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AIMA JOURNAL EDITORIAL GUIDELINES

Message from AIMA's CEO

Jack Inglis
CEO, AIMA

The necessity of change is a central theme running through this edition of the AIMA Journal. From adapting to the remote working environment forced on us all by the pandemic, to the more positive forces of ESG and technological innovation, change is everywhere. As the hedge fund industry adapts to the latest 'new normal' these pages are filled with forward-looking insights to help readers map out how the market landscape will be moulded by the myriad market forces currently at large today.

The Q3 2021 edition is unfortunately still dominated by references of how COVID-19 continues to overshadow discussions around business practices and economic prospects, but with a new emphasis on preparing for the post-COVID era that is hopefully not too far ahead.

ESG is also presented by multiple contributors as a double-edged sword of risk and reward, which for hedge funds means opportunities abound for those with the acumen to navigate the shifting sands of rules frameworks and challenges around greenwashing.

Adaption means shedding what may once have been useful but is now redundant, which in this instance means legacy systems that are no longer fit-for-purpose in the digital, automated, and agile world. This journal offers guidance into how to offload the dead weight and embrace the new.

Other than COVID, the most prominent external force for change is regulation, and this edition provides detailed insight into the latest rules frameworks impacting the hedge fund universe today. Special focus is given to the new rules including the US' marketing rule on private fund advisors, Germany's pre-marketing rules for alternative investment funds, the Cayman Islands' expanding economic substance regime, and what it means to be FCA regulated in post-Brexit Britain.

Elsewhere, the growing prominence of private markets in the minds of institutional investors also shines through in this issue with a review of how private assets have faired in recent months and predictions on likely further growth. Another area of increasing interest – digital assets – is explored with several common misconceptions challenged.

Finally, the highly-topical issues of company culture and the increasing intensity of the so-called war for talent are addressed with some dos-and-don't offered on how to retain top talent, foster a positive work environment and manage known risks from the emerging hybrid work model.

As always, my thanks go to all the authors in this edition which make it such a valuable and sought-after resource for AIMA's members and the wider industry.

Jack Inglis
CEO, AIMA

Asset servicing post the pandemic – five evolutionary changes managers must be ready for after COVID-19

Jay Peller
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The pandemic altered everything we did. The way we lived our lives, the way we interacted, and the way we worked were all forced to change as the world experienced a once in a lifetime event that few people have ever been through.

The pandemic has also altered investment markets in many ways, including what types of assets managers are seeking to buy, how they securely access them, and how the entire infrastructure behind their operations functions remotely. While some may assume that areas like fund administration will return to a pre-pandemic state over time, particularly after the success of vaccination programmes globally, a far more likely outcome is that we will see many of the changes instigated to help cope during COVID-19 remain in place. Many of the solutions and stop-gaps introduced to keep funds running during the pandemic, have highlighted inefficiencies within established operating models.

Having shown how much can be achieved via a new way of working, and the benefits it can bring to businesses, we now expect a shift to take place which sees these emerging trends become the norm over time.For fund managers, this has clear implications for everything from data management to going paperless, and much of the focal point will be on how they engage with asset servicers. The good news is there are a lot of positives to take from the changes instigated during the pandemic. Below we highlight five of the key areas where this evolution is likely to occur.

Digitisation

In this new environment, many funds will need to move the initial subscription and capital commitment process into the digital space – completely removing paper from the process while simultaneously improving the quality of the information supplied by investors. The digitisation of IR means managers will be able to gauge investor sentiment with live usage reporting during the capital raising process. By embracing digital onboarding, they can have visibility on which potential investors are engaging with fund offering materials, as well as seeing where investors stand in the multi-phased subscription process. Digitisation can also help managers score their portfolios against environmental, social and governance (ESG) metrics, for example, and there are various tools either available or in development that can help with this process.

Data management

Data is becoming increasingly important for many industries, and across the world of funds it is paramount. Collating it is one challenge, but increasingly the new frontier is in how that data is used. Managers will need data management tools to help them make sense of their data, as well as that provided by fund administrators and other parties. Data management platforms are one solution that we expect will see increasing demand from fund managers to tackle the mountains of data being harvested. Platforms can provide better transparency, unearthing efficiencies and driving real business value through actionable data. With the increasing use of cloud technology, we expect those platforms which are already operating in the cloud will be at the forefront of this trend.

Centralisation of services

The demands on managers to deliver returns in a world where returns are challenged means they need to dedicate as much time as possible to focus on their portfolios and spend less time on administrative duties.

Outsourcing is the obvious solution, but one issue with this is having to deal with multiple providers for different services. We expect this will drive managers to increasingly turn to service providers who can offer it all under one roof.

This is likely to be particularly pertinent when it comes to areas such as middle-office services, where it increasingly makes sense to have treasury, collateral and cash management carried out by one provider who then has full oversight of managers' cash positions, for example. Our expectation is one provider, one tool, and this simplification for businesses could be one of the biggest growth areas in fund administration going forward.

Security

Never far from the agenda, security is nonetheless continuing to rise in importance in this era of increased connectivity.

Ensuring security of data is absolutely critical. The rise in online trading requires more security options underpinning it, such as dual factor authentication, watermarked documents, and digital certificates embedded in documents that are tamper-proof once signed.

The fund administration sector is seeing increased interest from managers when it comes to portal usage in their interaction with investors. Data storage is also a hot topic – data needs to be securely acquired and stored, where managers can communicate electronically with their prospects, as well as existing investors. Cutting edge technology that enables the above to happen seamlessly is already in high demand, and that will almost certainly continue.

