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ESG as a component of investment DNA
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and more...

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The Long-Short Podcast

Your window to the alternative investment universe

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Paul A. Volcker Senior Fellow in International Economics, Council on Foreign Relations
Author of The Power Law and More Money than God

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Co-Rapporteur Platform for Sustainable Finance
European Commission

Dan McCrum
Investigative reporter at the Financial Times
Author of Money Men

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Message from AIMA's CEO

I always welcome the highly informative articles focused on established trends such as private credit, digital assets, ESG and technology, but this edition is notable for its contributions highlighting some of the emerging trends readers may not be as aware of.

Firstly, the growth of Dubai as a financial centre both for our industry and wider markets has commanded many column inches already this year and I read with interest this journal's contribution to the discussion. The piece articulates how the jewel of the United Arab Emirates' economic crown aims to rival established hubs of London, New York, Hong Kong, and Singapore.

Secondly, I am pleased to see greater attention given to the increasing demand for exposure to alternative investments by retail investors. I highlighted this trend in a blog in December 2022 outlining seven predictions for 2023. Intriguingly, the article in this journal includes data indicating that retail investors in APAC are more bullish on alternative investments than their global peers, although the figures are encouraging across the board.

AIMA will be closely monitoring both of these trends. As I have suggested previously, the AIMA Journal will always keep readers informed about issues at the forefront of the industry's development. This is true for new trends and developments in established topics like ESG. For example, articles in this edition allude to the increasingly sophisticated products and data in the sustainability space with a focus on biodiversity among the new hot topics.

As ever, there is too much high-quality content to mention here, so readers are encouraged to dive into all this edition has to offer. Digital assets, jurisdictional updates, and regulatory deep-dives – including a timely reference to ELITIF 2.0 – are among the pieces that should not be missed.

Readers are also encouraged to visit AIMA's Newswire section to learn more about the valuable work of my colleagues in all the areas mentioned above.

My thanks, as always, go to all contributors to this edition. Readers looking to join the discussion can find details on how to submit articles on page 69.

Jack Inglis
CEO, AIMA

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8 Jun Acorns of APAC - Emerging Manager Outreach 2023

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12-13 Oct AIMA Global Investor Forum 2023

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Dubai: An emerging global hedge funds hub

Muneer Khan
Partner | Middle East Regional Head
Simmons & Simmons

In 2022, Dubai ranked 1st regionally and 17th internationally in the Global Financial Centres Index (the **GFCI**). It also ranked 9th in the GFCI "Future Prospects" list, where respondents were asked which financial centres they considered would become more significant over the next two to three years. The Dubai International Financial Centre (the **DIFC),** a financial free zone within the Emirate of Dubai, is the largest financial services centre in the Middle East, Africa and South Asia (**MEASA**) region. In fact, the DIFC's most recent annual report shows that the DIFC was home to over 4,300 active companies in 2022 and has experienced 20% year on year revenue growth. In recent years, a growing number of hedge fund managers have been attracted to the DIFC as a result of various pull and push factors. The DIFC has rapidly emerged as the largest hedge fund management hub in the MEASA region and continues to experience exponential growth.

1. What is driving this growth?

One main contributing factor that explains this influx of asset managers is the COVID-19 pandemic. Whilst some financial hubs like London, Hong Kong, Singapore and New York were subject to significant COVID restrictions and stringent lockdowns, Dubai took a more balanced approach (combining a strategy of rapid vaccine rollouts, sensible social distancing measures, open borders and generally remaining open for business). This led many people, including hedge fund portfolio managers, to relocate.

The UAE's favourable tax regime (in particular, there is no personal income tax) has been a key driver, especially when this is contrasted with the global rise in living costs and tax rises. In the global war for talent, having the ability to offer the option of a Dubai office is often becoming a decisive factor. This is particularly the case for the multi-strategy multi-manager platforms, more and more of whom are setting up a significant presence in Dubai.

The UAE "golden visa" scheme, which is a five- or ten-year self-sponsored renewable residence visa scheme for "specialised talents" and investors has also been a draw for founders, senior managers and certain specialised finance professionals, such as quants.

2. The UAE's multi-faceted regulatory landscape

The UAE has a multi-faceted regulatory landscape. Financial services such as financial promotion, advice, arranging deals or asset management, are usually undertaken from one of the jurisdictions of (i) "onshore" UAE, (ii) the DIFC or (iii) the Abu Dhabi Global Market (the **ADGM**), each of which has its own financial laws and regulations. The DIFC and the ADGM are financial free zones that were formed to encourage foreign investment by offering concessions such as zero tax guarantees and complete foreign ownership of entities.

The Dubai Government has been notably bold in its readiness to establish the Emirate as a global hub for virtual assets: in February 2022, the Dubai Government established the world's first dedicated independent virtual assets regulator (the **Virtual Asset Regulatory Authority** or **VARA**) tasked with the regulation, governance and issuance of licences for virtual asset related activities, including brokerage and asset management. Six months later, it became the world's first independent regulator to enter the metaverse, a move which illustrates Dubai's commitment to the future digital economy.

This diverse landscape ultimately provides a number of options for alternative asset managers wanting to relocate. The DIFC in particular has gained international recognition as a world-class financial centre and is seen as an example of how other governments around the world can potentially fast track legal and regulatory reform.

3. Will this last forever?

The Dubai Government just recently announced a US$8.7 trillion economic plan to boost its finance sector over the coming decade

Despite the recent successes of the UAE and Dubai in particular in attracting major hedge fund management names over the last few years, it is important not to be complacent. The global financial crime watchdog, the Financial Action Task Force, placed the UAE on its grey list in March last year with one of the main issues mentioned being the apparent lack of anti-money laundering enforcement action. There also are wider concerns about the disruption to the status quo, such as questions over the long-term sustainability of the 'crypto-bubble' and whether the introduction of corporate taxation for the first time this year and the rise in real estate prices will increase business costs and the cost of living.

That said, the future for now looks bright, and the Emirate is doing its best to face these potential headwinds directly – the Dubai Government just recently announced a US$8.7 trillion economic plan to boost its finance sector over the coming decade. It is also, in any event, clear that the UAE and especially Dubai is now at the top of the list for some of the world's largest alternative asset managers and their talent, who increasingly see it as a longer-term home for them and their families. Though one can never predict the future of global markets, especially in current times, based on our own pipeline of applicants, we expect the speed at which hedge fund managers have entered and set up in the UAE will most likely continue over 2023 to 2024.

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Lessons from the 1970s

Henry Neville
Portfolio Manager
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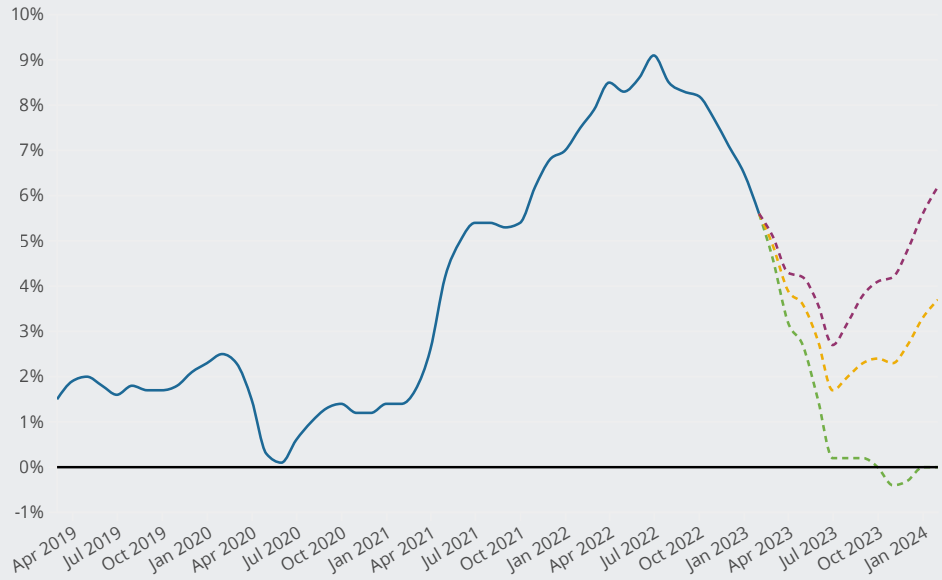
Those who cannot remember the past are condemned to repeat it. Credited to George Santayana. But could have been Rene Magritte or Winston Churchill. Google isn't quite sure. In any event, it's a wise old saw, and one which today's central bankers and investors would do well to keep in mind.

Headline inflation in the US has fallen by 260 basis points in six months, from 9.1% to 6.5%.[1] Our models suggest it will continue downward. Fast. To reach 2% this year. By-the-by, we don't even see that as a particularly bold prediction. The past six month-on-month readings of the non-seasonally adjusted headline CPI basket have averaged at...0.0%.[2] Unless future monthly readings move abruptly higher, the power of the base effect will do a lot of heavy lifting. **Figure 1** shows three pathways for year-on-year (YoY) inflation based on different monthly increases. At current rates we will have outright DEFLATION on a YoY basis in 2023.

Figure 1. *US inflation pathways based on different monthly readings*



Source: Man DNA; as of 6 February 2023

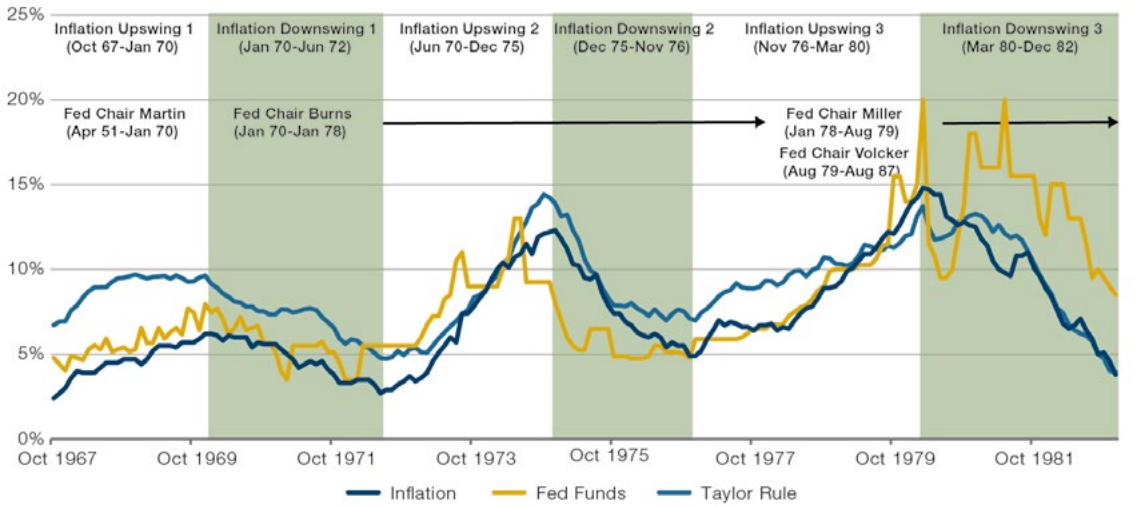
To be sure, we view this as unlikely, and a two-point-something trough is our base case. But still, with expectations continuing to run above this (Wall Street's average 12-month ahead estimate is 3.6%, with a low of 2.5% and high of 7.4%[3]), we think many market participants, from Cathie Wood to Jay Powell, will be left with the warm fuzzy feeling of disinflation, the recent monster non-farm payroll print notwithstanding.

But inflation is like the Terminator chasing Sarah Connor. Until it's completely destroyed – in the hydraulic press or the lake of molten steel (the various sequels merge into one) – it will keep coming back. This was the experience of the succession of Federal Reserve chairs in the 1970s.

1 Source: US Bureau of Labor Statistics; as of 12 January 2023
2 Source: US Bureau of Labor Statistics; as of 12 January 2023
3 Source: Bloomberg; as of 6 February 2023

In **Figure 2** we show YoY inflation, the Fed Funds Rate and Taylor Rule implied rate for the three inflationary waves between 1967 and 1982. In the centre of the graph, we annotate with the tenures of the various Fed chairs through this time.

Figure 2. *Inflation and interest rates in the 1970s*



Source: Man DNA; as of 6 February 2023

Two things jump out to us. First, monetary policymakers clearly responded to the inflationary waves as they rose. Arguably their responses were much more impressive than their successors today. Indeed, from the chart it looks like the reputation of good old Arthur Burns, now the financial hack's go-to analogue for feckless central banker, has been unfairly traduced.

On his watch, inflation rose from 3% to 12%. But one can reasonably argue that he put his shoulder manfully to the wheel in response, keeping real rates positive for almost the entire period, and by an average of +1%. During the most recent inflationary surge, when headline CPI YoY went from 2% to 9% between February 2021 and June 2022, the current administration, with all the boldness of brave brave Sir Robin, took rates from 0.25 to 1.75%.[4] Over that period, real rates were negative all the time and on average -6%. So, while the past six months have seen some impressively hawkish sounding noises, it is dust on the scales given what has come before.

The second thing we observe from **Figure 2** is that it wasn't until rates were taken meaningfully and persistently above the Taylor Rule (as we have previously discussed in The Forgotten Rule) that the inflationary sequels stopped. Again, to be fair to Chairman Burns, he did move rates above this threshold. At one point, the Fed Funds Rate was 11% while the Taylor Rule would have implied just 7.5%. But ultimately, he was too easily cowed by President Nixon and retreated before the job was done. It wasn't until Volcker, who took rates to 20%, some six points higher than the Taylor Rule, and proceeded to keep them above inflation until his retirement in 1987, that the WIN could be declared.

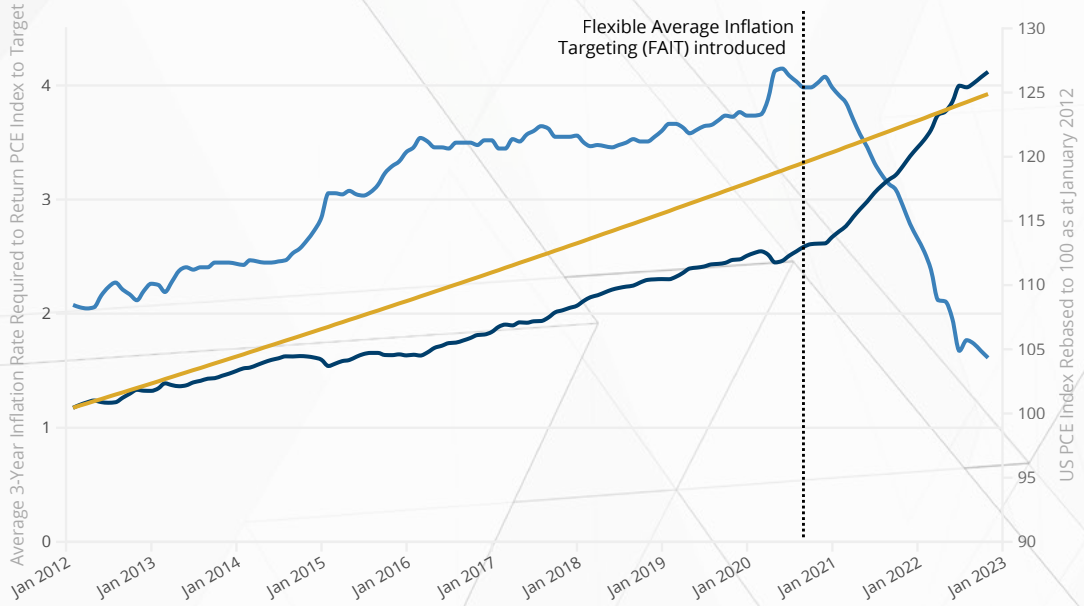
Of course, the Taylor Rule was not formulated until 1993, so it cannot have been being discussed explicitly in the 1970s. But we think it would have been there implicitly in a number of ways, not least of which the fact that the rule takes account of realised inflation. That is, if you have 9% inflation in year one and 2% in year two, some might see this as job done, but for most actual people, they've just seen their bills go up by 9% and the fact that they're now 'only' going up by 2% is scant consolation. It should be noted that the Fed itself implicitly made this point by explicitly incorporating the reverse into its Flexible Average Inflation Targeting (FAIT) framework in August 2020.

