPE) funds |
| Social venture funds | Funds for distressed assets | |
| Infrastructure funds | | |

Forecast

Investors are looking into alternative products as India's economy expands at a rate of 7%. According to IMF projections, when India's GDP surpasses US\$5 trillion, it will pass Japan and Germany to become the third-largest economy in the world. India hopes to have a developed economy by 2047.

The expanding population of domestic investors from tier-II and -III cities could propel AIFs to the size of the ~US\$481 billion mutual funds sector in the next few years. There is considerable familial and intergenerational wealth in these cities, and their involvement has been crucial to the wealth creation that the startup ecosystem has facilitated.

SEBI estimates that by 2022, fund administrators overseeing AIFs will have raised close to ~US\$1010.7 billion in capital, up from less than ~US\$54 billion two years prior. Approximately 72,000 individual contributions have been made to AIFs. This has been established on retail, HNI, or ultra-HNI capital, as opposed to institutional capital, which has been the foundation of global AIFs. Clearly, the situation has changed for investors. The ecosystem has expanded, which is beneficial for all parties involved, and the market now offers a wealth of nuanced data.

Challenges and the way forward

The entry threshold for this category is ~US\$125,000.1, which restricts the accessibility of these investments to retail investors in general. Category-III AIFs, such as hedge and private equity funds, are limited to investing only 10% of their capital in a company when it comes to AIF investments.

AIFs are adaptable investment vehicles capable of providing one-of-a-kind investment solutions spanning various asset classes, themes, and strategies. Conversely, considerable effort is required to further develop the AIF industry and ensure that a broader spectrum of eligible (accredited) investors can benefit from AIFs. To ensure that all participants in the ecosystem can leverage the full potential of AIFs as investment vehicles, prevailing obstacles, including taxation, benchmarking, and transparency, must be proactively addressed by stakeholders.

Furthermore, despite the tremendous growth of the AIF ecosystem, distribution in India continues to be a challenge. Although regulations have simplified the process for asset management firms to introduce AIFs, distribution fees must be kept in check to encourage the industry to facilitate technology-driven investor onboarding.

In summary, an AIF investment environment that is prosperous and provides a variety of risk-return vehicles and investment solutions will benefit investors, institutions, and the economy in the long run.

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2023: A compliance odyssey

Executive summary

- Regulatory pace not slowing down – underrated attributes to cope in compliance and remain a key business partner:
 - Bouncebackability – individual resilience and learning from past mistakes.
 - Message management – headline -> sub-headline -> detail.
 - Commercial awareness – build the information puzzle using various sources to provide enterprising solutions.



Ranjeet Sahni
Head of Compliance
Torq Capital Management

2008 was not when compliance was invented, as I have had a few people muse to me in my career. Admittedly, you do not see compliance mentioned in seminal books like *"Liar's Poker"* (Michael Lewis) or *"When Genius Failed"* (Roger Lowenstein) but I have been in compliance since 2007 so that is an obvious piece of evidence to the contrary! Since the global financial crisis of 2008, compliance's prominence has risen rapidly because of the frenetic, widespread release of regulations, aimed to provide more effective supervision of the financial services industry, greater protection for investors and preventing systemic risks from (re)occurring. Below are a few attributes worth highlighting that sometimes go under the radar.

Individual bouncebackability

I've previously discussed an idea of [corporate bouncebackability](#) but within compliance, the classic definition of bouncebackability is vital. In all lines of work, it is important to be resilient and learn from one's mistakes. This is even more the case with compliance. Compliance can be a thankless task at times, where if you've done performed well or no regulatory issues happen on your watch, there is a risk nobody says anything because they don't think it's anything special or even simpler than that – this is what was expected of you and it's why you were employed so what's the big deal?! Conversely, when matters do go wrong, compliance can be seen as an easy target (regardless of how much or how little compliance was at fault).