Increasing complexity

As managers increase diversification across asset classes in search of returns - moving into hybrid strategies and accessing a wider range of investment vehicles - the complexity of investment administration will continue to grow. There will be a need for continued innovation, with managers adopting emerging technology faster than ever, whether that be through proprietary offerings or via third-party partnerships.

The role of fund administration has already evolved significantly of course, from simply providing month-end NAV calculations to offering truly front-to-back office and tailored outsourced solutions. But the challenge continues. There is growing demand, for example, for access to private markets by institutional investors, while demand for fund finance is another popular area that is equally complex.

ESG and being able to report on it clearly across factors such as ecological impacts, employee engagement, and business ethics have become increasingly vital, as non-financial indicators of the health of businesses and investments globally takes centre stage amid the climate crisis.

In addition to the above, it is also critical for managers to find a partner that understands how day-to-day transactions are impacting their portfolios, whether that be complex loan activity or enhanced agency services for syndicated and complex transactions.

Alongside experienced and knowledgeable staff, software and systems that can tackle this – and the other factors above – are going to be crucial to streamline managers' businesses, enabling their success.

ESG in the investment process: Mitigating litigation risk

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In this article we explore the litigation risks arising from incorporating environmental, social and governance (ESG) into investment decisions. We look at this issue through the lens of hedge funds and private credit funds and we use the term 'investment manager' with that focus in mind.

In practice, relatively few such firms manage funds that are specifically ESG-focused. However, an increasing number of mainstream funds include some ESG integration and certain key regulatory developments nonetheless apply to many firms, and investors (generally) have increasing expectations on ESG issues. Recently we have seen increased regulatory focus with the UK FCA's letter to authorised fund managers outlining its expectations on ESG and sustainable investment funds. This may indicate the direction of travel for managers of other alternative investment fund structures.

The relevant regulations and investor expectations cover several facets of how managers operate in practice, including:

1. Whether the manager is required to take account of ESG issues when making investment decisions
2. If so, how to go about addressing ESG issues within the investment process

It is important for investment managers to understand the risks to which they expose themselves when making these decisions. In this article we therefore examine those issues from a litigation risk perspective.

Is the manager *required* to take account of ESG issues when making investment decisions?

The starting point is whether an investment manager is required to take account of ESG. We view this issue in terms of potential regulatory requirements, contractual requirements, then in terms of broader fiduciary or tortious duties. Starting with the regulatory position, for most hedge fund managers and private credit funds, the Article 4 requirement in the EU's Sustainable Finance Disclosure Regulation (SFDR) to publish a statement concerning adverse impacts of investments decisions on sustainability factor may not apply. This is because the SFDR allows smaller firms to explain why they do not consider adverse impacts of its investment decisions on sustainability factors. However, under Article 3 of SFDR there may be a requirement to disclose polices on the integration of sustainability risks in investment decision making processes.

There is scope for debate about whether the FCA might seek, in future, to impose directly applicable regulations that require the incorporation of ESG factors on the managers of hedge funds or private credit funds. The guiding principles that now apply to authorised fund managers (see briefing here) indicate the direction of travel for now.

As for the contractual position, it is critical for investment managers to look carefully at what has been agreed regarding ESG in offering documents, the investment management agreement, or any other document setting out the scope of investment mandate. Managers should be aware that an agreement to take account of ESG can be incorporated via cross-reference, for example by agreeing to adhere to an investor's own stated investment principles (a common requirement of many institutional investors). If any of these sources contain a commitment to assess the likely adverse impacts of investment decisions on sustainability factors, that must then be borne out in reality. Failing to do so exposes the manager to litigation risk.

This bears out a deceptively simple point: investment managers need to make sure that what they do in practice matches what they have promised to do. Of course, there are shades of risk that can arise from the contractual position. For example, the manager should only make commitments that are within its control.

Accordingly, it is safer to focus ESG commitments on process rather than outcome. A common example is that many investors are seeking to align their portfolios with the UN Sustainable Development Goals (SDGs), addressing economic, social and environmental developments.

However, investment managers should be careful not to overcommit to macroeconomic targets (in the SDGs or otherwise) that are outside of their control.

As to broader fiduciary or tortious duties, there has been a discernible shift in how these duties might be interpreted. In the 1980s, the English Courts held that the *"best interests"* of investors were (exclusively) their best financial interests, without reference to moral considerations, and that investment managers must not fetter their discretion by reference to *'extraneous'* factors.

That can be contrasted with the widespread recognition (now) that ESG factors are considered financially material. We see this in a number of ways:

- The United Nations Environment Programme Finance Initiative concludes that investment approaches which consider ESG factors are permissible and may even be required.
- SFDR refers to 'sustainability risk' as an ESG event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.
- Various regulations (e.g., relating to pensions) define "financially material considerations" as including ESG factors.

The debate is therefore shifting to whether ESG due diligence forms part of essential investment risk management. An investor's argument might be that investment managers should incorporate sustainability factors into their investment decisions to discharge their fiduciary duties.

Whilst that position is so far untested, it is not as extreme a position as it might at first appear.

Managers should bear in mind the following:

- The longer the investor's time horizon, the stronger the argument that ESG is a risk management issue
- Portfolio companies can face huge damages claims from adverse ESG events, harming the value of the company. We are seeing an increase in 'mass tort' litigation, in which a group of claimants allege a duty of care against a major corporate. Such litigation against parent companies based on overseas human rights and environmental impacts has passed threshold admissibility challenges in the English, Canadian and Dutch courts.
- It is entirely possible that in future a company's success (and share price) will increasingly depend on *avoiding* adverse ESG events.