4 Source: Bloomberg; as of 6 February 2023

The idea then was that, per **Figure 3**, the actual personal consumption expenditure (PCE) index since the Fed first adopted a 2% inflation target was close to 5.5% below where it would have been if that target had actually been met. Thus, to return the index to target would require inflation to run at around double the objective over three years. And the Fed would take this 'memory' of inflation into account when setting policy rates. Not much has been heard of FAIT since then. Perhaps coincidentally, it suggests policy will now need to be tightened such that inflation is 50bps below the 2% target.

This is no time to go wobbly, as a wise woman once said. And what was true of the Gulf in 1990 could equally be applied to US monetary policy in 2023. To really end the inflationary waves here and now, to cast the ring into Mount Doom as it were, rates would need to peak, not at the 5% where market pricing is at present, but closer to 9% as is today implied by the Taylor Rule. Clearly, the Fed can't realistically do that. The impact on housing alone would simply be too painful and too politically unpalatable. Like Isildur we expect them to turn back, and understandably so. But for investors this does mean that the inflationary surge of 2021-22 is unlikely to be the last of this decade.

Figure 3. *Implied rate of inflation required to return the Fed to its long-run target*



Source: Man DNA; as of 6 February 2023

The other lesson of the 1970s is that even though high inflation decades are, overall, not good times to hold equity risk, the periods in between the waves can be very strong. Returning to **Figure 2** (page 13), while over the full time period US equities returned -0.5% in real annualised terms, the corresponding figures for the three inflation downswings (the green shaded areas) were, respectively, +7%, +18% and +15%.[5] At the start of the year, we wrote a piece entitled It's All Going To Be Okay, making this same point, that a period of disinflation is generally a time when the market rallies. And this continues to be our view for 2023. Despite the fact that earnings forecasts have been revised down by close to 2% year to date, the S&P 500 Index has rallied by nearly 8%.[6]

The market can only focus on one thing at a time, and currently that thing is inflation. So, we continue to see the next couple of quarters as being risk-positive and expect stocks to continue to climb the wall of worry.

But towards the end of the year and into 2024 we expect the inadequacy of the Fed's response to be revealed, and the 2020s' second wave of inflation to be initiated. This is going to be a turbulent decade for investors. Buckle up.

5 Source: Man DNA; as of 6 February 2023
6 Source: Bloomberg; as of 6 February 2023

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5 important ESG developments that will carry into 2023

Dan Mistler
Partner, ESG
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Marie Luchet
Managing Director, ESG
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At first blush, some might have regarded 2022 as the year of 'ESG backlash'. But that's only based on the headlines.

On the ground, investors continued to methodically press ahead on the environmental, social, and governance (ESG) front, further incorporating ESG factors into their existing investment frameworks. A Pitchbook survey of general partners (GPs), limited partners (LPs), and other investors found that 62% now fully or partially integrate sustainable investment principles throughout their portfolios, up from 58% in 2021. This has resulted in unprecedented demand for ESG data to help monitor, measure, and benchmark ESG performance over time and against stated ESG claims. Spending on ESG data and analytics, for example, was expected to exceed US$1.3 billion in 2022, up from US$1 billion the prior year. Overall spending on ESG business services is expected to grow 32% a year for the next five years. Another driver of this growth is the fact that ESG has become an area of increasing focus for regulators—not for political reasons, but to root out greenwashing in a strategy that continues to grow in popularity and assets, irrespective of the backlash talk.

The heightened regulatory scrutiny of ESG is likely to continue this year, as are several other trends.

Here are 5 key ESG trends that unfolded in 2022 which are expected to continue to be big themes in 2023.

Overall spending on ESG business services is expected to grow 32% a year for the next five years.

The arms race for high quality data heats up

From increasing regulatory scrutiny to greater investor demand for accurate monitoring and measurement, the need for ESG data continues to expand. This goes beyond basic ESG scoring. Investors are demanding higher-quality data and analytics to help them track and benchmark ESG performance over time. In fact, a recent EY survey of institutional investors found that around half of asset managers are concerned about the lack of real-time and forward-looking ESG reporting.

The challenge for the industry is to improve the breadth and quality of the data that's available to them. This is particularly true in the private markets, where investors are seeking quality data for privately held companies

when very little information is publicly known. We expect this demand to grow further in 2023. In particular, in Europe the main objective of the new Corporate Sustainability Reporting Directive (CSRD), previously known as the Non-Financial Reporting Directive (NFRD), approved by the European Parliament in November 2022 and coming into effect in 2024, is to increase ESG data quality and comparability.

Biodiversity becomes a front-burner issue

One area where data demand is expected to grow is around biodiversity. While climate issues in general have been a leading area of focus among ESG investors for years, biodiversity, which is a subset of that theme, began to pick up steam in 2022. In fact 41% of investors say that biodiversity, which speaks to the variety of species within an ecosystem and the resulting strength of those habitats, is a "significant factor" in their investment policy today. That's up from just 19% two years ago. And over the next two years, that figure is expected to climb to 56%, according to Robeco's 2022 Global Climate Survey.

This focus on biodiversity is being driven by investor interest. More than half of investors surveyed cite their commitment to *"reducing long-term systemic risks associated with biodiversity loss impacting all sectors, societies, and economies"*. In other words, because biodiversity, which is directly affected by climate issues, impacts communities and economies on critical issues like clean water, food, and energy, it is where the "E" in ESG (environment) meets the "S" (or social impact). At the same time, as regulators and investors seek greater transparency on ESG performance and impacts, the need to monitor and measure how company operations and investment decisions affect local communities and ecosystems is only growing.

It is also worth noting the historic deal to stop the destruction of biodiversity at COP15 in December, 2022. This deal includes targets to protect 30% of the planet for nature by the end of the decade, reform US$500bn (£410bn) of environmentally damaging subsidies, and restore 30% of the planet's degraded terrestrial, inland water, coastal and marine ecosystems.

ESG enforcement at the SEC picks up steam

There was a clear theme in US Securities and Exchange Commission (SEC) enforcements actions in 2022 - if you say or imply what you do, you have to do what you say. In November, the agency charged a prominent asset manager for policies and procedures failures involving two mutual funds and one separately managed account strategy marketed as ESG investments. This came a few months after the SEC charged another large investment adviser for implying that all investments in certain funds had undergone ESG review though this was not always the case. And a few months prior to that, the SEC charged a robo-advisor for misleading statements implying that its advisory services were compliant with Islamic Shari'ah law, though written procedures were not in place to ensure compliance with the claims.

Investors can expect this push to continue, as the SEC announced this year that among its Division of Examinations' priorities is ESG. This includes ensuring that firms are operating in a manner that aligns with their ESG disclosures, ESG products are appropriately labeled, and ESG-related recommendations are made in the best interest of investors.

Regulators propose a 'bigger stick' approach to greenwashing

In recent years, Europe had taken the lead in pushing for a regulatory approach to combat greenwashing, through efforts such as the EU's Sustainable Finance Disclosure Regulation (SFDR), the NFRD (soon to be CSRD), and EU Taxonomy. This year was the SEC and the UK's Financial Conduct Authority's (FCA) turn.

In March, the SEC proposed amendments to existing rules requiring additional climate related disclosures for publicly traded companies. The SEC also proposed enhanced disclosures by investment advisers and investment companies on ESG practices, along with rules changes to prevent misleading or deceptive naming of funds that don't invest 80% or more of their assets in securities that match the terminology. The SEC's proposals are not politically based, but instead reflect best practices so firms live up to their advertised and stated ESG claims.

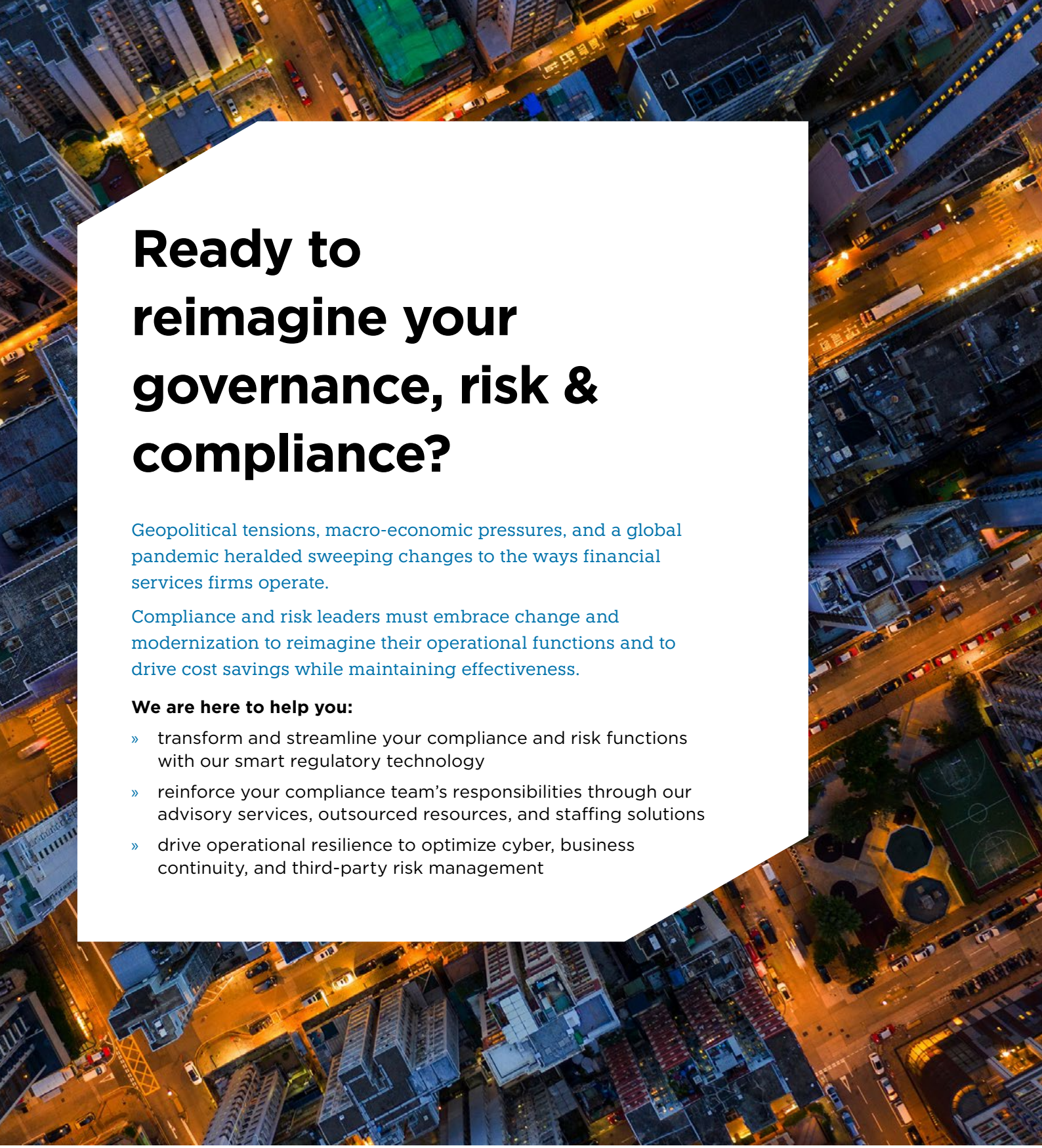
In August the FCA also warned that it will scrutinise ESG claims made by hedge funds and private equity firms as part of its annual supervisory priorities ensuring that marketing materials accurately describe their product.

The FCA has also published its proposal for clamping down on greenwashing across all sustainably labelled products - CP22/20: Sustainability Disclosure Requirements (SDR). The proposal aims to build transparency and trust by introducing labels to help consumers navigate the market for sustainable investment products and ensure that sustainability-related terms in the naming and marketing of products are proportionate to the sustainability profile of the product.

Economic realities bite

A new wrinkle presented itself in the ESG discussion in 2022: the global economic downturn, which is affecting virtually every asset class and making it harder to prioritise ESG goals as the overall business climate weakens. The challenge for investors in this environment is to continue to push forward against these geo-political headwinds. For some, the answer is simply ignoring the headlines and sticking with their long-term plans. For others, it may be finding alternative solutions that are lower-cost and more efficient to achieve their longer-term ESG needs.

The ESG landscape is evolving at a rapid pace and requires additional resources to meet investor and regulatory expectations. Firms would be prudent to consider their regulatory and investor requirements and determine if any changes need to be made to their ESG program to meet this increased scrutiny.



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ESG as a component of investment DNA

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Polarising debate

The question of whether ESG should be made a part of fiduciary duty in investments has supporters at both ends.

Take a look at the global political arena, where certain lawmakers and companies have banded to try to preclude the use of ESG factors when state fund managers make investment decisions. And then there's the other side, with notable global organisations setting out in the 2019 final report *Fiduciary Duty in the 21st Century*[1] that ESG issues are increasingly a standard part of regulatory and legal requirements for institutional investors, along with the need to integrate sustainability-related preferences of clients and beneficiaries.

Make no mistake, a client's best interests, traditionally speaking, is defined by financial return. In investments, this ideal is supported and protected by fiduciary duty – an established concept of corporate responsibility under both common and civil law – where investment managers need to act in good faith, impartially balance conflicting interests of different beneficiaries and avoid conflicts of interest, among other things.

However, if law purports to reflect, support and protect a people's perspectives - what they stand for as a general whole - it is understandable why many are calling for more ESG attributes to be included as part of the investment decision. In any case, does the inclusion of ESG priorities really redefine a client's best interests?

Significant investor support

According to the *Principles for Responsible Investment (PRI)'s Annual Report 2021-2022*[2], the growth in signatory numbers has continued to accelerate, increasing 28% year-on-year to 4,902 (4,395 investors and 507 service providers) as of 31 March 2022.

These signatories account for roughly US$121.3 trillion of assets under investment (AUM). What this means is that a very significant amount of assets is being committed to responsible investments by institutional investors – pension funds, endowments, foundations, insurance providers, development finance institutions, sovereign wealth funds, family offices, wealth managers and asset managers (multi asset or single asset), as well as businesses that provide services to investors.