Once this happened to me and it was horrifying. Without going into the specific details, I had erroneously made a regulatory disclosure because I had misinterpreted some information I had used from our own systems. No debate here – I was at fault. The regulatory authority contacted me later that day to ensure the disclosure was correct. I knew them contacting me was not frequent, so when I went through my working out again, I realised I had made that mistake. I can still remember how nervous I was. The sweaty palms. My mind racing at a million miles an hour. The thoughts of what this might mean for my future employment. The best way to describe it was like if you've ever accidentally left luggage behind on public transport. Your instant thoughts go towards (i) how silly/stupid it was of you for not concentrating enough to make the mistake originally; then (ii) what contents you had and what you're going to miss most, swiftly followed by (iii) the wider implications of leaving luggage behind on public transport and the security risk that might cause. Luckily, I submitted an amended disclosure, and nothing further came of it in one sense. In another sense though, the stress from that situation acts as a constant reminder of how pivotal paying attention to detail is.

Newspaper vs essay dichotomy

I have always said to people that I have worked with that how we write now must be different to what how we wrote when studying. In education, I would crudely generalise constructing an essay/thesis/dissertation as (i) pros; (ii) cons and (iii) conclusion. In the working world, writing in a newspaper style is more effective, particularly so with compliance. If we are trying to decipher the latest piece of regulation to affect the business and get the key points across to management for example, the 'essay way' is unlikely to work because the audience must get through all the substance to reach the conclusion. Instead, it is more effective to get the message across like a newspaper: (i) headline; (ii) sub-headline and (iii) backfill with detail. This way, management can get the gist of what you are trying to say and can delve further into the details if they want/have the time.

That is only one part of the story though – to make the message more effective, it needs to be written in a language your audience understands. If you are writing a message to management for example, then you need to consider how they think. What are their priorities? Try to see yourself in their eyes. Their first reaction might be *"So what?"* or *"Why does this matter to me?"* Does this regulation affect the firm's trading strategies (and if so, how)? Or the ability to raise money from a certain jurisdiction or a certain sub-set of investors? It can be easy to fall into the trap of writing detailed, eloquently written notes to prove your worth (thereby showing you have done the analysis and research) but that might not mean much if your audience is unlikely to read it and absorb the key details.

Being more 'strategic' or 'commercially aware'

I do not particularly like either phrase, but they get used often enough that to ignore them is a mistake.

In my experience, what this means is (i) not just throwing the rules/legislation back at whoever asked without adding any context; (ii) speaking in the business' language (as noted above) and ultimately (iii) creating something akin to a 'mosaic theory' method of gathering different pieces of information together in developing an enterprising solution:

- Internal research:
 - What do you think the regulations mean for the business?
 - What do others in your firm think this means?
- Market research from your peers:
 - What do other Compliance Officers, CCOs/GCs/COOs think?
- Other external parties:
 - Prime brokers?
 - Auditors?
 - Regulatory consultants?
 - Lawyers?

The aim is to build a clear and concise approach to present to the business in a language they understand.

Compliance is the one department where you can get criticised for being right. We do not write the rules. We are trying to apply them in as commercial and pragmatic a fashion to match our business needs and demands. The relentless pace of regulation can make it difficult to “*see the wood for the trees*” because of how easy it can be to get immersed in updating the business with the latest regulatory output. However, not every piece of work needs the same level of attention, detail, and review. This could save you time to allow to spend more focus on strategic matters.

Being asked to ‘rubber-stamp’ an initiative, however, does *not* mean you are being strategic. This might be a ploy that the business (reasonably) knows that compliance issues might cause problems for the initiative to proceed in its current form, so be wary of that.

Like pulling teeth?

As someone said to me recently, compliance reminds them of dentistry: (i) there is always a bit of fear and anxiety going to the dentist because you don’t know what the dentist will say regarding your teeth and what treatment (if any) you require; (ii) not going to the dentist will only make things worse but (iii) the feeling of relief (maybe not quite euphoria) when you’ve come out and everything has been fixed is worth it!