The issue of whether an investment manager breached its duty of skill and care is always going to be highly fact sensitive. However, a core reference point is likely to be the extent of regulatory compliance. That is because regulation affects the interpretation of the scope of an investment manager's private law duties, and it is harder for a manager to argue that it acted with reasonable skill and care if it falls short of regulatory requirements. Adherence to regulations is therefore an important step in managing litigation risk.

Looking to the future, if regulations relating to ESG in the alternative investment industry extend in scope, that will tend to signal an increase in litigation risks. We saw an indication of this direction of travel in July with the FCA publication of a letter that, although addressed to the chairs of managers of UK authorised funds, provides scope for read across into the alternatives space. When it comes to ESG, there is an element of race to the top, that will drag up the expectations on others.

Addressing ESG issues in the investment process

In our experience, a range of approaches have been taken by investment managers to incorporating ESG factors into investment decision making. These include:

- Proprietary scoring systems in determining ESG-level risks
- Focusing on ESG risk with similar scrutiny to other credit risks
- Developing frameworks to identify the ESG issues that are most relevant to a sector's financial performance and performing due diligence on them

A particular challenge is of incomplete and inconsistent ESG data, since ESG disclosures by companies vary greatly, with not all companies tracking ESG key performance indicators and – even for those that do – considerable variation in the standards for tracking ESG impact.

This is where a systematic approach, backed up by good record keeping, can act to mitigate the litigation risk for the investment manager. If an aggrieved investor seeks to allege a breach of the manager's tortious duty to exercise due skill, care and diligence, then the framework of policies, systems and records for investment decisions will provide a crucial line of defence.

Of course, another important defence is to give accurate disclosure that describes the role played by ESG due diligence in the investment process – this is doubtless a key part of litigation risk mitigation. In this regard, the SEC recently opened a major investigation into ESG processes, and related disclosures, at DWS Group, following whistleblower allegations by its former head of sustainability. This shows that enforcement activity is more immediate risk than some may appreciate.

For those that are in the early stages of the journey to incorporating ESG into the investment process, it is worth exploring the available materials and due diligence frameworks such as the UN Principles for Responsible Investments. This is likely to trigger thought processes that in turn lead to litigation risk mitigation.

This is undoubtedly a complex and fast-evolving area. For all the reasons explored above, it deserves careful treatment as an important risk management issue.

ESG: Changing the landscape of investing

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The future of finance is rapidly changing with the proliferation of environmental, social and governance (ESG) investing. This rise has led to an increase in demand by investors for greater transparency and new regulatory reporting requirements in every jurisdiction. We see global regulatory bodies and governments demonstrate their commitment to generating more sustainable investment opportunities. As a result, they share ESG disclosures, new standards and action plans for financing sustainable growth with increasing frequency.

ESG factors present both risks and opportunities and, with it, an explosion in ESG data.

Bottom line: staying on top of it all can be a daunting prospect.

In the beginning

Responsible investing, the precursor to ESG investing, can be traced back to the 18th and 19th Centuries and faith-based organisations, which initially avoided investments that weren't socially responsible. This practice widened with socially responsible investing in the 1960s and 1970s by university endowments.

In 2000, the involvement of global institutions began with the publication of the UN Millennium Development Goals aimed at tackling poverty. These goals were replaced in 2012 by the 17 UN Sustainable Development goals, seeking to address environmental, political and economic challenges by 2030. Then the 2015 Paris Agreement followed, focusing on reducing greenhouse gas (GHG) emissions.

More recently, the G20 Task Force for Climate-Related Disclosures (TCFD) wants more companies to manage and report climate-related risks and opportunities. As a result, investors are now paying greater attention to companies' direct, indirect and supply chain GHG emissions.

Why it matters to investors

In 2004 the United Nations global compact published the whitepaper *Who Cares Wins* and was the first to use ESG. The call to action led to the 2006 UN Principles for Responsible Investing (UN PRI), which now has over 3,000 signatories managing more than US$3 trillion in assets. With so much money controlled by responsible investors, it's not surprising they expect more from asset managers.

The new scrutiny for asset managers includes due diligence questionnaires on investor practices, mandates tied to exclusion lists and exposure monitoring, and ESG transparency reporting of trend analysis and risk profiles. Additionally, with the rise of social media, more and more companies are under increased media and investor scrutiny.