1 The report was initially launched by the Principles for Responsible Investment (PRI), the United Nations Environment Programme Finance Initiative (UNEP FI) and The Generation Foundation in 2015 to clarify investors' obligations and duties in relation to the incorporation of ESG issues in investment practice and decision-making. https://www.unepfi.org/investment/history/fiduciary-duty/

2 New and former signatories | PRI Web Page | PRI (unpri.org)

PwC's 2021 global investor survey[3] reinforced this by pointing out that investors are poised to pay more attention to ESG risks and opportunities facing the companies they invest in: Nearly 80% in the survey said ESG was an important factor in their investment decision-making; almost 70% thought ESG factors should figure into executive compensation targets; and about 50% expressed willingness to divest from companies that didn't take sufficient action on ESG issues.

One investment firm's ESG head was quoted in the survey saying that "ESG has gone mainstream." The executive went on to add that "you can't walk into a financial institution now to talk about long-term themes without mentioning ESG." For now, such an approach seems right on the money: Since its establishment in 2019, the S&P Global 500 ESG Index has roughly tracked the standard S&P 500 index, and even outperforming it slightly since 2020 as of January 26, 2023.[4]

Regulation

Governments in many developed jurisdictions have also introduced or changed policy in favour of ESG priorities. For instance, on 26 November 2021, Hong Kong's Mandatory Provident Fund Schemes Authority introduced the Principles for Adopting Sustainable Investing in the Investment and Risk Management Processes of MPF Funds. These set out a high-level ESG integration framework for trustees of MPFs – investment entities for the city's mandatory retirement protection scheme – across four key elements consistent with widely followed recommendations by the Task Force on Climate-Related Financial Disclosures (TCFD): governance, strategy, risk management and disclosure.

This followed, on 20 August 2021, the Hong Kong Securities and Futures Commission's issuance of a circular to licensed corporations – Management and Disclosure of Climate-related Risks by Fund Managers, which set out standards for complying with its amended Fund Manager Code of Conduct that largely adopted the same elements.[5]

Further, in the UK, the Occupational Pension Scheme (Investment) Regulations 2005 (OPS Regulations) was amended in 2019 to define 'financially material considerations' as including ESG factors, which placed a legal obligation on the concept that ESG factors contribute to financial performance. This means that integrating ESG factors into fiduciary duty is not inconsistent toward the beneficiary's best financial interests.

While the OPS Regulations apply to pension fund trustees, given that investment management is consistently outsourced, the amendment will inevitably influence how fiduciary duties of investment managers are generally interpreted. In addition, the Financial Conduct Authority published a policy statement in December 2021 that outlined rules and guidelines tied to requirements under a new climate-related disclosure regime for asset managers in alignment with TCFD recommendations.

Then there is the EU, where its Sustainable Finance Disclosure Regulation (SFDR) and Taxonomy Regulation establish specific environmental criteria related to economic activities for investment purposes, and which forms part of enhanced disclosure obligations required by the SFDR.

Under such guidance, SFDR aims to reorient capital towards sustainable growth and help investors make better sustainable investing choices. A sustainability risk is defined as an environmental, social or governance event, or condition that, if it occurs, could have a negative material impact on the value of an investment. The SFDR applies to all EU-based financial market participants and financial advisers, as well as those who market products to investors in the EU.

3 https://www.pwc.com/gx/en/services/audit-assurance/corporate-reporting/2021-esg-investor-survey.html
4 A 'fiduciary question' looms large over the ESG debate in 2023 | S&P Global Market Intelligence (spglobal.com)
5 Circular to licensed corporations Management and disclosure of climate-related risks by fund managers | Securities & Futures Commission of Hong Kong (sfc.hk)

In the US, the Department of Labor released a final rule (Final Rule) that addressed investment selection and ESG considerations for retirement plans tied to its Employee Retirement Investment Security Act (ERISA). It took effect the 30 January this year.

The Final Rule clarified that fiduciary duty should be based on factors that are reasonably relevant as reflected in a risk and return analysis, using appropriate investment horizons consistent with investment objectives and funding policy. Such factors may include the economic effects of climate change and other ESG factors on a particular investment decision, though they are not required to be considered. On the other hand, compared to a previous rule introduced in 2020, the Final Rule is expected to make it easier for ERISA plans to pick investments that prioritise ESG attributes. Further, as has been seen in other jurisdictions, the Securities and Exchange Commission (SEC) proposed amendments to rules and reporting forms which would require SEC-registered advisers to include ESG factors and strategies for investors in fund prospectuses, annual summaries and brochures.

Conclusion

It is not inaccurate to conclude that there is gradual and increasing support globally for ESG factors to feature in the investment DNA. This has been reflected in more and more investor and government impetus as both sets of parties converge in a way that arguably shows the market operating as we know it does: assigning limited investment resources to the most efficient use based on what it believes is most important.

And crucially it has been shown that ESG considerations do not necessarily impede the fiduciary's best interests-objective of financial profit. For better or worse, depending on one's beliefs, it is irreversible that ESG considerations are now an integral part of the fiduciary duty debate, if not already codified as a concept in markets like Hong Kong, the UK and the EU. It is also hence important that investment managers understand their obligations under these relatively new laws as they carry increased regulatory and legal risks. It will be imperative that they consider their clients' sustainability-linked preferences in order to avoid being taken to task for losses due to a lack of consideration for ESG attributes.

As the world ramps up on action to tackle climate change, it is certain that regulators everywhere will take an equally proportionate approach to imbuing investment mandates with ESG considerations. If it hasn't already been the new normal, we expect it will be, sooner rather than later.

Disclaimer: Information contained in this briefing is current as at the date of first publication and is for general information only. It is not intended to provide legal advice.

Navigating the private credit landscape

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Private credit has been the shining star in the private markets' universe over the past decade. While private equity fundraising tapered off significantly in 2022, private credit reportedly reached an all-time high, despite a slowdown in fund launches. Watching all the institutional capital flowing into private credit, it's not surprising more hedge fund and private equity managers are tempted to diversify into the sector. However, as many have already found out, it's not easy. Between fierce competition and operational complexity, new entrants have more than a few obstacles to navigate.

Growth drives competition

In the ten years running up to 2022, private credit (or private debt) funds experienced faster growth in asset under management (AUM) than private equity, venture capital and real estate. The reasons are clear: private lending is popular with borrowers and investors. Privately held companies get a more flexible and often faster funding alternative to bank loans. Meanwhile, investors can earn comparatively predictable returns at attractive, risk-adjusted rates. Volatile equity markets and rising interest rates have further increased investor appetite for this asset class.

Private debt has also become extremely competitive, both in deal sourcing and fundraising, dominated by well-established players. Managers coming into the market with a new fund must have a clearly differentiated proposition to attract investor attention.

Big operational differences

From an operational perspective, private credit and private equity are very different. Private credit requires an understanding of debt underwriting and loan facilities. Where a typical private equity portfolio might have 10-12 companies, loans in a single credit fund can number in the hundreds. Systems designed to support private equity or real estate funds are not readily adaptable to the volume, complexity and multiple moving parts associated with private debt funds.

Moreover, private company loan data does not lend itself easily to automation. Company information comes in various forms, with little standardisation, resulting in a high degree of paper-based and manual processing. Cash flows, too, can be sporadic and unpredictable, with variable interest rates on multiple loans, different payment schedules and occasional delinquencies.

As we've seen across private markets, institutional capital has largely fueled private credit growth. Institutional investors come to the private markets with high expectations for transparency and operational integrity. In an uncertain economy, they are likely to be highly selective and restrained in their allocations. Managers should be prepared for rigorous due diligence. With all the competition in the market, the ability to demonstrate a sound operational infrastructure can be a scale-tipper.

Put your foundation in place

Sourcing deals or launching a fund without the infrastructure to support the business is risky. Before setting up, prospective private debt managers need to conduct a comprehensive review and add capabilities where needed, with a focus on three key areas:

- Loan servicing and administration: the ability to collect payments and allocate returns among limited partners efficiently and accurately.
- A portfolio accounting solution that can handle a high volume of transactions.
- Efficient support for different fund structures: credit funds are typically closed-end, but some may be hybrids and or may include multiple special purpose vehicles (SPVs).

Fund managers investing globally also need to be aware of the compliance requirements of the various jurisdictions in which their loans originate, as well as be able to account for each fund entity's investments in multiple markets and currencies. Treasury management becomes more important as well. With a wide range of deals and continual cash movement, funds need to stay on top of their available cash and opportunities to optimise the proceeds from their investments.

The outsourcing option

If you haven't run private debt before, you may think you are looking at a substantial investment in technology and operational expertise to be competitive from day one. That's a good reason to consider partnering with a technology and services provider with established infrastructure and expertise specifically to support private debt funds globally, including solutions for loan servicing and administration, portfolio accounting, and managing various fund types and structures. If you want to diversify an existing private equity or hedge fund business, working with a provider with experience and resources across private markets would be optimal. You should also be looking for experience with the regulatory, accounting and tax requirements in all the jurisdictions in which you are likely to invest.

Private credit represents a significant opportunity for fund managers to diversify their offerings and capture more of their limited partners' allocations. With a provider to help you navigate the operational challenges, you can get to market faster and avoid getting caught up in complexity, freed to focus on sourcing deals and raising capital. The provider should also be able to help you gain investor confidence with a technology platform and best-practice processes that stand up to rigorous due diligence. Once the operational obstacles are out of the way, the path to opportunity appears much clearer.

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Retail participation: A new frontier for private markets?

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The private markets landscape

The year 2022 posed some of the most significant challenges to the financial markets and economic growth in living memory. For the first time in two generations, the world entered a period of low growth and high inflation. Coming off the back of nearly a decade and a half of extremely low inflation and predominantly bullish markets since the end of the Great Financial Crisis of 2008, this has unnerved investors and policy makers who are unaccustomed to such a volatile economic environment.

This backdrop has also disrupted some longer-term trends. Private markets have seen exponential growth during the past decade. However, we are now seeing a sharp slow-down in fund raising activities.

At the beginning of this year, we released the findings from our annual Private Markets study, with responses from 480 institutional investors across North America, Latin America, Europe and Asia Pacific (APAC), that explores how institutional investors will allocate across private markets in 2023. Respondents observed that higher interest rates triggered by central banks globally to tame inflationary pressure makes leveraged investments less attractive. In APAC, 71% of investors cited this as a concern, largely in line with the global average of 69%.

However, approximately two thirds (64%) of the respondents in APAC also said they plan to continue their allocation to private markets in line with current targets, only slightly under the global response of 68%.

According to McKinsey's 2022 report on the sector, private markets fundraising grew annually at 6.3% between 2016 and 2021[1], and our research suggests that this growth was structural and will continue beyond an economic downturn. The findings align with the observations in APAC. In Australia, for example, we expect that Superannuation Funds will continue to hold or increase allocations to private markets, particularly while the majority of members are in their accumulation phase. The key challenge for them would be an increased focus on deal quality and track record of the general partner (GP). However, we are seeing a slowdown in fundraising across APAC. The number of exits has fallen considerably, suggesting portfolio valuations still remain high. This creates several challenges for the GP ecosystem, but likely brings about opportunities for distressed players.

1 https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/mckinseys-private-markets-annual-review

Private equity (PE) however, still remains the most favoured asset class within private markets, with 69% of institutional investors in APAC anticipating it to be their largest allocation over the next two to three years, which is higher than global investors (63%).

This could be explained by two main drivers. Despite the slow fund-raising environment and the increased focus on valuations and concentration risks, there are many asset owners in APAC who have just started or are considering starting a private markets allocation programme. This new wave of investors would typically rely on a fund of funds or larger and more well established GPs with a proven track record.

The difficult macroeconomic environment will also see a greater focus on distressed assets, which was again highlighted by our survey, with 74% of APAC respondents (in line with the global average of 75%) saying "tougher times" would yield more "bargains" in private markets.

Retail investor demand investment in private markets

In the APAC region, 61% of respondents said there is "strong demand from retail and high net worth investors for increased access to private markets". Globally, 55% of the respondents agreed with this sentiment.

APAC respondents were largely in line with their global peers in their analysis of the reasons behind this growing demand, citing diversification (62%), yield (53%) and the desire to invest in successful companies before they announced their initial public offerings (53%).

In the APAC region, 61% of respondents said there is "strong demand from retail and high net worth investors for increased access to private markets".

Globally, 55% of the respondents agreed with this sentiment.

This is a trend we have observed consistently in Australia and it presents opportunities for Superannuation Funds to provide a globally diversified portfolio to its members. This demand can also be seen clearly in the growth of listed investment trusts typically providing real estate exposures.

Despite this observation, only 36% of APAC investors agreed with the proposition that private markets would function like public ones in terms of liquidity and accessibility in 10 years' time. But this was more than the global average of 29% and significantly more than respondents in the United States and the wider Americas (23%).

APAC investors were also clear about the difficulties in expanding this asset class widely to retail investors. Around three quarters (76%) said private markets need to be more transparent for this to become the case (72% of respondents globally said this), and 70% said there are a lack of suitable products and platforms (66% globally).

These concerns notwithstanding, more than half (53%) of respondents both globally and in APAC, felt that "despite higher fees and transparency issues, private markets have much to offer retail investors".

How to give retail investors better access to private markets

APAC respondents were more inclined to favour investment trusts as the best vehicle for distributing liquid securitised private market assets to retail buyers. Half (50%) of the respondents said that this was the most suitable

mechanism, compared to just over a third (36%) globally. Conversely, the favourite vehicle of the total respondent base was funds of funds (46%), which was the top choice of just 34% of APAC respondents.

Real estate was the asset class most respondents globally (60%) and in APAC (65%) felt was most appropriate for retail. APAC investors were considerably more inclined than the global average to see private equity as a good retail asset class (56% compared to 46%). This could be explained by the proliferation of investment trusts structures that are mainly listed in APAC, giving investors exposure to this asset class in a frictionless manner.

Another area APAC investors were more confident in than their global peers was digital asset tokenisation as a means of democratising private markets. Only 20% globally believed tokenised shares representing fractions of large illiquid assets, traded on blockchain or distributed ledger via smart contracts, would become mainstream in the next two to three years. However, 28% of APAC respondents felt this would be the case.

The use case for such tokenised private funds from a distribution perspective is not without its challenges, both from a liquidity-matching as well as secondary markets perspective. However, it is not surprising given Asia's younger demographics that have a high percentage of savvy digital natives.

Conclusion

Private markets are not immune to the macroeconomic headwinds affecting capital market growth worldwide. However, while short term challenges might stymie investment in certain areas of the asset class, they do not present a threat to the long-term attractiveness that has driven its growth over recent years. Private markets also present opportunities to retail investors. However, the product, platform and regulatory environment will need to adapt before these opportunities can be properly realised.

UK's new holistic crypto regime can learn from global regulators

Rebecca Thorpe
CEO
Bovill

The UK's proposed new regulatory regime for crypto assets shows the government's determination for the UK to be a key player on the crypto stage, and is bold timing given the shadow still cast over public sentiment by FTX. While the proposals are welcome progress, the UK regulator would be wise to learn from the approaches of other jurisdictions. Digital assets are here to stay and present a wide range of risks which should be managed – and regulated – holistically.

The scope of the UK consultation brings home how far there still is to go but, uninhibited by EU harmonisation, the UK still may steal a march on the rest of Europe when it comes to a robust and welcoming destination for global crypto asset businesses.