No portion of this article was drafted by generative artificial intelligence (e.g., ChatGPT, Bard or the like). I would not want a HAL 9000 coming after me!

Empowering hedge funds: How getting KYC and KYP right can transform the investor experience



Stefan Pantazis
Hedge Business Lead
Aiviq

In today's complex and ever-changing financial landscape, due diligence and transparency has become paramount. Hedge funds around the world find themselves in a shifting environment that requires a meticulous understanding of investor needs and product objectives. At Aiviq, we believe the concerted global regulatory focus on reliable and efficient *Know Your Client* (KYC) and *Know Your Product* (KYP) compliance regimes provides the bedrock for getting this right.

KYC and KYP are not just regulatory buzzwords; they provide the scaffolding for wider client and product governance initiatives and can transform investor outcomes. Hedge funds that prioritise these processes will be well-positioned to attract and retain client inflows in an ever-evolving investment ecosystem.

Hedge fund innovation in 2023

Hedge funds, and equally their investors, are embracing modernisation. A primary example of this is the shift away from traditional funds with manual subscription processes and lengthy offering memorandums to more agile liquid alternatives funds with lighter onboarding requirements and more flexibility. This market trend, underscored in a recent BNP Paribas¹ research paper sees investors favouring immediate access to assets and near-instant onboarding processes through digital apps and online portals for faster, lower-risk onboarding.

Digitising the investor onboarding and subscription experience increases fund flows, but also offers a range of broader benefits such as data security, contract governance and the creation of digital data assets that can drive management reporting and actionable sales insights – critical as firms start to leverage Generative AI and machine learning to transform the investor experience.

As the retail investor footprint grows in the industry, we see these digital and AI trends complemented by regulatory trends for greater transparency accountability and compliance, where robust KYC and KYP becomes paramount.

¹ Mulligan Fiona, Hedge funds explore the next big distribution opportunity, <https://securities.cib.bnpparibas/hedge-fund-retail-distribution/>

The significance of KYC in hedge funds

Globally, KYC is often considered the cornerstone of compliance frameworks aimed at identifying and validating investors, providing a mechanism to standardise investor data collection, prevent fraud, money-laundering and ensure regulatory compliance.

Conceptually, KYC has been around for a long time and many solutions have emerged to that attempt to increase investor due diligence and oversight in various jurisdictions or vehicle types. However, establishing globally consistent, regionally compliant processes that can maintain suitably flexible as a hedge fund scales or expands its distribution or product set remains a challenge for many firms. Whilst the major benefits of digitising KYC and subscription documents still centre around compliance and cost-reduction, firms also need to consider how this investment can help optimise internal sales teams and empower distribution strategies.

The four drivers of investment in KYC processes:

1. **Compliance:** The regulatory environment is evolving, and hedge funds must ensure they meet regulations across all their legal jurisdictions to avoid legal penalties and reputational risk.
2. **Risk mitigation:** Understanding investors' backgrounds and financial situations allows managers to assess the risk they may pose to the firm and other investors.
3. **Credibility and trust:** Investors are more likely to deploy capital with funds that can demonstrate a commitment to understanding client needs and offer differentiated investor experiences that reflect the brand.
4. **Personalisation:** KYC data facilitates the customisation of investment strategies by providing a single view of investors, enabling them to tailor products to meet individual need. Think "how do my onboarding and due diligence processes bring investors closer instead of scaring them away?".

The vital role of KYP in product selection

While KYC focuses on the investor side, KYP regulatory initiatives centre on the products offered by investment firms and covers how assessments of investment instruments are undertaken to ensure they are suitable given a fund's strategy, objectives and approach to risk. Importantly, KYP arms distributors and advisors with the necessary knowledge to successfully match products to suitable investors.

As Alternative Investment Funds (AIFs) become more accessible to accredited investors² (formerly they were the sole preserve of institutional investors), regulators are setting out requirements (e.g., IIROC Rule 3300 in Canada) for additional due diligence on investment instruments to be made available to investors.