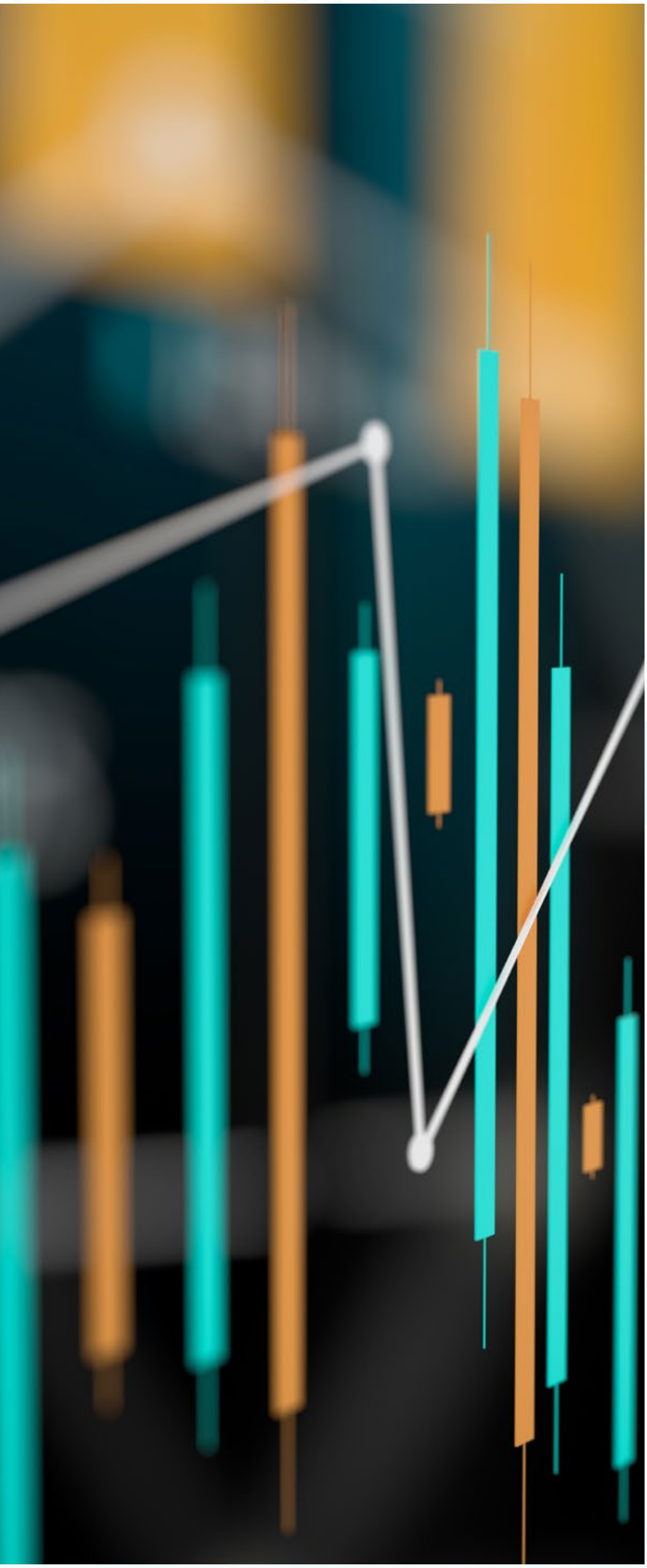
ESG regulation

The introduction of financial market regulations was inevitable. The Sustainable Financial Disclosure Regulation (SFDR) requires financial market participants in the European Union (EU) or EU investors or EU funds to consider 14 mandatory Principal Adverse Indicators, with another 46 optional indicators. These include GHG emissions, biodiversity, water, waste and social and employee matters, with reporting commencing in 2022. In addition, TCFD- elated regulations may follow soon, requiring more prescriptive reporting by companies in certain countries.

Inconsistent standards: the reporting challenge

Between investors and regulators, asset managers are under increasing pressure to explain how they integrate ESG factors into their decision-making processes, and the metrics used to monitor ESG and manage risks within their portfolios. While the regulatory framework around ESG is still taking shape, asset managers should prepare for the likely evolution from voluntary to some form of mandatory ESG reporting soon.

The challenge for asset managers is the lack of standards for defining, measuring and reporting on ESG. Crunching ESG data on companies has become an industry unto itself, with more than 100 vendors providing ESG scoring, rating and reporting services. Their methodologies vary widely. Many of these rating firms rely primarily on self-reported information via companies' disclosures in their annual and quarterly reports. In the digital age, however, no company is fully in control of its own story anymore. This has given rise to data providers using artificial intelligence to track market sentiment on companies based on news coverage, regulatory actions and social media commentary – scoring companies on their 'real' rather than self-reported ESG behaviour.



Not surprisingly, this disparity of rating methods leads to a disparity of results. Different vendors' scores for a single company can be all over the map. It's important for asset managers to understand exactly how a vendor arrives at its scores or ratings and the underlying data sources used. It still falls to the fund manager to make informed judgments based on information from disparate sources, and to be able to communicate its ESG policies and practices to clients.

Data to the rescue?

There are over 100 data vendors supplying the market with ESG scores, ratings and reports on companies based on company disclosures and independent research. ESG data is still in the early stages of development and this can lead to ESG data vendors reaching different ratings when looking at the same company. It's therefore important to understand exactly how an ESG vendor calculates their ratings and the source data driving the ratings. This will then help end-users to understand unexpected results, such as the March 2021 investor report that listed a tobacco company and a mining/commodity trading company as being in the top five ESG rated companies in the UK FTSE-100.

How can we help?

To discuss any of the points raised in this article or find out how SS&C can help you, please contact RegInquiries@ssnc-corp.global

Tech Debt: The vicious cycle of legacy tech in asset management

Thomas Kim
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There's a tech debt crisis in the asset management industry.

Every year, the sector's average annual technology spend increases. Without fail, **the headlines** point to this upward trend as a signal of the industry's digitisation. When you dig beyond the headlines, however, it becomes clear that this innovation assumption ignores the full picture.

As leaders of asset management firms know all too well, large technology budgets do not always automatically translate to strong investments in innovation. The fact of the matter is, a very small amount of that spending actually goes towards true technology advancements. True technology advancements better enable the business, increase return on investments, decrease risk, improve operational stability, open up global access, scale up and down dependent on business needs and provide access to unified data for better decision making.

In this article, I will discuss a phenomenon, which I've coined '*tech debt*', that is hampering real innovation in the asset management sector and contributing to ballooning annual tech spends.

If it's not funding innovation, where is the money going?

The answer to that important question can largely be summed up in two words: legacy technology. An estimated 80% of technology budgets are devoted to simply 'keeping the lights on' and maintaining, repairing, and updating old, legacy technology systems.

80% is a staggeringly high figure, particularly when you think about the billions of dollars the asset management industry invests in technology each year. Analysts expect the wealth management industry alone to spend more than US$24 billion on technology by 2023.