The last few years have been sobering for the world of digital assets. It is thought that the closures of key market players in 2022 wiped out US$1.5 trillion in crypto market capitalisation.[1] As the popularity of the sector increases, the risks to retail consumers as well as institutions need to be properly monitored and managed. The collapse of FTX, despite some of the commentary, did not sound the death knell for crypto. Instead, 2023 will be an important year to reflect and react, and for all global regulators to speed up their move to bring all aspects of necessary virtual assets regulation into statute to prevent any further scandal.

A broad church

It is first important to note that the digital asset ecosystem is a broad church, which covers far more than the headline grabbing cryptocurrencies. A cryptocurrency is a digital-only currency, that usually has no central issuing or regulating authority and uses a decentralised system to record transactions and manage the issuance of new units.[2] A 'stable coin' is a type of cryptocurrency which is 'pegged' to a traditional currency or commodity, in order to make its price more stable. Just these two examples have quite different risk profiles. Also noteworthy is that some digital assets are already regulated under existing traditional securities regulation. Others will require new and nuanced regulatory oversight to take into account the different risk profiles of the different financial instruments.

1 Singapore's crypto ambitions shaken by FTX collapse - BBC News
2 Cryptocurrency Definition & Meaning - Merriam-Webster

More than money laundering

The attention of regulation in the digital asset sector historically focused for too long on anti-money laundering (AML), when financial crime is only one of a number of important risks to be managed. For example, exchanges and issuers must be made to hold sufficient regulatory capital before they can operate, to mitigate prudential risk. This was made clear by the collapse of both FTX and Terra Luna which was backed by the stablecoin TerraUSD last year. The Monetary Authority of Singapore (MAS) recently proposed prudential regulation for stablecoin issuers, which is an example of proposed good practice.[3]

Harmonised proposals

Prior to the publication of the UK HM Treasury proposed regulatory framework, MiCA, or the Markets in Crypto-Assets, was without question the most holistic proposed digital assets regulation across the globe. MiCA is now being agreed at European Parliament level and so on paper seems more progressed than the UK proposed framework. MiCA will be required to be implemented across every EU member state. The downside is that history suggests that it will take a long time to achieve the utopia of harmonisation across EU countries; we still do not have consistent approaches to marketing alternative investment funds in Europe, despite AIFMD being first introduced back in 2011.

Holistic and robust controls

The proposed UK framework, in simple terms, will insert cryptoasset regulated activities into the existing mature activity-based framework already in place in the UK. For this reason, it is beautiful in its simplicity of design, and also means the coverage is as broad as the coverage of risks for traditional asset classes. The complete range of regulatory activities will be in scope, from operating trading venues, advising on cryptoassets, managing cryptoassets, to secure custody and to lending and more. Specific crypto activities are also mooted, such as mining coins and validating transactions on a blockchain. As with MiCA, the UK framework will also seek to create a cryptoassets market abuse regime, which will be based on elements of the existing Market Abuse Regulation (MAR). Offences will apply to all persons committing abuse who are trading on a UK venue, wherever the person is based.

The downside is, the devil will be in the detail (the detailed rules still to be drafted by the FCA that is), to adjust the implementation of the framework for the unique cryptoasset class. Some areas of proposed regulation will be very similar to existing ones – the basic concepts of managing conflicts of interest, segregation of duties and sound governance arrangements will apply to authorised crypto firms in the same as to all regulated firms.

Other areas such as custody will need more tailoring, to accommodate crypto-specific concepts like cold storage or hot wallets. Other important conduct risks are also considered in the new UK proposals, including proper segregation of client money, the importance of which was made evident in the US Securities and Exchange Commission (SEC) charge against Sam Bankman-Fried and FTX, which diverted customer funds to Alameda Research - Bankman-Fried's privately owned hedge fund.[4]

Operational resilience is also key. The UK provisions include ensuring firms have proper wind down planning, cyber security is robust, and controls are in place to protect against third party outsourcing risk. In December last year, the Prudential Regulation Authority in the UK fined TSB Bank a total of £48,650,000 for operational risk management and governance failures, including management of outsourcing risks, relating to the bank's IT upgrade programme.[5] Large digital assets companies tend to implement a lot of third-party and cross-border outsourcing, and so this risk is particularly pertinent.

3 MAS proposes measures to reduce risks to consumers from cryptocurrency trading and enhance standards of stablecoin-related activities
4 SEC.gov | SEC Charges Samuel Bankman-Fried with Defrauding Investors in Crypto Asset Trading Platform FTX
5 TSB fined £48.65m for operational resilience failings | Bank of England

Consumer protection and a financial promotion work-around

Digital asset trading is a highly risky activity and regulations cannot protect consumers one hundred percent from losses arising from this inherently speculative sector. However, better disclosures requirements and rules around financial promotions can help investors make more informed choices. Research by the Hong Kong Monetary Authority last year,[6] called for stronger disclosure requirements for stablecoin issuers and restrictions on the assets backing their value, to prevent volatility in cryptocurrency infecting the wider financial system. This was evidenced by the mass redemptions in Tether and collapse of Terra USD earlier in 2022.

The UK has for a long time promised better disclosures, but inclusion of cryptoassets in the UK financial promotion regime still seems a frustratingly distant goal. The publication of the UK proposed regulatory framework on 1 February 2023 was accompanied by an update on cryptoasset financial promotions. The statement points out that, in the absence of the long-promised change to the UK Financial Promotion Order, no current route for crypto firms to be authorised and a reluctance of any existing regulated firm to provide the necessary approval of cryptoasset financial promotions amounts to an effective ban on all crypto advertising.

This does not sit well with the UK Government aim to become a 'crypto hub' and attract additional post-Brexit investment. So, a temporary fix has been suggested, to amend the existing Financial Services & Markets Act and create an exemption allowing cryptoasset firms currently registered with FCA (for AML supervision purposes only) to issue their own financial promotions.

Time for regulators to act

Recent events in the crypto world have caused governments and regulators to pause and reflect, but the bottom line is that the digital asset sector is here to stay. Once the UK Treasury consultation concludes, the ball will be firmly in the FCA court to speed up progress of the delivery of the cryptoasset regulatory framework. The current proposals will bring crypto trading into the UK regulatory perimeter; and the UK may pass the finish post ahead of MiCA country implementation.

Whoever gets there first, regulators need to significantly speed up their response, and make sure they take a holistic approach to consider all types of regulatory risk. Assuming that ongoing scandals will eventually 'make the problem disappear' is no longer an option. Effective regulation of digital assets is a global challenge and some jurisdictions are stronger on certain areas and risks than others. As the UK designs its own regime to encourage investment while protecting consumers, its regulators would do well to learn from others and cherry pick the best examples.

6 An assessment of the volatility spillover from crypto to traditional financial assets: the role of asset-backed stablecoins (hkma.gov.hk)

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Embracing the digital asset future

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Whilst events unfolding throughout 2022 have resulted in alarm surrounding institutional adoption of digital assets, it's undeniable that crypto assets are here to stay as an asset class, especially with clarity emerging across the regulatory landscape globally. According to research in Fidelity's 2022 crypto adoption report,[1] nearly 6 in 10 institutional investors (58%) invested in crypto assets globally. Further, market data research[2] by Goldman Sachs has shown that Bitcoin has the greatest total return (27%) and risk adjusted ratio (3.1) of all asset classes in January YTD. Given this context, hedge funds, asset managers and funds of funds have different considerations associated with the assessment of risk and potential returns of crypto assets. At a minimum, the following factors should be considered:

1. **Fundamentals:**

   As with traditional assets, it is important for institutional clients to assess the fundamental value of a crypto asset. Beyond its regulatory characterisation, this includes evaluating the technology behind the asset, the adoption and use case of the asset and the overall strength of the asset's ecosystem. Consider as well whether the issuer of the crypto asset is licensed and how the asset generates value (and in the case of stablecoins, assess the level and quality of the underlying collateral underpinning the value of the crypto asset). Each crypto asset should be reviewed independently and may have different fundamentals.

2. **Liquidity:**

   Market conditions may give rise to a need to quickly change investment positions. It is therefore important to consider the liquidity of a crypto asset, including the volume of trades and the presence of deep and liquid markets through exchanges. Blockchain intelligence tools can effectively provide data on the liquidity of the asset, the exchanges the asset is listed on and the risk levels of these exchanges.

3. **Volatility:**

   It seems obvious, however crypto assets can be highly volatile, with prices fluctuating significantly over short periods of time. It is important for institutions to consider whether the price volatility of a specific crypto asset aligns with their investment objectives.

1 Fidelity Digital Assets Research, 2022. Institutional Investor Digital Assets Study: Key Findings
2 Goldman Sachs Finds Bitcoin Tops Gold, S&P 500, And Nasdaq As The Best-Performing Asset Of 2023 (forbes.com)

4. Regulation:

Institutions must consider the regulatory environment in which a crypto asset and its issuer operate. Some jurisdictions have developed regulatory frameworks for the treatment of crypto assets, which provide greater legal clarity and protections for investors. This assessment is multi-lensed and should also include a consideration of your own business:

I. Does your institution require special licensing or permissions to invest in crypto or to create a fund?
II. Does your institution understand the regulatory characterisation and treatment of the crypto asset? i.e. could it be a security, a commodity, etc. as per the Howey Test?[3] Remember crypto assets are not all the same.

5. Risk management:

It is important for institutional clients to have robust risk management processes in place to mitigate the risks associated with investing in crypto assets. This may include diversification of portfolio, thoughtful asset allocation, and use of risk management tools e.g. stop-loss orders.

Safekeeping your digital asset investments

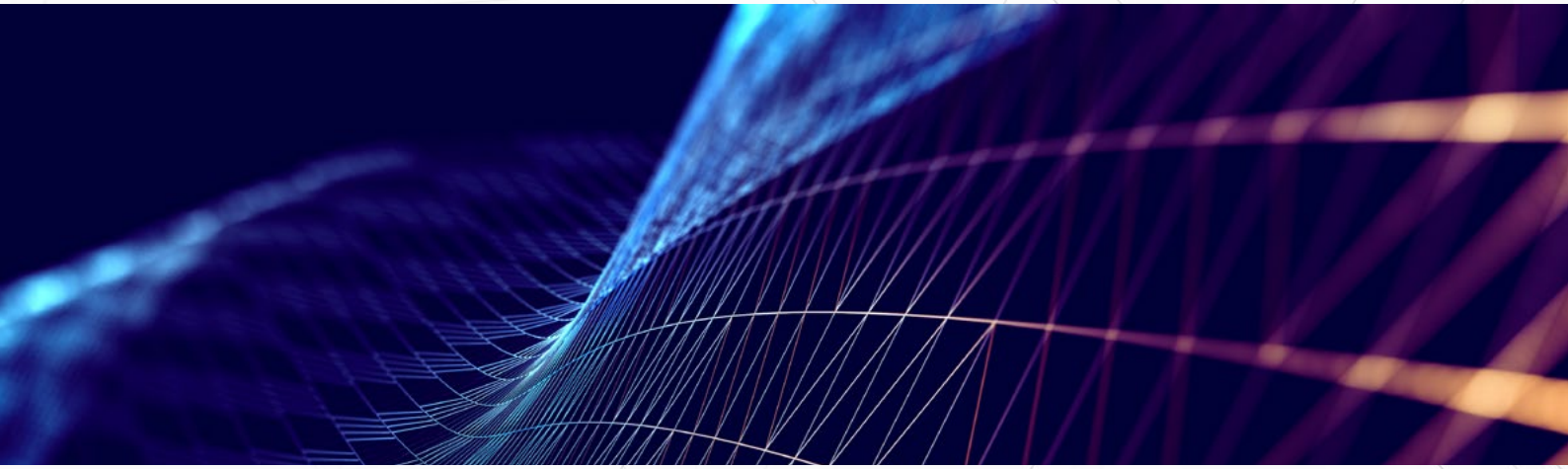
Like other assets, crypto assets require safekeeping. For institutions, this service is usually provided by a custodian. Unlike traditional custody, digital assets have no centralised entity acting as a clearing house. Additionally, digital asset custody differs in that safekeeping is provided for the private keys[4] which control an institution's access to their crypto assets and which may be stored on paper or on hardware devices.

It is therefore critical for an institution to be able to prove control over the private key in their relationship with the custodian (e.g. through a trust arrangement or proof of beneficial interest in the digital assets). In many jurisdictions, technical advancements have superseded legal principles, resulting in the custodian having more legal freedoms compared with traditional custody.

An institution therefore has several options with respect to the storage of their private keys, outlined below. Note: wallets are solutions through which private keys are managed in order to operate a public address.

3 SEC.gov | Framework for "Investment Contract" Analysis of Digital Assets
4 Strings of data that bear a unique mathematical relationship to the public keys where digital asset ownership is recorded on the blockchain.

	Custody Option	Considerations
Hot	**Exchange Wallets**	Online access to wallets, simultaneously making it both quick to transact and highly exposed to attacks (and insolvencies).
	Software Wallets	Private keys stored on software wallets either on a computer or mobile device, with additional security and sign-in measures. Results in the holders/users of the aforementioned devices being exposed to physical harm or coercion.
	Hardware Wallets	Hardware devices which contain software that stores the private keys and signs off transactions.
	Multi-signature addresses	Requires a "M of N" approval mechanism whereby a minimum subset of signers (M) are required to sign before a transaction can be executed. Results in operational execution being slower and additional user maintenance requirements, which sometimes vary by blockchain.
	Paper Wallets	Seed phrases or private keys are written on paper, making it highly exposed to loss, damage or errors.
Cold	**Cold Storage**	Private keys stored offline in devices that are not connected to the internet. Results in operational execution being slower (i.e. slower asset transfers, delays in claiming rewards from network participation such as staking, forks, airdrops, etc).



The allure and risks of self-custody or non-custodial solutions

Under the guise of improved security and greater efficiency, some institutions have implemented one or more of the above options in a self-custody arrangement, without the use of a specialised digital asset custodian. The disadvantage of doing so is that self-custody results in processes that are exposed to error and complexity, leaving employees and company resources vulnerable to physical compromise. Besides these factors, self-custody does not adhere to institutional requirements related to internal controls, audit standards, and single points of failure (or restriction of access to the crypto assets by individuals!).

Digital Asset custodian scorecard

Clearly self-custody is exposed to risks, as noted above. For this reason, the use of digital asset custodians with specialised expertise is recommended. Not all digital asset custodians are alike, however. The scorecard below can be used as an assessment tool.