With this in mind, we believe KYP and KYC are tacitly interconnected concepts, given investor suitability cannot be evaluated without a robust and consistent understanding of what the fund sets out to achieve. Similarly, firms that can demonstrate detailed product due diligence and documentation are likely able to focus in more on their target market, garnering greater, more sustained inflows versus peers.

2 <https://iclg.com/practice-areas/alternative-investment-funds-laws-and-regulations/canada>, 7.0 Trends

Why robust client and product due diligence goes hand in hand:

1. **Regulatory compliance:** Just as with KYC, adhering to the regulations surrounding product selection is essential in ensuring hedge fund's products align with stated strategies and objectives.
2. **Risk management:** A thorough KYP process enables hedge funds to identify and manage the risks associated with their chosen investments - essential for protecting both the fund and its investors.
3. **Sales optimisation:** Effective product selection is fundamental to achieving the fund's investment objectives and delivering on its promised returns.
4. **Diversification:** A well-executed KYP process allows hedge funds to diversify their product offerings, catering to a broader range of investor needs and preferences.

Market challenges and opportunities

1. The challenges that Aiviq sees firms grappling with centre around the complexity of product strategies, the need for high quality, up-to-date investor and market information, and the ever-evolving regulations. However, these challenges also present opportunities for innovation and growth. Technology integration: Hedge funds can implement technology to streamline and automate KYC and KYP processes, reducing the risk of human error, increasing consistency, and speeding up onboarding and product selection for investors.
2. Data analytics: Advanced data analytics can help hedge funds make better-informed decisions about their clients and products. By harnessing emerging pools of internal and external data, funds can gain deeper insights into market trends and investor behaviour.
3. Expert partnerships: Collaborating with third-party experts who specialize in KYC and KYP services can alleviate the burden on hedge fund management. These experts can provide the knowledge and tools necessary to ensure compliance and efficiency.
4. Continuous education: Staying updated on regulatory changes and industry best practices is essential. Hedge funds need to continue investing in their teams to ensure they can adapt to evolving requirements.

In conclusion, shifting product and investor dynamics, coupled with evolving regulatory initiatives means hedge funds have an opportunity to differentiate from peers by embracing KYC and KYP processes. The opportunities brought about by technology and AI are also working to compound the benefits associated with the digitisation of data and automation of manual workflows that have historically plagued onboarding and subscription processes.

In a competitive industry where trust and transparency are essential, we see investments in streamlined and reliable KYC, KYP and subscription processes is an investment in long-term success.

Prime brokerage: Consistency, reputation & service are key

Changes in the prime brokerage sector have resulted in mid-tier providers increasingly attracting funds that were previously associated with large, well-established prime brokers. Many funds have been compelled to seek out new primary or secondary prime brokerage services, affording them the chance to evaluate the market landscape and revisit their criteria and expectations from their prime broker.

Having been in the sector for over 25 years, Jack Seibald, Managing Director and Co-Head of Prime Services and Outsourced Trading at [TD Cowen](#) has seen first-hand the positive impact that a strong prime brokerage relationship can have on a fund. Here, he explains why a consistent team with buy-side experience and a strong track record should be a priority for fund managers when selecting a prime broker.

1. Choose a service provider that thinks and acts like a buy-side organisation

Having grown up on the investment side of the business, first as an analyst and then as a portfolio manager, I've always been mindful of the importance of bringing the buy-side's perspective to the solutions and services we provide and the manner in which we deliver them. It's important that your prime broker fully understands the needs of buy-side clients and that your outsourced trading provider looks, feels and functions like a buy-side organisation, from the technology used to the people delivering the service. This approach means they will represent you in the most credible and professional manner - a true extension of your organisation, with a high calibre institutional offering.

2. Check out the experience of the team

The calibre and experience of the team is key to your success. If you are seeking investment, for example, it's important the team members you will be working with have strong allocator backgrounds and can provide insight and guidance of how best approach and interact with potential investors. Find out about their access to potential investors and the breadth of their network. Ask them about their track record in securing investment.