As investment technology has advanced, legacy technology providers have bolted on additional functionalities to systems that are decades old. Each of those updates, in turn, carry a cost to the asset managers that rely on that technology.

'Tech debt' is a phrase I've coined to describe this phenomenon and what I view as an innovation crisis in the asset management industry. Put simply, tech debt is the perpetual cycle of spending to update and fix outdated technology that directly stands in the way of the business from evolving and developing meaningful capabilities that power growth.

Because asset managers have put so much money into their legacy systems, they often feel they have invested too heavily to change course. In essence, they feel 'indebted' to their 20+ year old technology systems.

Escape the cycle of tech debt

When faced with the decision of whether to update ageing infrastructure or explore new, cutting edge technology, it's critical for asset managers to think about the long-term implications of the decision. While patching old technology might be a cheaper option in the immediate term, it's not a permanent solution. The reality is those costs add to a growing pile of tech debt that asset management firms eventually have to pay down at a higher interest rate when they are left with no other option.

It's time for asset managers to confront their own tech debt and ask themselves:

1. How much have we invested in repairing legacy technology already?
2. How much will we be forced to spend to update legacy technology over the next five years? The next 10?
3. What is our total tech debt?
4. Where does our current technology stack fall short?
5. Does our technology position us to serve the next generation of our clients effectively?
6. How could adopting cutting edge technology transform our operations?
7. What technology would we build if we could start from scratch?

The last question is an important one. The 'build-it' mentality is one emerging managers have adopted and it has given them an agile, competitive edge in some markets, but requires continued investments in order to keep it from going stale and then turning into tech debt.

The opportunity cost of delaying the adoption of new tech

A lot has already been written about legacy technology's stronghold on large financial firms. In addition to deepening their tech debt, asset managers also face an opportunity cost when they maintain their legacy technology and delay the adoption of new systems.

A recent Oracle study calculated that large financial institutions could lose up to US$1.5 billion in revenue for moving too slowly to integrate new technology. Oracle refers to this revenue loss as a laggard penalty. By contrast, firms that have already reached an advanced digital stage report more than an 8% increase in revenue.

When factoring in the opportunity cost and the full picture of asset managers' tech debt, it becomes painfully clear that the cost of maintaining legacy technology is far more exorbitant in the long run than starting fresh with a new, cutting-edge system.

For many asset managers, the cycle of tech debt likely started more than 20 years ago. The question is: when will it end and why wait when newer technologies have removed the friction and lowered the risk associated with change?

A simpler, faster and more unified way to operate

Enfusion represents a new paradigm for investment management operations. By freeing asset managers from legacy technology limitations and breaking down information silos, Enfusion joins the dots between portfolio management, trade execution, order management, risk, and general ledger making it possible to see clearly in real time, unfetter talent across the enterprise, move faster, and boost the internal innovation that drives differentiation and returns.

A comprehensive cloud-native SaaS investment management platform with integrated middle- and back-office managed services, Enfusion connects the front office through to the back, seamlessly, to help you to see, perform and grow at the height of your talents.

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See clearly. Act confidently.

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How hedge funds and their investors can manage increased reporting demand in the digital age

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Over the next five years, hedge fund chief financial officers (CFOs) expect investors to demand an increased volume and frequency of reporting in areas ranging from trading and performance data to risk parameters and ESG.

While compiling our recent report, The Future Hedge Fund CFO: Preparing for Disruptive Tech and Emerging Asset Classes, we found investors hungry for frequent updates.

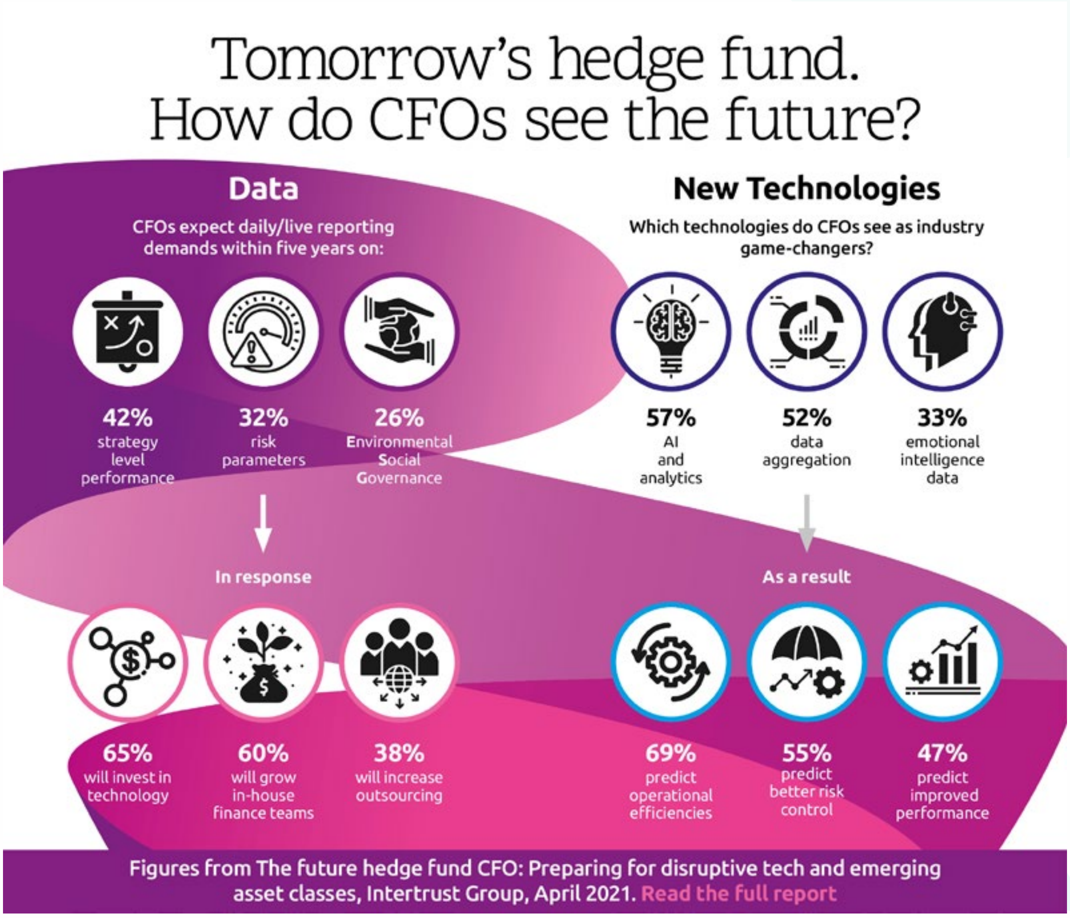
Our survey found 33% of respondents seeing demands for daily reporting on strategy-level performance, with an extra 9% seeing demands for live reporting in this area. The second-highest demand for daily reporting was over risk parameters at 26%, with an additional 6% demanding live reporting.