Factor	Considerations
Custody arrangements and legal treatments	• What is the custodian's overall business model? o What method(s) do they use to safeguard the private keys? o Do they have a related exchange business that may introduce conflicts of interest? o Do they segregate proprietary assets from client assets? o Are client assets segregated per client or comingled in a single account? • What protections do you have on your assets in the event of a custodian's insolvency? • What is the legal characterisation of the storage of the private key, its deployment and the underlying digital assets controlled by the deployment of the private key?
Security and access to assets	• How does the custodian enable authorisations as defined by your institution? o Are approvals audited? o How is the identify of approvers verified? o Are these approvals unforgeable and signed cryptographically? o How does this impact timelines on executing transactions? • Are disaster recovery, back-up procedures and business continuity plans in place? • If hot wallets are used, does the custodian have any reserve to cover the possibility of hacks?
Governance, Risk & Compliance approach	• Is the custodian licensed, registered or regulated? o Where? o Do they comply with key regulatory requirements, especially those related to money laundering and counter terrorist financing? o Do they demonstrate proactive identification and awareness of upcoming regulation in the short and medium term in the jurisdictions where they operate? • Does the custodian have a risk management framework with relevant policies and procedures? o How resilient are the custodian's services? o Is the custodian overly reliant on third party service provision? Do they demonstrate oversight over critical third parties? o Does the custodian have appropriate cyber security measures in place? e.g., bug bounty programmes, penetration testing, insurance o Does the custodian apply any fraud detection and behavioural analytics tools on transactions? o Does the custodian operationalise FATF recommendation 16 which specifies the need to obtain sender / receiver information of digital assets? o Are crisis management and insolvency measures in place? • Does the custodian have any independent reports published (e.g. SOC 1, SOC 2) or reviews conducted (e.g. ISO 27001) on their operations?
End to End service offering and product suite	• What breadth of crypto assets do they offer support for? • What value added services are provided? e.g., connectivity to exchanges, yield generation, etc. • Particularly in light of recent events in the crypto industry, is an off-exchange settlement solution available (enabling segregated storage of assets off-exchange which can be mirrored and securely traded on exchanges)?

Lying ahead of the industry is greater regulatory clarity which serves a key milestone in crypto's further integration within the overall economy. It is therefore vital for institutions to equip themselves with information and decision-making tools that will empower them in their digital asset future.

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Navigating the technological landscape in 2023

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Advancements in technology are developing at a rapid pace, fuelling even faster change and progress in the world of financial services and asset management. In 2023, the technologies that are continuing to gain even more traction are automation, collaboration and of course, cybersecurity.

George Ralph, Global Managing Director & CRO at RFA explores these three technologies in greater detail, explaining why they are essentials tools for professionals working in the alternative investment sector.

Let's start by explaining that I see navigating the technological landscape in 2023 will be like participating in a game of chess. With regards to cybersecurity, defence remains a key priority. Playing conditions have never been as volatile as they are today. Yet, in this game of chess, there will be windows of opportunities that provide leaders with the chance to attack and embrace innovation.

If we look to automation, businesses are becoming increasingly more reliant on this technology. Automation should be seen as a suite of technology options that can carry out tasks that would otherwise be conducted by humans freeing up time to focus on performance and strategy. Traditionally speaking, the financial services industry has lagged behind when it comes to the implementation of using automation to streamline operations of day-to-day tasks.

However, with automation, businesses are able to relieve already overworked teams from tedious and time-consuming tasks and direct their time elsewhere. The implementation of automation can not only reduce costs, but also improve overall productivity. This can be beneficial in terms of staff retention and overall job satisfaction.

When employees are overloaded with tasks, and are overworked in the long term, this can lead to job dissatisfaction and burnout. The likelihood of leaving their job therefore increases, and we know that competition is fierce to retain or employ the best staff at the moment. The Financial Conduct Authority (FCA) recommends firms utilise automation where possible within the Sysc 13.2 framework as a way also to reduce human error.

'The Great Resignation' was a widely discussed topic last year. In May 2022, Enterprise Times shared findings that finance teams were specifically impacted by people resigning due to job dissatisfaction. Researched from IFOL established that 73% of finance professionals believe that staff productivity and morale is a cause for concern. 78% of professionals from the same study stated that manual work is overwhelming for teams and people are left feeling as if they cannot keep up with their workload.

Embracing automation in 2023 can be a solution to this problem as teams can be relieved of manual workloads and reallocate their time to others. For businesses that are prioritising international growth, implementing automation for operations should be a necessity. In such efforts, time is a highly valuable asset that needs to be distributed wisely. In an articled shared by Enterprise Times in 2022, 16% of finance professionals stated that their financial operations as they currently stand limit growth and are an obstacle for firms wishing to streamline for international success. Perhaps what is even more interesting from the same article is that 29% of finance professionals have stated that they have seen more manual finance tasks in the past two years. This almost counters the notion of accelerated digital transformation that was highly documented since the onset of the pandemic being a success.

The next year will be a challenge for executive teams in the finance sector with potential freezes on hiring. Automation could help businesses with these potential threats, support growth and boosting staff morale. However, the key to automation is that, regardless of its prevalence in the media and the promotion of its benefits with regards to streamlining operations, lowering costs and aiding employee retention, it is only as good as its execution. Firms need to strategise for how they will implement automation in their business and the technology they will use to do so. For example, we have completed automation for firms globally around Annex 4 through to onboarding and offboarding of third parties, staff and deals. This strategy will need to be laid out with long term goals in mind, whilst keeping space for making continuous modifications in the face of technological developments.

A fundamental requirement for all successful businesses in 2023 and beyond will be collaboration. Without the capacity to collaborate using remote platforms, businesses will stunt their ability to grow. In an article published by Harvard Business Review back in January 2023, it was cautioned that executives this year will have the challenge of not just embracing individual technological trends, but rather, they will need to think about how all technological developments will create new possibilities when used together, thus creating combinatorial trends.

Growth in use of collaboration software was fuelled by the rapid transformation of offices embracing hybrid work. Three years on from that sea change, collaboration is a necessity and cloud technology is the tool to help empower businesses to do so successfully.

Prior to 2020, it was much more usual for collaboration amongst teams to occur via in-person meetings and any technological platforms served as a complement to this. Now, teams collaborating via technology is commonplace and for some businesses, it is the medium used the most. Cloud collaboration tools offer teams a way to work that is convenient and ideas can develop faster. However, whilst the use of cloud collaboration tools can empower businesses, there are also limitations to their implementation. If teams are only communicating with their colleagues via technology, there is a threat that they will not feel a connection with each other and perhaps even the organisation's culture.

Finding opportunities for team building and social collaboration will be vital to ensure staff find a purpose and feel integrated. For example, we utilise Yammer, Viva and other tools for social events, charitable functions and more to ensure teams can meet up in and out of work and also discuss topics there are passionate about or have as shared hobbies. Relationships are important in businesses and serve to be the fabric in which a company is held together. Whilst cloud collaboration online can serve as a way to be productive and to get work done effectively, organisations also need to strategise for ensuring that employees have a deep form of collaboration when they are onsite that focuses on relationship building and establishing meaningful connections with managers and colleagues.

Yet perhaps one of the most vital considerations for collaboration in technology leads us into our final thought: cybersecurity. Collaboration via cloud technology enables people to share resources and data online. However, in today's world, threats are continuing to increase in both sophistication and volume, thus collaboration needs to be secure. In hybrid work environments whereby team members are located in many places at different times, it is critical that they are able to carry out their tasks and communicate with each other and clients in a manner that is both secure and seamless.

Cybersecurity is an absolute priority for all business leaders globally. This is for all sectors and not simply the financial services industry. At the start of the year, Gartner, Inc predicted that by the end of the 2023, 65% of the world's population will have their personal data covered under modern privacy regulations. This is up from 10% in 2020. In the US, there will be five major states rolling out new comprehensive data privacy laws this year.

Looking further ahead, Gartner predicts that by 2024, organisations 'adopting a cybersecurity mesh architecture will reduce the financial impact of individual security incidents by an average of 90%. By 2025 '60% of organisations will use cybersecurity risk as a primary determinant in conducting third-party transactions and business engagements. Investing in cyber-defense will be critical for all businesses worldwide. In short, the adoption, design and implementation of a cybersecurity strategy will be a necessity for businesses. The financial risk and the potential loss of data is too far too great for businesses to think otherwise.

Whilst the world of business and finance can be unpredictable and at times volatile, what is clear is that in 2023 and beyond, leaders will need to think like a chess player and craft their own strategies for the careful implementation of automation, collaboration and cybersecurity within their operational structures.

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IFPR hotspots - What's on the FCA's radar?

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It's been one year since the implementation of the IFPR in the UK, and it's apparent that some firms are still trying to get to grips with the multifaceted regime. There's a range of new concepts and jargon on the platter, such as complex K-factors, transitional provisions, new definitions of capital, new regulatory returns with stringent deadlines and higher frequency, the ICARA process, wind down planning, the group capital test exemption, the 'overall financial adequacy rule', assessment of harms, MIFIDPRU disclosures, new remuneration codes, calculations of thresholds and indicators. The implementation of the IFPR has triggered a complete overhaul of the prudential rules on capital adequacy and liquidity.

Through our own continuous engagement with the industry, we sense that there's generally a good understanding of the rules, but equally, there's some apprehension around how much is 'enough' in terms of demonstrating compliance with the regulation.

The ominous uncertainty of various factors, such as inflation, rising interest rates, recession, and major disruptions to global trade, cause further harm in the short and medium term to how traditional ways of doing business may change as new forces begin to propel the industry. In this article, we discuss finding the right balance and share our thoughts on what we think the Financial Conduct Authority (FCA) is likely to focus on in 2023.

FCA's 'data gathering process'

Over the past few years, the FCA haven't refrained from informing us about the progress they continue to make relating to the upgradation of their 'Digital Regulatory reporting' (DRR) project. In their own words, *"Regulatory reporting is vital to the supervisory process, and a core mechanism for identifying risk, ensuring compliance and achieving our operational objectives. Our project explores how we might automate and streamline various aspects of the regulatory reporting process by analysing the entire regulatory reporting lifecycle, from harm identification to implementation. This process has been called creating machine readable regulation (MRR) and machine executable regulation (MER). The FCA is embedding DRR as part of the FCA's Data Strategy, which aims to harness data and advanced analytics to support our Mission, and ultimately transform how we carry out financial regulation in the UK."*

This obviously puts a significant amount of onus back on the firms to ensure that the data reported to the FCA is accurate and complete. A typical asset manager regulated by the FCA is obliged to submit nearly 40 regulatory returns through RegData every year, which amounts to nearly 1,000 boxes of data (although not all returns and not all boxes would apply to every type of firm). The data comprises financial information contained in the firm's balance sheet, profit and loss account, capital adequacy position, liquidity position, counterparty information, controllers, close links, client money, financial crime update, audited financial statements, compliance with the SMCR, compliance with the ICARA and concentrations. Not to forget the additional notifications and permissions featured on FCA's Connect platform.

Specifically with regards to the IFPR, the FCA started reminding firms of the supervisory powers that they hold over them. This was clear in recent 'Dear CEO' letters issued which include the following statements:

"All firms should have implemented the Investment Firms Prudential Regime (IFPR), which came into force on 1 January 2022, and considered our recently-published observations on wind-down planning. Firms' boards should test the adequacy of their firm's IFPR implementation, including their internal capital adequacy and risk assessments (ICARA), as well as their recovery and wind-down plans. Where we identify material prudential weaknesses, we will take action. This has recently included imposing capital/liquidity scalars, business restrictions and skilled persons reports" – letter dated 1 December 2022

"To improve financial resilience, firms should review the level of liquidity that they hold under the new Investment Firm Prudential Regime (IFPR) and ensure that their assessment is commensurate with the risks they face. We will be carrying out targeted work in this space, and where we identify material weaknesses or firms underestimating their liquidity needs, we will take action, which may include business restrictions and Board effectiveness reviews. Firms should also look beyond recent historical precedent when modelling stresses, noting that the past 12 months have produced a series of events that were previously considered implausible based on historic modelling. While we generally expect to see more prudence in this environment we accept there are limits to capital and liquidity that can be held against stresses, which mean a careful balance must be struck " – letter dated 11 January 2023

Further, on **27 February 2023**, the FCA published their initial observations on ICARAs, wind down plans and regulatory returns they reviewed as part of a wider multi-firm review.

Key concerns expressed by the FCA are:

- Insufficient consideration of firm-specific risk and harms in the assessment of threshold requirements of individual firms required by MIFIDPRU
- Inadequate integration of the firm's approach to managing financial resources to mitigate the risk and harms from its operations within the assessments made as part of the ICARA process
- Lack of comprehensive own funds and liquid assets triggers and inadequate explanations where there was a reduction in risk capital
- Incorrect implementation of the 'group ICARA process' without an appropriate 'Voluntary Requirement' approval obtained from the FCA
- Unsatisfactory governance and Board & Executive involvement in ICARA
- Weak wind-down planning assessments in terms of scope and quantification, reflecting an incomplete understanding of the purpose of the exercise and of guidance previously provided
- Inconsistent and inaccurate data submitted in regulatory reports

Supervisory Review and Evaluation Process (SREP) – the big change

One could argue that it's the regulators' job to 'regulate', and the FCA has always used the SREP as a tool. However, in our opinion, the clarity of their approach to the SREP, as explained in chapter 7.10 of the MIFIDPRU Handbook, is unprecedented. The intense spotlight on the ongoing regulatory reporting and the ICARA process is evident in the following extracts from the MIFIDPRU chapter.

Decision to conduct a SREP	Information and factors considered by the FCA when conducting a SREP
• The nature, scale and complexity of the business • Analysis of the risks associated with the firm or investment firm group and its potential to cause harm to consumers or to the financial markets • **The information provided by a firm to the FCA under any notification and reporting obligations under MIFIDPRU or other obligations** • The history of the firm's interactions with the FCA • Any broader concerns about the types of products or services offered by the firm or the markets in which it operates • Any concerns relating to the firm which may be notified to the FCA by other regulators (including non-financial services regulators).	• **The firm's ICARA document** • **Any relevant information provided by the firm as part of its reporting obligations under MIFIDPRU 9 any other information or documents requested by the FCA for the purposes of the SREP** • Interviews with members of the firm's governing body, or its employees, advisers, service providers, and auditors • Information shared by other authorities • Any other relevant information that the FCA holds

Prevention is better than a cure

The chapter on SREP goes further into the details of the actions that the FCA will take depending on the severity of the issues identified. However, our attitude has always been that firms shouldn't give the FCA a reason to initiate any questioning. Granted, there may be some wider reasons why the FCA would want to take a closer look at your regulatory returns or may ask you to submit your ICARA. It is, therefore, very important that all the documentation is in line with their expectations so that further damage can be avoided.

We anticipate the FCA will publish more guidance and possibly a thematic review on the ICARA process during the year, which will be expected to be taken into account when you carry out your annual assessment. This could involve an in-depth focus on stress testing and reverse stress testing, assessment of group risk or more robust wind down plans.

Over the past year, we have conducted many independent reviews of regulatory returns and ICARAs, which has led to substantial corrections and enhancement of the documents. As much as it has been a learning curve for us, we have developed a wealth of experience in peer benchmarking and thorough understanding and application of the rules. If you believe a 'regulatory health check' could strengthen the quality of your documents, please feel free to contact us.

HMRC to legislate mandatory UK transfer pricing documentation requirements

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Introduction

In March 2021, His Majesty's Revenue and Customs (HMRC) embarked upon a process to transform the UK transfer pricing documentation requirements. After nearly two years of consultation, the final proposals are due to be enacted into law during Q1 2023. The new requirements will create a mandatory transfer pricing documentation obligation for the largest UK businesses.

Why did HMRC seek to update the UK transfer pricing documentation requirements?

In 2015, the OECD published Action Plan 13 on Transfer Pricing Documentation and Country-by-Country Reporting (Action Plan 13). In response to this report, the UK implemented the Country-by-Country Reporting (CbCR) minimum standard but did not introduce specific requirements regarding a master file or local file, as HMRC had considered the existing broad requirement to keep and retain sufficient records to demonstrate that the tax return is complete and accurate to be adequate.