Given the current climate, make sure that the team has experience of working through seismic shifts in the global economy and can guide you through turbulent times.



Jack Seibald
Managing Director and Co-Head of Prime
Services and Outsourced Trading
TD Cowen



The right prime brokerage team, aligned to your values and with an in-depth understanding of your business and aspirations, should provide valuable consultancy and advice ranging from operational efficiencies through to growth strategies.

3. Consider both the consistency & vision of the prime broker

The prime brokerage industry has been through a period of turbulence in recent years. Consistency is key. Rankings such as the annual Global Custodian Prime Brokerage Survey provide a good independent benchmark. Look out for firms that have consistently ranked in the top 10 over the last decade as this level of endorsement provides an indicator of strong, stable performance and a robust business model.

In addition to stability, you should also seek a prime broker that champions innovation and pushes boundaries. Partnering with a provider that focuses on its own evolution, whether through reaching new geographies, adding new asset classes, services or technology, is an indicator of their quest to continually improve their offering for clients.

4. Ensure your service provider offers a breadth of services

Whilst all funds need strong operational support, state-of-the-art technology and solid risk management from their prime brokers, additional requirements vary according to the age, stage and in-house capabilities of the fund.

Prime brokers provide an array of institutional services that can be customised to meet the individual needs of investment managers at any stage of their business. These can include trade execution and custody, middle and back-office support, securities lending and portfolio financing, capital introduction and outsourced trading.

Outsourced trading is, in fact, increasingly in demand as an efficient route to expertise, scale and reach – improving access to liquidity, asset classes, markets and geographies. This is a trend that looks set to continue throughout 2024 and beyond. It does not necessarily need to be deployed across all areas of trading and can be added as a permanent or temporary solution. It's a proven and effective way for fund managers to build their businesses.

Select a prime broker with a breadth of services and capabilities that can support the full lifecycle of your fund. Don't just think about your current needs as additional services may be required as your business evolves.

5. Added value and a 'client first' approach are key for success

Having a 'client first' philosophy is essential from a prime broker – in terms of having the flexibility to tailor offerings around the client's needs and being responsive at all times. Proactivity is also important. Strong client service not only means delivering against agreed objectives but also suggesting new ideas or opportunities which could strengthen your offering.

With the current economic challenges and the focus on cost efficiencies, it's more important than ever before for prime brokers to be able to deliver value. They should be able to find ways to do more for clients and enhance their businesses without necessarily costing them more.

In my experience, it is the combination of the elements above that make for a strong and successful long-term partnership between the prime broker and fund manager. Only a limited number of prime brokers can offer the full spectrum of services on a global basis and provide the level of high-touch customer service that many funds need. Do your due diligence thoroughly and choose carefully!

Thank you for reading the
Edition 136 of the AIMA Journal.

If you would like to contribute to future editions,
please email [Caterina Giordo](mailto:Caterina.Giordo@aima.org)

PUBLICATION PLAN 2024

- **Q1 Edition 137**

Deadline for submission 5pm UK time Monday 12th February | Publication Monday 18th March

Please note the deadline for reserving a spot for the Q1 2023 edition of the AIMA Journal is 5pm UK time, Friday 26th January.

- **Q2 Edition 138**

Deadline for submission 5pm UK time Monday 20th May | Publication Monday 17th June

Please note the deadline for reserving a spot for the Q2 edition of the AIMA Journal is 5pm UK time Friday 6th May.

- **Q3 Edition 139**

Deadline for submission 5pm UK time Monday 29th July | Publication Monday 23rd September

Please note the deadline to reserve a spot for the Q3 edition of the AIMA Journal is 5pm UK time Friday 12th July.

- **Q4 Edition 140**

Deadline for submission 5pm UK time Monday 21st October | Publication Monday 18th November

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

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

We kindly advise all contributors to email us prior to submitting to make sure we can include the contribution. We can't guarantee the inclusion of any last-minute submissions.

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