Reporting frequency is increasing because of technological advances, which in turn drive expectations. The average manager reports data to many stakeholders within and outside their organisation, from the front and back offices to management and C-level executives and fund investors. Each wants the data in a different format.

Delivering data in a timely fashion

To meet these demands, hedge funds must be able to access data in a timely fashion, both to report to investors and for front-office efficiencies in the all-important trading realm.

Hedge fund managers require reliable information on reconciliations, profit and loss, cash, positions and other metrics before markets open. If the front office is still receiving reports at 10am, the firm is at a disadvantage. Having service-level agreements in place; maintaining solid relationships with prime brokers, banks and other parties; and standardising data presentation and analysis formats enable service providers to do their jobs effectively and deliver clean, useful data to clients. Technology is important for engendering efficiency, but at least equally important are human connections between firms and process expertise developed over years.



This is where service providers excel. For example, if a client is adding a new prime broker, Intertrust Group probably already has a connection with that broker and understands their technical requirements.

Receiving data that is not in the correct format for validation and output highlights another challenge to delivering on timeliness – how data is digested.

Digesting data in a meaningful way

A key obstacle to meeting heightened reporting frequency demands is the mixture of separate internal systems that often exist within a manager firm. Company operations departments face the challenge of sending this data over different systems to help the front office best position itself at the start of the trading day.

Providing standardised data helps firms bridge situations where, for instance, back and front offices use different systems. In this context, being technology-agnostic enables services to be provided as flexibly and in as customisable a way as possible. Firm size, complexity, broker relationships and the amount of trades involved can all affect the efficiency of data digestion – the more data there is to digest, the more potential for something to break.

Service providers must be experts at ingesting data in multiple formats and outputting it with a unified structure to make it more meaningful, providing what Intertrust Group calls actionable insights. This requires investment in robust technological infrastructure.

The extent to which a firm will outsource to nullify problems related to the timeliness and digestibility of data is, we believe, intimately related to where it is in its growth. Larger firms often decide to build systems in-house, while smaller ones may not have the budget for outsourcing or appreciate its cost-effectiveness.

We also find that as small to medium-sized firms grow, they need more operational due diligence and greater efficiency. This prompts them to investigate outsourcing.

Discerning meaningful patterns in data

Gathering 'meaningful information' is not simply about successfully ingesting data. Instead, it means discerning patterns that can be fundamental to providing actionable insights.

For example, managers might want to understand patterns on issues occurring on a more frequent basis and the root causes for such issues. They might use these insights to advise the third party in question. With this approach, a service provider becomes a partner helping hedge funds to eliminate breaks in process, rather than simply fixing recurring breaks.

Although a firm might be able to glean these insights on its own, it is unlikely to be able to match an outsourcer's economies of scale. Perhaps the greatest challenge in providing data to facilitate front-office trading and accurate reporting to investors is managing third-party relationships between various data producers. Outsourcing providers can navigate these relationships continuously in a way that is increasingly in demand in a digital-first world.

The Future Hedge Fund CFO report canvassed the views of 100 senior-level respondents, evenly split between continental Europe, the UK, North America and Asia. Read the full report here.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Understanding and applying robotic process automation

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Digital transformation is in full swing, driven by data and dramatically shaping how companies across industries work. Then again, you could have a mountain of clean, organised data, and as much as it could be a gold mine, it could be a bust if a company is unprepared for the work it takes to derive value from it.

Robotic process automation (RPA) is the use of technology to operate systems without the assistance of humans. Its foremost aim is to perform repetitive and tedious tasks that don't advance a company's goals but still must take place because they underpin operations. RPA doesn't just mimic humans; it allows work to be performed with far greater speed and accuracy.

RPAs look nothing like larger-than-life robots from movies; they're typically just computer applications. But because they can interact with computerised processes without constant supervision, they're proving powerful in business. Still, RPAs need to be carefully designed and fed the correct data to free their human co-workers of rote activities and enable them to focus on higher-level tasks that add greater value.

Different types

Like artificial intelligence (AI), there are two types of robotic process automation - specialised and general. Specialised RPA is designed to automate a particular task. This type of RPA, while highly customisable, works only on the process it was designed to take care of.

General RPA, on the other hand, can be used for a larger variety of processes and achieved via machine learning (ML). Further, it can be trained to understand and automate processes with unstructured, semi-structured, and structured data. Companies that use general RPA software are often large enterprises that have the data flow to support automation.