However, since 2016, transfer pricing has grown to represent a significant area of tax risk and it is seen by HMRC as a major source of tax uncertainty for UK businesses. This is evidenced by the fact that HMRC brought in over £6 billion of additional tax from transfer pricing compliance during the five-year period 2015/2016 to 2019/2020,[1] and this number has only continued to grow in the subsequent years, with additional tax raised of over £2.1 billion in 2020/21[2] alone. In light of this, it was not surprising that HMRC has now set out to clarify the documentation requirements and prescribe a standardised format for the largest businesses.

What are the new UK transfer pricing documentation requirements?

HMRC had originally cast the consultation net wide, with a number of extensive measures proposed, including the introduction of an international dealing schedule and an evidence log. However, after much consultation, HMRC have settled on a more balanced approach, opting to largely align the new requirements with the globally recognised standards prescribed by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) and Action Plan 13 by adopting a master file[3] and a local file[4] requirement.

1 HMRC Transfer Pricing Documentation Consultation, publication date: 23 March 2021.
2 HMRC Transfer Pricing and Diverted Profits Tax statistics, 2020 to 2021, publication date: 28 April 2022.
3 A high-level report to provide context to a group's transfer pricing practices.
4 A more detailed report relating to specific intragroup transactions to evidence compliance with the arm's length principle.

The key details of the new requirements (pending legislative enactment) are summarised below:

- The mandatory obligation to **prepare a master file and local file** in accordance with the requirements set forth in Annex I and Annex II to Chapter V of the 2022 OECD Guidelines **for accounting years starting on or after 1 April 2023** (for businesses with a calendar year-end, the first year of application will be the year ending 31 December 2024).

- The new requirements are **only applicable to UK businesses that are part of a multinational enterprise group with total consolidated revenue over €750 million** (this is aligned to the CbCR threshold). For businesses that do not meet this threshold, the master file and local file format will not be a mandatory requirement; however, alignment with these standards will be encouraged and considered to represent best practice.

- The master file and local file will not be required to be submitted to HMRC with the tax return or require any form of time stamp. However, they **must be maintained and made available to HMRC within 30 days upon request**. Failure to comply will result in the presumption of carelessness if an inaccuracy is found in the tax return.

- For corporate taxpayers, information on **UK-to-UK transactions is not required to be documented** in the local file unless a party has either elected for the Patent Box regime[5] or is carrying on a ring-fenced trade in the oil and gas industry.[6]

HMRC is also expected to issue a technical support paper during Q1 or Q2 2023. This paper is expected to provide HMRC's view on best practice and answer the practical questions that are on businesses' minds, such as how to determine whether a controlled transaction should be reported in the local file and how a UK group should approach consolidation for their local file(s) (e.g., the optionality for a UK country file v an entity file).

Summary Audit Trail

The Summary Audit Trail (SAT) is the most contentious proposal that remains in the new UK documentation package because it is an original concept that goes beyond the requirements in the OECD Guidelines / Action Plan 13 and will be unique to the UK.

HMRC had intended for the SAT to be applicable for accounting years starting on or after 1 April 2023, however, in December 2022, it made the decision to separate the introduction of the SAT from the local file and master file requirements and delay its introduction. The delay will allow HMRC further time to refine its proposal and undertake full public consultation. While delayed, the legislation that is to be enacted during Q1 2023 is drafted in a manner that will allow for HMRC to implement the SAT at a later date via published notice thereby eliminating the need to pass further legislation.

Based on HMRC's comments to date, it is our expectation that the SAT will be a short questionnaire that will be appended to a UK local file and contain a series of yes / no and short answer questions. Its intended purpose will be to show the behaviours that the business observed when preparing the local file by requiring it to disclose the steps taken in preparing the local file. In particular, the SAT may request information regarding when a functional analysis was prepared, when fact-finding interviews were performed, who was interviewed, and whether the analysis has been reviewed annually.

5 Election under s357A of the Corporation Tax Act 2010.
6 Defined under s277 of the Corporation Tax Act 2010 (oil activities).

The SAT will be provided as part of any formal documentation request and will provide HMRC with increased information during an enquiry to enable targeted requests linked to specific steps that were undertaken during the preparation of the local file.

UK businesses should look out for the public consultation, which is expected later in 2023 and will contain the full list of proposed requirements. UK businesses will have the opportunity to submit feedback on this proposal as part of the consultation process and should raise any concerns or feedback that they have with their advisors or trade association, such as AIMA.

What actions should UK businesses be taking to prepare for the new requirements?

For some UK businesses, their existing documentation may require little updating to achieve compliance, however, for others there may be a large amount of planning required. There is still time for businesses to start planning and to consider where to best focus their time and resources. Based on our experience, we have collated some common considerations below. We note that there is nothing within the new requirements that is specific to asset managers (traditional or alternative) that would suggest that they are required to approach this any differently from other UK businesses.

- Has a gap analysis of the existing transfer pricing documentation been performed to identify any content gaps with the OECD master file and local file requirements? The commonly observed gaps for local files have been the existence of intercompany agreements and the ability to reconcile transactional data to the financial statements.

- Does the business have access to the right financial information to prepare a local file or know how it will go about obtaining the transactional data in order to be able to prepare accurate documentation? Further, has the report tested the transfer pricing policy outcome (rather than the transfer pricing policy)?

- When was the functional analysis prepared? Were interviews conducted, and who in the business was involved? HMRC will be interested to see that local fact finding / validation occurs on a regular basis and that the appropriate people within the business are consulted in the preparation of the reports.

- Has benchmarking been performed to support the controlled transaction, and if so, when was this performed or last updated? In supporting controlled transactions, HMRC will be interested to see that the data is comparable, up to date, and has been selected in accordance with the OECD Guidelines.

- Where a taxpayer is not headquartered in the UK, do they have access to the group's master file, and the relevant information required to prepare a local file?

- Are there any other evidentiary requirements that are critical to the characterisation of entities and their role in the covered transactions (e.g., are key decisions made outside of the UK? Is there evidence of decision making, local approvals, etc.)?

If there are any questions from this article, please get in touch with AIMA, your advisor, or us at darren.andrews@uk.ey.com, as we would be happy to discuss.

ELTIF 2.0: A step towards true democratisation of European private funds

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Background

The original ELTIF Regulation[1] (**ELTIF Regulation**) entered into force on 19 May 2015 with the objective of raising and channeling capital towards European long-term investments in the real economy, in line with the European Union (EU) wider objective of smart, sustainable and inclusive growth. The ELTIF framework initially received considerable attention, particularly as it allows ELTIFs to be marketed to retail investors by way of an EEA-wide passporting regime. However, it has become clear that the original ELTIF Regulation has not achieved the desired success. As of January 2023, only 84 ELTIFs have been registered in the entire European Economic Area (EEA) (48 in Luxembourg, 21 in France, 13 in Italy and 2 in Spain) with only a single digit figure in billion under management. This is an extremely low number for a vehicle that was destined to re-stimulate the European economy post-Euro crisis.

After a public consultation, on 25 November 2021, the European Commission (**Commission**) published its proposal for a revised ELTIF Regulation (**ELTIF 2.0**) to address what were perceived as the main shortcomings of the original ELTIF Regulation.

Following informal negotiations between representatives of the European Council (Council), the Commission and European Parliament (**Parliament**), on 7 December 2022, the Council published a note indicating that it would adopt the current text of the proposed revision of the ELTIF Regulation agreed between the Council and the Parliament in October 2022, provided that Parliament agreed to adopt the same text. The text of the overall compromise package is included as an annex to the Council's note. The next step is for the Council and the Parliament (plenary session) to formally adopt the revised ELTIF Regulation.

This reform process has been met with enthusiasm in the funds' industry as it is hoped that the ELTIF 2.0 is the missing piece in the European funds' toolbox for true retailisation of private funds.

What are the main changes of ELTIF 2.0 compared to the original ELTIF Regulation?

Below is a non-exhaustive summary of the main changes:

1. Eligible investments

Eligible assets under ELTIF 2.0 are greatly improved compared to the ELTIF Regulation. **The definition of "real assets" has been modified and the threshold to qualify as a "real asset" has been removed under ELTIF 2.0.** Furthermore, the market capitalisation threshold, portfolio composition requirements, asset diversification limits and concentration risks have been modified to enlarge

1 Regulation (EU) 2015/760 on European long term investment funds

the scope of eligible assets for an ELTIF. This is also true for the (limited) possibility of an ELTIF to invest into financial undertakings, master-feeder structures or securitisations. Importantly for non-EU managers who may be attracted to the ELTIF, the geographical limitations on non-EU assets that some regulators applied in relation to the ELTIF Regulation has been modified allowing for a much wider geography of the potential underlying assets in an ELTIF structure. ELTIF 2.0 further clarifies that minority co-investments will be possible (which was often seen as a major obstacle by industry participants). ELTIFs can potentially be set up as fund-of-fund structures - something the fund industry also strongly lobbied for. From an 'eligibility of investments' perspective, ELTIF 2.0 is a major improvement compared to the ELTIF Regulation.

2. Retail investors

One of the most far-reaching and innovative amendments under ELTIF 2.0 is to differentiate between ELTIFs that target either professional only or ELTIFs that target retail investors. Stricter investment limitations, borrowing restrictions and concentration limits all apply to ELTIFs that are targeting retail investors. The suitability assessment for retail investors to invest into an ELTIF has been modified - removing the minimum invest limit and the 10% limitation, potentially making the new ELTIF a true retail product without any minimum investment amount. Greater access for retail investors is however coupled with some additional protection mechanisms (both via obligatory risk warnings and explicit investor consent requirements under certain circumstances).

3. Manager authorisation

The double-layer of authorisation (both at ELTIF and ELTIF manager level) will be replaced by a system whereby solely the ELTIF needs to be authorised. The AIFM[2] will not need a specific authorisation to manage ELTIFs. This is intended to increase cross-border activity in the ELTIF market.

One of the most far-reaching and innovative amendments under ELTIF 2.0 is to differentiate between ELTIFs that target either professional only or ELTIFs that target retail investors.

4. Redemptions / Liquidity window

The explanatory paragraphs and the ELTIF Regulation itself clearly stipulate that the European legislator intends the ELTIF 2.0 to remain fundamentally a closed-ended fund product. However, there are possibilities to create semi-liquid structures under the ELTIF 2.0 framework – these will be subject to a lock-up period equivalent to the ramp-up period of the relevant fund regarding its risk diversification limits and certain liquidity management tools to ensure the fair and equal treatment of investors. It will be interesting to see how the European Securities and Markets Authority will exercise its power to provide for further rules on redemptions via the issuance of draft regulatory technical standards.

ELTIF 2.0 also includes a new matching provision for the secondary trading of shares/units of an ELTIF – the relevance and impact of such mechanism remains to be seen.

2 **Alternative Investment Fund Manager** per Alternative Investment Fund Managers Directive (2011/61/EU) (**AIFMD**)

5. Borrowing

ELTIF 2.0 increases the borrowing limits for an ELTIF (from 30% to 50% for retail ELTIFs, and to 100% for ELTIFs solely marketed to professional investors). ELTIF managers will also be able to pledge all the assets of the relevant ELTIF - previously this was limited to 30%. This amendment is expected to substantially facilitate the ability of ELTIFs to enter into loan arrangements with banks and other providers of debt capital.

6. Equal treatment

ELTIF 2.0 specifies that all retail investors benefit from equal treatment, with no preferential treatment or specific economic benefit granted to individual investors or groups of investors within the same class or classes. The aim being to create greater legal security for carried interest structures or other differentiations that may otherwise occur between classes.

7. Conflict-of-interest and co-investments

Under ELTIF 2.0, co-investments by the ELTIF manager and its affiliates will be allowed provided that any conflicts of interest arising from such co-investment are properly dealt with and disclosed. Co-investment is a common feature in other fund structures to ensure 'alignment of interest' so this amendment will align the ELTIF 2.0 with other private asset vehicles.

ELTIF 2.0 is not perfect...

Notwithstanding the positive sentiments around the ELTIF 2.0, there has been some criticism. For example, the redemption limitations during the ELTIF's term may be perceived as an obstacle for retail investors who may not want to lock in their liquidity for a substantial amount of time. ELTIF 2.0 could have arguably broadened its appeal with regards to master-feeder structures. Creating a double layer of ELTIFs (where both the feeder and the master need to qualify as ELTIFs), is seen by some as unduly burdensome and restrictive without adding obvious investor protection.

A different source of criticism relates to the overlap ELTIF 2.0 with the on-going AIFMD review. Proposals for reform of the ELTIF Regulation were launched on the same day that the Commission set out its proposals to make significant amendments to the AIFMD. From a loan origination perspective, in certain countries, ELTIFs are the only fund vehicles that are permitted to originate loans alongside banks or other licensed professionals.

The reform of AIFMD as regards the 'loan originating funds' and the potential possibility to passport the 'loan originating' activity by the AIFMs across the EEA could reduce the attractiveness of the ELTIF vehicle, even following its reform.

What's next?

It is expected that the legislative procedure will be finalised by early March 2023 resulting in the formal entry into force of the ELTIF 2.0 around that time. Based on previous experience, it is likely that the final approved text would be published in the Official Journal of the EU at the end of March or early April 2023, with its provisions entering into effect nine months thereafter (expected January/February 2024).

Notably, ELTIF 2.0 includes 'grandfathering' for existing ELTIFs. Under ELTIF 2.0, an existing ELTIF that complies with the ELTIF Regulation will be deemed compliant (i.e. grandfathered) for five years following the date of application of ELTIF 2.0. However, ELTIFs that are authorised under the current ELTIF Regulation, but that wish to make use of the terms of the new ELTIF 2.0 rules, can simply notify their national competent authority of their wish to do so.

Conclusion

ELTIF 2.0 is currently attracting a lot of interest from industry participants as it fits well with the political desire to unlock large amounts of savings from private individuals for much-needed European infrastructure and other long-term projects. ELTIF 2.0 also provides retail investors with an opportunity to invest in assets other than stock markets or UCITS funds thereby increasing diversification and risk spreading, while also maintaining certain safeguards and specific investor protections.

In terms of jurisdiction, Luxembourg seems well placed to benefit from ELTIF 2.0 given its global recognition as a tried-and-tested investment fund location and its favourable local legal framework which will allow for different ELTIF structures with different investor horizons (from full retail to high-net-worth individuals/semi-professional to professional).

An update on private debt funds in Luxembourg

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As is the case for most strategies and fund types in Luxembourg, the debt funds sector has continued to grow, with an increase of over 45% between June 2021 and June 2022. While up to date figures are not available, the expectation is that this impressive positive growth has continued into 2023 despite unfavourable economic conditions and geo-political challenges.