However, with increased data in businesses of all sizes, and the competitive advantages it can provide, the possibilities are attracting a greater number and variety of companies.

Cost, competitiveness, and quality

The benefits of RPA are far-reaching. First off, when done right, it'll automate tasks an employee would otherwise have to do, only faster, more accurately, and with no training or ramp-up needed. This can add up to a lot of time and cost savings. At the same time, though, when it comes to money, you have to consider the cost of not automating; competitors that do will clearly be in a stronger position.

RPA mitigates human error to raise both the quantity and quality of work, too. For example, an investment firm tracking different asset classes face a daily process that requires a lot of manual reconciliation. If a mistake is made, it might not be realised for weeks, and in the meantime, investment decisions would be based on flawed data.

Further, with settlements not causing issues - and processes moving in the right sequence, between the right people, at the right times - approvals come more quickly, and checks and balances are in place to keep work running smoothly.

It's pretty simple: costs are less, and efficiency is high when everything is done right the first time.

Empower, adapt, and allocate

RPA can allow businesses to redeploy their employees, removing them from repetitive tasks and engaging them in projects that support true growth, both for the company and individual.

Work where human strengths are needed, such as emotional intelligence, reasoning, and judgment, typically bring greater value to the company, and they're also often more personally rewarding. This can raise job satisfaction and help retain employees. Further, the ability to reallocate employees can enable a business to apply their useful company knowledge to other value-adding areas, supplement talent gaps, and more.

Of course, there's the attraction of being able to do one's job more efficiently, without manual processes that can make time drag. For instance, let's say you're at that same investment firm and there is a rapidly growing hedge fund, requiring human resources (HR) to onboard a lot of people fast. Between provisioning accounts, providing access to the right tools, sending out emails, and more, there's a lot of work involved. With an RPA bot, 20 new people could be processed at once, with the HR person monitoring progress through a window on the corner of their screen, which also notifies them if anything needs their attention.

We're talking about boiling a two-week process into days – that's the type of time savings that can make an employee and company happy. And in a realm like investing, the ability to adapt and reallocate resources quickly can make all the difference.

Getting off on the right foot

Organisations need to create a prioritisation framework and plan before plunging into RPA. Too often, executives say they need RPA now, so IT starts initiating various projects. Four months later, all they have is a thousand bots, costing many more thousands of dollars, and half of them don't work. This erodes executive confidence, budget, and IT bandwidth.

That said, decide what project you want to do first, how to implement it, and the ways you'll measure results. Support it with a robust roadmap that keeps things moving ahead incrementally. This will enable you to illustrate ROI and then build out your program further with the support and funding it deserves.

A cross-sector view of the EV revolution

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The invention of the internal combustion engine (ICE) in the late 19th century changed personal and commercial transportation forever. Since that time, ICE technology has evolved and proliferated to the point where ICE-powered vehicles are fundamental to how people and things move around the world. As of year-end 2020, there were nearly 1.2 billion ICE passenger vehicles and more than 13 million commercial vehicles on the road.

However, concerns regarding climate change have caused people, governments, and companies to consider how we can reduce greenhouse gas emissions – including moving away from ICEs. Governments around the world have been enforcing ever-stricter regulations mandating improved fuel efficiency and reduced emissions in an attempt to reduce greenhouse gas emissions. In order to reach the ultimate goal of many governments, a net-zero economy, the widespread adoption of electric vehicles (EVs) is a necessity.

Advances in battery technology and government incentives have encouraged the growth of electric vehicles from less than 1% of global passenger vehicle sales in 2015 to more than 6% in the 4th quarter of 2020. We believe this trend has reached a tipping point in 2021 where consumers, Original Equipment Manufacturer (OEM) and governments align to push the electrification forward with significant growth over the coming decades.

Thus far in 2021, we have seen OEM automakers announce greater and greater commitment to electrification – both with massive capital spending plans and with targets to end ICE production in the relative near term. To name a few notable commitments to EV and autonomous vehicle (AV) spend, Ford has committed to spending US$30 billion by 2030, GM has committed US$35 billion by 2025, and VW has committed €73 billion by 2025. These investments have been paired with commitments to fully replace ICE offerings with EV offerings as early as 2030 in some cases.

Given this level of OEM investment, the high levels of current and expected governmental support, improving the economics of EV ownership and increasing consumer interest we and industry sources expect to see a huge increase in EV sales as a percentage of total passenger vehicle sales in the coming years. Most industry prognosticators have centred around ~30% of global passenger vehicle sales by 2030. Bloomberg New Energy Finance (BNEF), a leader in the field, recently increased their projection to 33% of global sales by 2030 and 68% by 2040. In the event that governments move even more quickly to incentivise EV adoption BNEF thinks that adoption could be even higher.

Key Sector Takeaways

European and US autos - Mixed implications

- Global vehicle electrification shift remains a multi-year trend. EVs accounting for 30% of sales by 2030 has been the general goal post, but 2020/2021 has served as a critical xinflection point , and the goalposts may now be moving to an even more rapid pace for EV market growth. In the leading global markets of Europe and China, vehicle electrification has been driven by stricter emission standards and incentives/subsidies, while in the US, President Biden is following a similar path over the next few years.
- Declining battery prices, in particular, have been the major driver of increased adoption as battery pack price/KWh has declined from over US$1000/kwh in 2010 to US$157/ kWh in 2019, and to US$137/kWh in 2020. Many OEMs suggest that a price below US$100/ kWh is the level for cost parity with internal combustion engines, and we highlight that battery prices are expected by BNEF to just about reach that US$100/kWh by 2023.