Investment target and strategy

The debt funds sector is well diversified, and the underlying sectors include the following:[1]

- 17% infrastructure and transportation
- 16% energy and environment
- 15.5% chemicals, IT, telecoms media and communications
- 14% healthcare and life sciences
- 13% consumer goods
- 10% food and agriculture
- 7.5% construction
- 7% real estate

The foregoing exposure is obtained primarily through direct lending strategies (64%), followed by mezzanine funds (13%) and distressed debt strategies (13%).[2] The investor base comprises largely of institutional investors (84% in June 2022) followed by retail investors (7% in June 2022).[3] The predominance of direct lending strategies and institutional investors will be of particular interest in respect of the elements contained in the Alternative Investment Fund Managers Directive (**AIFMD**) 2.0 Proposal and ELTIF 2.0 (both as defined below), respectively. Last but not least, 23% of Luxembourg debt funds already promote environmental or social characteristics and comply with Article 8 of SFDR.[4]

Observations as to legal and regulatory structuring

With respect to the choice of legal form and regulatory structuring, a continuing trend away from regulated fund vehicles to unregulated fund vehicles continues to be observed, which aligns with AIFMD's focus on manager regulation rather than fund (vehicle) regulation. The two forms of limited partnership (special limited partnership or SCSp and common limited partnership or SCS) continue to be the preferred legal forms in the debt funds sector but other forms (including the corporate partnership limited by shares or SCA) are also used, typically in conjunction with special funds legislation (and then usually as a reserved alternative investment fund or RAIF).

1 KPMG/ALFI Private debt fund survey 2022
2 KPMG/ALFI Private debt fund survey 2022
3 KPMG/ALFI Private debt fund survey 2022
4 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector

It is interesting to observe, at European level and in light of the AIFMD 2.0 Proposal and ELTIF 2.0, that a set of specific rules will apply to funds that originate loans.

AIFMD 2.0 – Outlook for loan-originating funds

At European Union level, the proposed changes to the AIFMD and the rules as currently foreseen to be introduced for 'loan-originating funds' are worth noting. On 7 February 2023 the Report of the European Parliament Committee on Economic and Monetary Affairs regarding a proposal for an AIFMD update was published (the **AIFMD 2.0 Proposal**).[5] As already observed during the period of time since the public consultation of the EU Commission was launched (22 October 2020), the AIFMD 2.0 Proposal contains relatively detailed proposals regarding rules to be applicable to 'loan-originating funds'.

While there is understanding of the importance of loan origination funds to the real economy, European regulators believe that a set of common rules are necessary in order to address the potential micro risks and macro prudential risks that loan originating funds could pose and spread to the broader financial system.

Below we summarise some key elements of the AIFMD 2.0 Proposal in this respect.

A '*loan-originating AIF*' for these purposes is '*…an AIF whose principal activity is to originate loans and for which the notional value of its originated loans exceeds 60% of its net asset value. This needs to be read in light of the definition of 'loan origination'* as the '*…granting of loans by an AIF as the original lender'.* The large scope thereof would, technically, also include shareholder loans.

AIFMs to loan-originating funds need to ensure compliance with specific risk management measures. This is not, as such, a new development. Funds using shareholder loans of up to 150% of their capital (meaning net asset value PLUS outstanding commitments) are exempt from this requirement.

Further rules foreseen for loan-originating funds in the risk management area are:

(i) limit of 20% of the fund's capital (net asset value plus outstanding commitments) per borrower, where the borrower is either a Solvency II financial undertaking or another AIF or a UCITS;

(ii) the 20% limit '*…ceases to apply once the fund starts to sell assets in order to redeem investors' interests after the end of the life of the [fund]*';

(iii) it may be suspended temporarily for up to an additional 12 months '*…where the [fund] raises additional capital or reduces its existing capital*';

(iv) prohibition of granting loans from a fund to its AIFM (incl. staff and group entities), the depositary or any of the delegates of the foregoing;

(v) proceeds from loans (minus costs) must be reserved to the fund – transparency on cost pursuant to amended Art. 23 AIFMD disclosure rules;

(vi) for secondary sales, 5% of the notional value should be retained with the fund until maturity, with an exemption for (i) loans acquired by the fund on the secondary market, (ii) a secondary sale to avoid an unintended breach of manager mandate or diversification rules, (iii) in a wind down scenario and (iv) if a sale is required further to EU sanctions;

5 A9-0020/2023 ***] REPORT on the proposal for a directive of the European Parliament and of the Council amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds (COM(2021)0721 – C9-0439/2021 – 2021/0376(COD)) Committee on Economic and Monetary Affairs

(vii) Prohibition of *'originate-to-distribute'*, so funds are allowed to originate loans *'…with the sole purpose of selling them'*.

The foregoing should apply to both closed-end and open-end structures. For open-end structures it must, however, be added that detailed rules as to the employment of a choice of fixed liquidity management tools (new Annex V) in a 'sound risk management system' are required. There are also additional reporting obligations (AIFM for an AIF to AIFM home member state regulator, the latter to ESMA and in case of '*…any potential risk to the stability and integrity of the financial system*', also to the European Systemic Risk Board).

An important subject for existing structures and stability of the market are the grandfathering rules. The AIFMD 2.0 Proposal foresees that existing open-end structures may disregard the employment of a liquidity risk management system for up to five years after the entry into force of the amending Directive. Very importantly a further clause foresees that existing funds which do not raise additional capital for five years after the '*…entry into force of this amending Directive are deemed to comply with the above-mentioned Articles*'. Market participants in Luxembourg currently understand this further clause as a grandfathering option available to all closed-end structures provided their final closing will happen before the date occurring no earlier than five years after the entry into force of the amending Directive.

ELTIF 2.0[6] – loan-originating ELTIF

As a quick reminder the regulation for European Long Term Investment Funds (**ELTIF**), contrary to the AIFMD, is a product related regulation in the EU and, as such, is applicable with direct effect in each EU member state. The ELTIF Regulation (in its previous form) did not enjoy large market acceptance. An intensive process for an update was therefore conducted and the Council of the EU adopted, on 7 March 2023, the revamped regulatory framework for ELTIFs, bringing the legislative process to a close. Luxembourg has historically played an important role in this context as is evidenced in the ESMA ELTIF register[7] with almost 60% of existing ELTIF in the EU having been established in Luxembourg. Passport marketing of ELTIFs across EU member states allows for the marketing to (a large range of) retail investors. One important element of the changes implemented via the revised ELTIF regulation (**ELTIF 2.0**) is that the allowance for marketing to retail investors via the EU passport has even been made more flexible, logical and achievable.

The implementation of the changes provides additional opportunities which both managers and investors are likely to perceive favourably and which combines very positively with the fact that loan-origination is allowed under ELTIF 2.0.

In essence an ELTIF now needs to invest 55% of its capital (as in the AIFMD 2.0 Proposal this includes net asset value plus uncalled committed capital, as the case may be) in eligible investment assets. The scope of the eligible investment assets has been broadened significantly (including e.g. infrastructure and real assets). In this context it is also specified that 20% of the capital of an ELTIF may be invested in instruments issued by, or loans granted to, any single qualifying portfolio undertaking. A limit which may still be somewhat challenging is that the loans *'…granted by the ELTIF to a qualifying portfolio undertaking may not have a maturity exceeding the life of the ELTIF*.

Given the leading role of Luxembourg as the preferred location for existing ELTIFs (and also for loan funds), the expectation is that the positive effects of the changes introduced under ELTIF 2.0 generally, but also in the debt funds sector are likely to lead to a significant increase in ELTIFs established in Luxembourg.

6 Text of the proposed Regulation amending Regulation (EU) 2015/760 as regards the requirements pertaining to the investment policies and operating conditions of European long-term investment funds and the scope of eligible investment assets, the portfolio composition and diversification requirements and the borrowing of cash and other fund rules (2021/0377 (COD); PE-CONS 69/22) as published by the Council of the EU

7 Register of authorised European long-term investment funds (ELTIFs) - Register of authorised European long-term investment funds (ELTIFs) (europa.eu)

Prime brokers rise to the challenge as funds seek stability and service

Jack Seibald
Managing Director, Co-Head of TD Cowen Prime Execution Services
TD Cowen

The prime brokerage sector has been through turbulent times but has reset with a renewed determination to help funds meet their goals. Jack Seibald, Managing Director, Co-Head of TD Cowen Prime Execution Services at TD Cowen discusses the value, service and stability that a partnership with the right prime broker can bring.

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 include trade execution and custody, middle and back-office support, securities lending and portfolio financing. There are two services areas in particular which will get a lot of attention this year - outsourced trading and capital introduction. Demand for these services are expected to accelerate throughout 2023 and beyond.

Outsourced trading

Outsourced trading is just one of the many functions fund managers are adopting in the search for efficiencies, access to expertise, and operational excellence. Once viewed with suspicion by institutional investors and larger hedge fund managers, outsourcing is now considered a wise move for fund managers, especially in a time of tight budgets, falling AUM and flattened fees.

Some funds outsource to rein in costs, while others see it as an efficient way to access services, resources and expertise to help them grow. It's also tried and tested way to extend their reach by trading in unfamiliar assets or geographies.

Outsourced trading is an attractive proposition because it is so flexible – for example, TD Cowen's solution can be a high-touch, complete outsourced trading solution, or simply supplement an existing trading operation. The service gives fund managers access to an established and experienced team of 'buy-side' traders, support staff, and trading and reporting infrastructure in addition to the existing relationships developed over the years with scores of institutional brokers that provide research, corporate access, and capital markets flows.

The solution also offers exceptional value to investment managers as it truly functions as the client's trading desk but avoids the cost of building and operating an in-house trading infrastructure.

Capital introduction

Cap intro is another service offered by prime brokers which is in the spotlight in 2023, particularly among emerging fund managers. Global investors withdrew US$55.4 billion dollars from hedge funds in 2022, according to HFR data, so if you are seeking investment, prime brokers with a cap intro specialism can play a significant role in bringing together emerging managers and early stage investors, including family offices, fund of funds, endowments and foundations.

Select a prime broker with a team who have strong allocator backgrounds and can therefore provide a high level of insight and guidance to fund managers seeking investment.

The calibre of the team, combined with the breadth of the prime broker's access to potential investors should be a key criterion for managers looking to partner with a prime broker.

Leaders in this service conduct a rigorous analysis of potential investors before introducing them to their investor clients to ensure their expectations are compatible. This results in greater success rates.

Selecting the right prime broker

What fund managers are looking for from their prime broker depends on their specific needs – a fund at an early stage of growth might look to a prime broker for capital introduction, whereas a more seasoned firm might be more interested in outsourced trading or expertise in a different asset class. Whatever their needs, it is important to select a prime broker for the fund manager's current and future needs. I have three key recommendations for fund managers:

1) **Look at the capabilities, not the size**: Many fund managers may initially look to bulge-bracket banks for prime brokerage services. Their global reach and reputations make them highly attractive for fund managers, and this is not expected to change. However, there is an argument that a prime broker's size is less important than it was. The priority for a fund manager is to work with a prime broker that offers capabilities to match those required by the client, particularly if those capabilities match what the bulge-bracket banks offer but are also combined with very high levels of service.

   Be mindful that some larger prime brokers can demand certain levels of revenue from the relationship, and might down-grade or even off-board a client who misses the target. With this in mind, it seems likely that more fund managers will increasingly explore the solutions offered by mid-sized prime brokers.

2) **Track record is key**: In addition to considering the breadth of services on offer, select a prime broker with a sound record of performance, longevity of experience in the business and commitment to their clients. Given the current climate, it's also important to ascertain if the prime broker has experience of working through seismic shifts in the global economy.

   As part of your due diligence, check the strength of the prime broker's risk management. Given the recent steep losses experienced by some prime brokers, regulators have reviewed risk management measures at banks providing such services, warning them to invest in their risk management framework and control infrastructure.

3) **Add value with complementary prime brokers**: There is an increasing trend towards partnering with several prime brokers and, in particular, diversifying by engaging non-bulge bracket firms, especially those with the right capabilities and a strong focus on providing high levels of service. Given the recent upheaval in the market, having multiple prime brokers provides fund managers with the security, stability, consistency and the full range of services they need to grow their businesses.

   Irrespective of a prime broker's size, adding a second or third prime broker brings many benefits. Fund managers gain access to different product offerings, allowing them to either complement those of its current partner or to fill gaps. With the right prime broker, they might also experience more attention and focus on their needs. A less tangible but important benefit is that with more prime brokers come more perspectives on the markets and more opportunities to access useful advice.

Above all, my final piece of advice, is do your due diligence carefully and select your stable of prime brokers who will evolve with you as your business grows and can help to plug any gaps you may have along the way.

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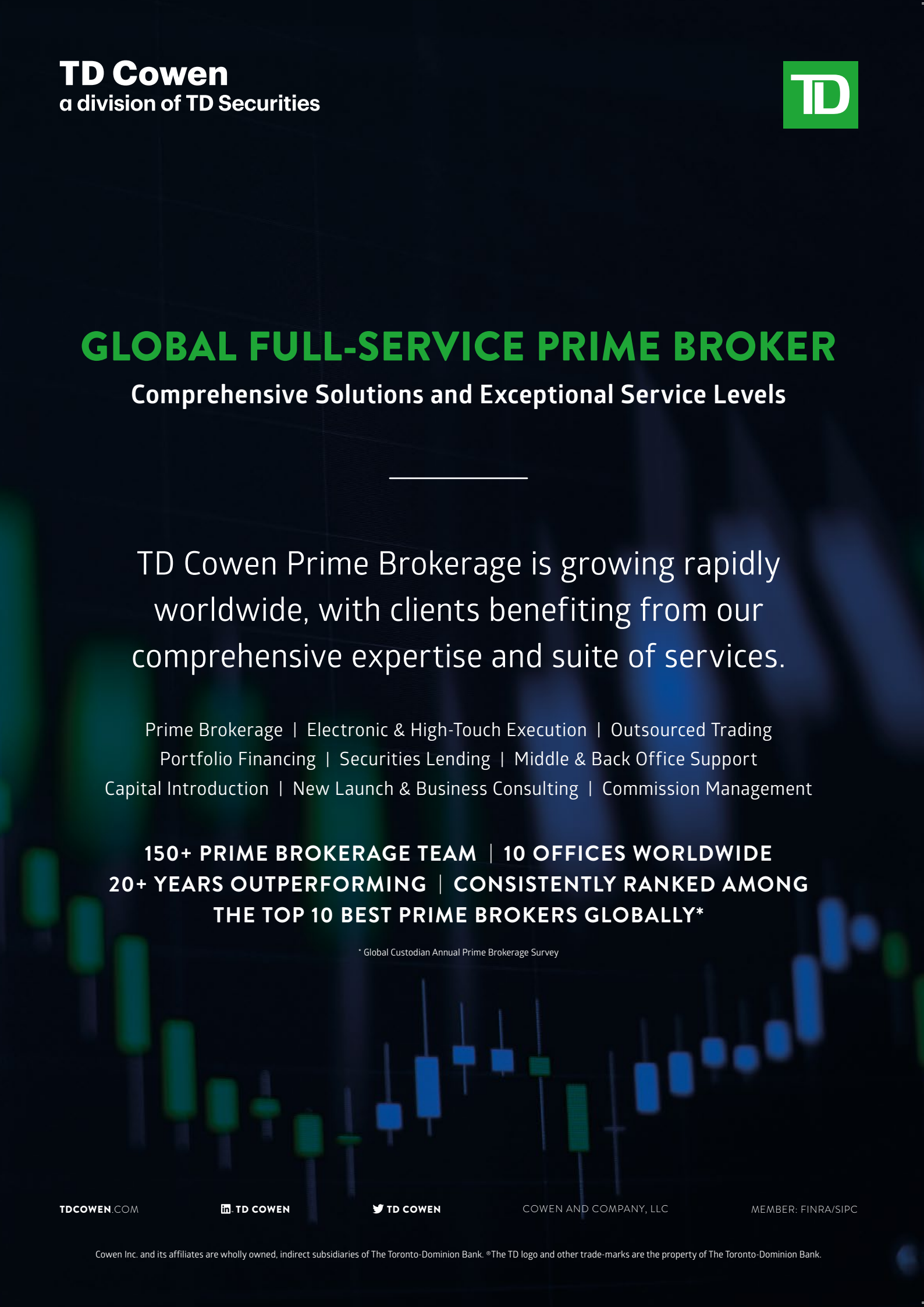

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Time's up for reverse solicitation? Case study: Monaco

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Introduction

Reverse solicitation as a sales practice is under increasing scrutiny by country regulators and the European Securities and Markets Authority (ESMA).

ESMA has conducted surveys of National Competent Authorities (NCAs) about their knowledge of the prevalence and use of reverse solicitation by Alternative Investment Fund Managers (AIFM)s and Asset Managers. Many NCAs suspect that reverse solicitation is being 'over-used' (abused) as a sales practice to circumvent EU Directives for the promotion of funds in the EU, especially in light of Brexit. This article will focus on the use of reverse solicitation for Alternative Investment Funds (AIFs).

So reverse solicitation as a sales practice is in the regulator's crosshairs.

While the Principality of Monaco is a third country with respect to the European Union (EU), it is still an important example of how reverse solicitation, which was a previously 'tolerated sales practice' with investors in Monaco, is now prohibited and how the Monaco Regulator, the *Commission de Contrôle des Activités Financières* (Financial Activities Supervisory Commission) (CCAF) has addressed reverse solicitation through legislation.

In this article, we analyse Monaco as our reverse solicitation case study for legal & compliance insight into reverse solicitation. The Monaco legal perspective is provided by expert Monaco Counsel Geoffroy Michaux, and marketing compliance commentary is from Global Sales Compliance Ltd.®, cross-border marketing compliance consultants.

Monaco legal perspective: AML Monaco advisory

Because the Principality of Monaco is not a member of the European Union (EU), EU regulations do not apply in Monaco and Monaco is under no general obligation to transpose EU Directives into Monegasque legal order. However, under a Monetary Agreement between the European Union and the Principality of Monaco of Nov. 29, 2011 (the ***Monetary Agreement***), the Principality of Monaco agreed to adopt certain EU legal acts or rules.

Relating to financial products and their distribution, and within the framework of the Monetary Agreement, EU Directive 2011/61(AIFM) and 2014/65 (MiFID II) have only been incorporated into the Monegasque legal order in 2021. Therefore, and until recently, neither the concept of marketing or pre-marketing of financial products in the Principality of Monaco, nor the relating practices, including their distribution products, were specifically addressed under Monegasque law.

Prior to that, the only applicable piece of legislation applicable to financial activities in Monaco in general was Law n°1,338 under which the exercise of any financial activity in the Principality (as defined in the said law) is subject to obtaining a license from the local regulator (CCAF).

Accordingly, foreign managers were not allowed to directly market their products to any investors in Monaco. Only duly authorised and CCAF-licensed entities could distribute financial products in Monaco, within the framework of a 'distribution agreement'.

However, applicable regulations did not formally forbid informing potential investors residing in Monaco in response to an unsolicited approach from that investor (the so-called reverse solicitation), and practice had it that reverse solicitation was tolerated provided that:

- the unsolicited approach was not a recurrent scheme;
- the fund manager was at all times able to prove that the initial solicitation was initiated by the investor;
- meetings and/or transactions took place outside Monaco;
- the fund manager had no physical or legal presence in Monaco.

This 'loophole' practice raised a very high degree of uncertainty and risk for both CCAF-licensed entities, and non-Monegasque managers and financial entities, and the Monegasque financial sector had requested clarification on this practice from CCAF for a very long time.

It has finally been heard through the enactment of law 1.515 dated December 23, 2021: Under the new law, *"Non-licensed companies are prohibited under the present law from canvassing, whether based on **active or reverse solicitation**, in order to offer, financial services or financial products, regardless of the place and medium used."*

This new piece of legislation raised many questions from CCAF-licensed entities, local legal practitioners and foreign managers and financial entities as to the actual intention of the legislator to fully forbid the marketing and distribution of financial products to all Monaco-based individual and entities as no exceptions were included in law 1.515.

Law 1.529 of July 29, 2022 clarified this matter establishing a number of exceptions for (i) institutional investors, (ii) CCAF-licensed entities and (iii) clients of such licensed entities provided that such canvassing is conducted through such CCAF-licensed entities. Also, the prohibition does not apply to events organised in the Principality gathering professionals from the banking and financial sectors, subject to prior notification to the CCAF.

On the contrary, Law 1.529 establishes a clear prohibition of unrequested solicitation, carried out remotely, by any non-CCAF-licensed entity with a view to offer, regardless of the place or the means used, services, financial instruments or products, to people domiciled in the Principality, except when the person domiciled in Monaco is a client of such entity.

Finally, Article 29 of Law n°1529 creates an Article 29-2 in Law n°1338 prohibiting CCAF-licensed companies from carrying out unrequested solicitation at the investor's domicile, residence, or place of work, with a view to offering services, financial instruments or products to people domiciled in the Principality.

Marketing compliance perspective: Global Sales Compliance Ltd®

For the past two decades, GSC Ltd. has investigated the sales practice of reverse solicitation with our legal Counsel network globally, including Monaco.

Reverse solicitation is a sales practice whereby the investor requests information about an AIFM's fund at their own initiative, under the assumption that there was no prior contact (or initiative) made by the AIFM and/or no contact was made by any third party to result in the investor's unsolicited request for information on the fund from the AIFM.

Reverse solicitation as a sales practice was intended by some regulators to be a regulatory carve-out or waiver from local country fund marketing and/or licensing requirements. In applying these regulatory waivers, some regulators were trying to be 'helpful' to the industry to acknowledge that indeed, in some cases, there truly are instances of unsolicited, inbound enquiries to the AIFM about their funds from potential investors.

Some country regulators acknowledge the sales practice of reverse solicitation as a market practice that is exempt from their local fund marketing and licensing rules; however, these regulators apply several ***substance tests*** to determine whether this sales practice qualifies as a potential regulatory waiver.

In order to confirm regulatory carve-outs or waivers from fund marketing and licensing regulations, some NCAs apply the ***initiative test***: who (which party) contacted whom first about the AIFM and its funds? Other law firm feedback is that Regulators apply the ***legitimacy test***.

In practice, our best guess is that true, legitimate unsolicited reverse enquiries from investors about an AIFM's fund without any prior contact by the AIFM or other third party to the investor are rare according to the original intent of the regulator. Even sales teams tell us they must make outreach to the investor first in order to 'generate' a so-called 'reverse solicitation' request from the investor about the AIFM's AIF.

Some industry players have taken what was intended by regulators to be a sales practice relevant for a 'one-off' instance of regulatory carve outs/waivers and are abusing this practice by conducting proactive, ongoing AIF solicitation in breach of AIF marketing regulations and licensing rules and calling it reverse solicitation. Regulators across the EU are now waking up to this practice.

In Monaco the big business opportunity for AIFMs has always been to target Monaco Family Offices, Private Wealth Management channels and high net worth individuals for the marketing of their AIFs. While reverse solicitation was a tolerated sales practice in Monaco until recently, CCAF has finally regulated – and limited – this practice under Monaco's regulations.

This sales practice has been used for many years and might have gotten out of hand to some extent, with AIFMs proactively soliciting Monaco's Family Office clients and high net worth individuals about their AIFs, trying to operate under the mirage of a 'regulatory waiver' called reverse solicitation. Perhaps this cross-border practice which was previously tolerated by CCAF rose to a higher, more dangerous level putting Monaco's Private Wealth Management industry at risk. Could CCAF's move to limit reverse solicitation be a protectionist move for Monaco's cottage industry (the golden egg), the Private Wealth Management/Family Office and high net worth individual investors?

Summary

Even though Monaco is not an EU member state, its regulator realised that the reverse solicitation 'loophole' needed to be closed and further legislative clarification was needed in respect of foreign fund managers soliciting investors in the Principality of Monaco under the guise of reverse solicitation. Could other National Competent Authorities (NCAs) follow CCAF's approach with a firmer legislative response to the overuse by some industry players of reverse solicitation as a way to circumvent national (country) regulations?

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2023, the dawn of private credit and the question of asset allocation

Karthik Athreya
Director and Head of Strategy (Alternative Credit)
Sundaram Alternates

What a year 2022 has been! Just when one thought one has lived through a global pandemic and survived, a rampage of economic missiles appear to have been fired across the world – the supply chain disruptions post-COVID with countries turning inwards, the Ukraine political war turned human disaster turned refugee social crisis turned leadership crises, oil and energy wars continuing amidst climate change measures, a giant global inflation bomb bankrupting several economies and marginalising entire continents. At a more individual level, regular income earners are seeing their capital eroded even before they spend it and wondering what they must do to keep their lifestyles going.

With the 2022 chapter now closed, we can reliably expect to see the following for the rest of 2023:

- The inflationary environment continuing for the next 12-18 months
- Rising rates / tight monetary policy ecosystem – unless local central banks decide otherwise
- Volatile currencies as global macro waits in anticipation of recessionary trends
- The next episode of the battle for world trade domination between *"oil"igarchs*, the alleged *"super"powers* and the *"con"munists* - collateral damage on price-takers across the world

Meanwhile, all Indian investment/asset managers sell the 'virtues of the Indian economy'- US$3.2 trillion GDP, growth rates of 5-15% (depending on who's selling what), analogies comparing the Indian economy to China, the USA, Japan etc., seemingly a super low-leveraged economy (~US$2.2 trillion leverage and a debt-to-GDP ratio of ~0.9x), the rocket-ship that is the Indian equity markets that has a heart and mind of its own.

All fingers point to the massive dosage of equity that India can absorb.

At the same time, over the last decade and a half, global macro material events like war, mega corporate scandals/market collapses, shifts in political/leadership paradigms, shorter business cycles, and super-volatile currency markets, not to mention a global pandemic like COVID (and the possibility of its recurrence) have resulted in a new normal of uncertainty that requires tremendous awareness, agility and flexible capital to take advantage of opportunities in a global inflationary phase.

Private equity, private debt, alternate capital, sustainability, transition capital and many other new-product nomenclatures greatly accentuate the importance of asset allocation or portfolio mix which is likely to prove critical for investors the world over in this new normal!

While benchmark returns from historically perceived safe/risk-free returns have changed, they do not seem to be keeping pace with cost-of-living increases.

As an investment professional, I would believe that the key goal of an investment product would be to both preserve capital and generate risk-adjusted returns that meet or preferably, beat projected inflation. I prefer to call this asset class a *"hedge against the cost of living"* for an individual investor or *"an anchor for portfolio stability"* for a typical growth investor in India who is targeting double-digit returns. This is my definition of private credit.

As a part of the investing community in India, an interesting set of data points for me in India versus more developed / sophisticated markets (excluding China, which is an animal of its own):

1. In India over time, banks and public debt markets account for ~80% of the overall debt / GDP Vs say ~20-30% in the USA – **banks have been the largest risk takers in India**.
2. Conversely, NBFCs / alternate capital contributes to ~20% of India's GDP Vs ~50-60% in the USA – **extraordinary room for alternate asset classes to grow in India**.

Regulations are increasingly focusing banks towards social lending, consumer banking & traditional project finance versus risk capital (barring maybe to the top 5-10 corporate houses in the country). For the vast majority of the rest of corporate India, capital needs are increasingly financed by equity markets & private capital alternatives that include NBFCs / funds / private lenders. This is estimated to be an annual US$13-22 billion investment opportunity growing at 10%-15% annually.[1]

So, a preferred portfolio mix for Indian investors could be longer duration strong equity propositions and assets that are credit-like from a capital protection perspective and yet generate quasi-equity-type returns for investors. To this end, the credit opportunity in India stands at an inflexion point, making this a strong case for increasing asset allocations.

1. Corporate credit to GDP is at a decadal low (~53% in March 2022 vs ~69% in March 2012)
2. Banks focus on low-risk weight highly rated assets – leaving a void in the mid-market credit
3. Re-start of private capex / growth investments after 5 years of stagnation post-restructuring, consolidations, post-COVID growth momentum etc.
4. Unmet growth capital demand from small and midsized corporates is estimated at ~US$8-10 billion and growing
5. Post RERA corporatisation of the ~US$180 billion real estate sector - ~1% to ~8% of GDP growth (over 2 decades) – sustainable consumer of high-yield financing
6. Steady evolution of bond markets - mushrooming marketplaces that are able to price illiquid private fixed-income instruments
7. Opportunistic, shorter cycle investments across listed bonds, special situations, IBC / NCLT-driven discounted assets and the like

The above are drivers for a rapidly growing alternative asset class of innovative public & private investment products which should provide investors with a greater chance of protecting their 'cost of living'. Within this, I see great opportunities for investment managers to create a robust set of high-yield investment opportunities backed by 'real assets' and credit enhancements to get to 'investment grade' status. The asset under management (AUM) of AIF funds stands at ~US$39 billion as on June 2022 with an additional ~US$48 billion commitments to be deployed (up from ~US$1.1 billion 7 years ago).[2]

1 Source: EY Private Credit report Nov 2021.

2 Source: SEBI website.

Alongside product diversity, we are already seeing a growing sophistication amongst investors in terms of the creation of multi-family offices, product specialisation within investment advisors & distributors, regulatory changes that allow insurance companies/banks to participate in AIF vehicles and new fund domiciles like the GIFT City where large offshore capital pools can set up and operate (a financial education hub if you will).

From a market & economic perspective, a wish list for 2023 could look like this:

- **For Corporate India:**
  - Capital to fuel the ~7.5% GDP growth that the government is forecasting
  - Flexible capital for small to mid-sized companies (that makeup ~40% of GDP)
  - A non-material dent in corporate earnings (if inflation does not hurt more) – the ability to operate at cash positive

- **For Investors:**
  - Enough choices among equity and fixed-income products to create ideal portfolios for all categories and scales of investors
  - Investment products that *generate risk-adjusted returns at premiums to inflation*

- **For Investment / Fund managers:**
  - Massive opportunity to create innovative products with this market opportunity
  - Be a catalyst for investor sophistication & scale in India

Disclaimers

The author is on the Board of Sundaram Alternate Assets Limited (SA), which is an alternate assets investment manager with ~INR 5000 crores of assets under management across equity strategies and private credit. SA also manages several private credit funds across real estate and mid-market lending opportunities and has generated ~15%+ returns from its credit funds for its investors from its senior secured investment portfolio.

The above article represents the personal views of the author and does not reflect the views of SA. Consequently, all investment ideas, stated return targets etc reflect the author's views on the market and based on his investment experience.

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Thank you for reading the Edition 133 of the AIMA Journal.

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

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- Q2 Edition 134

Deadline for submission 5pm UK time Monday 22nd May | Publication Monday 19th June

Please note the deadline for reserving a spot for the Q2 edition of the AIMA Journal is 5pm UK time Friday 5th May. Please note that availability is limited, and we cannot accept any additional contributions once all the spots have been filled.

- Q3 Edition 135

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- Q4 Edition 136

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