Metals & mining - Positive implications

- Battery demand will be a material driver of metals consumption in the coming years and, without additional investment, supply for certain metals may be insufficient to meet demand. We expect that prices will remain high enough to incentivise investments to expand capacity. As a result, the sector will benefit from tighter supply/demand fundamentals (positive), but increased Capex to drive production growth will impact FCF (negative).
- Lithium, one of the key metals for battery production, is a relatively small market with ~180 kt of demand in 2020 but lithium demand is set to explode to ~1,670 kt by 2030, according to Bloomberg New Energy Finance. While projected lithium demand is expected to outstrip supply in the latter half of the decade, new capacity can be brought online to help balance supply & demand fundamentals given the abundance of reserves globally.
- Cobalt will also benefit from the EV growth story, but the industry is moving towards higher nickel cathode chemistries that require lower cobalt content. As such, nickel is likewise projected to run into supply issues absent additional investment. We expect this supply deficit will help bolster nickel pricing and incentivise investment in nickel laterite and sulfide projects.
- The EV growth story will also drive demand for both copper and aluminium. Copper will not only benefit from EVs but also from green infrastructure, power generation, and energy storage. Similarly, aluminium will also benefit from the secular light-weighting trend in the automotive sector.

Exploration & production - Negative implications

- Electric vehicles are expected to result in ~19 mmbd of avoided gasoline and diesel demand growth through 2040, according to BNEF forecasts. However, passenger vehicles, the core segment for EV growth, represents ~30% of crude demand and the impact of electric vehicles is expected to be offset by trends including population growth, petrochemicals demand, and aviation demand with Platts pegging 2030 global crude demand at 114 mmbd. Longer-term headwinds in the form of electric vehicles and higher mileage standards, however, serve as headwinds to growth beyond 2030.
- The world will still need oil for a long time and meeting future demand and offsetting natural declines from existing assets will require continued investment from the global upstream industry, with ~38 mmbd of new production needed over the coming 20 years to meet 2040E demand of ~100 mmbd.

Refiners - Negative implications

- Downstream/Refining is likely to be one of the most negatively impacted subsectors within our coverage over the longer term. BNEF has a widely-cited forecast that if 60% of total light-duty car sales in the US are EVs by 2040, this would equate to 33% of total passenger cars, thereby reducing gas demand by the same amount. This drop will hurt both utilisation and profitability unless refiners are able to curtail supply and/or find new avenues for growth. CreditSights has real concerns that there is nothing the refiners are doing or planning at the moment to address this longer-term risk, but we list potential ways to offset these headwinds.

Midstream energy - Mixed implications

- While rhetoric towards clean energy continues to accelerate, peak oil and gas demand is not a realistic near-term outcome. Crude demand is expected to grow 1% annually through 2030 to 114 MMbpd in spite of EV demand impacts, according to Platts.
- Increasing EV penetration will drive higher grid demand for power, and as a resulthigher natural gas demand (projected to increase by 15% over the next 20 years).

US utilities - Positive implications

- We see growth in electric vehicle usage as an obvious positive for utilities and, to a lesser extent, independent power producers (IPPs) with the caveat being the potential for significant rooftop solar growth still creates a small potential long-term risk to bondholders in each sector.
- The consensus in the market is 30% US EV penetration in 2030 is expected to lead to a 2-3% increase in power demand and while a 2-3% increase in demand doesn't move the needle very much in some sectors it equates to almost a decade of normal load growth for utilities (2010 to 2019 deliveries increased 1.5%). This additional load growth requires some new generation (wind, solar, gas and storage) but more importantly, new transmission lines to bring the power to market and significant new spending on the distribution front to support the increased residential demand.

Europeans utilities - Positive implications

- We do not believe growth in demand from EV charging is a big issue. Various scenarios suggest demand from EV charging in Europe will reach around 130TWh by 2030, which represents around 3% of total European electricity demand in 2020. There will need to be considerations around generation planning but utilities have big plans for growing renewable capacity and so should be able to easily accommodate the increase in demand from EVs. Higher volume sales will be a small incremental positive for the utilities.
- In our opinion upgrading and expanding the network will be the bottleneck in terms of EV growth and in facilitating the energy transition. Various estimates have suggested network investments of between €5 billion and €10 billion will be required per country by 2030 to enable the energy transition, but most regulatory regimes have yet to incorporate this.

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What works when inflation hits?

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Introduction

Inflation risk has increased. However, over the past three decades, a sustained surge in inflation has been absent in developed markets. As a result, investors' decisions to reposition their portfolios need to be based on the lessons learnt from earlier episodes.

Rather than predicting when (or if) inflation will increase to disruptive levels, we aim to answer a simpler question: what passive and dynamic investments have historically tended to do well (or poorly) in environments of high and rising inflation?

Why does inflation matter for asset prices?

Treasury bond prices are obviously impacted by unexpected inflation. Their current prices reflect an expected real interest rate, an expected rate of inflation and risk premium. If there is an unexpected surge in inflation, the expected inflation embedded in the yield increases and the bond price usually falls. If the new level of expected inflation is long lasting, bonds with higher durations will be more sensitive than those with shorter duration bonds. A change in the uncertainty about inflation rates may also impact the risk premium.

Equities are more complicated. First, higher and more volatile inflation creates more economic uncertainty, thus harming the ability of companies to plan, invest, grow and engage in longer-term contracts. Moreover, while firms with market power can increase their output prices to nullify the impact of an inflation surprise, many companies can pass on the increased cost of raw materials only partially. Margins therefore shrink.

Second, unexpected inflation may be associated with future economic weakness. While an overheating may cause companies' revenues to increase in the short term, if the inflation is followed by economic weakness, it will decrease expected future cash flows. Third, there is a tax implication for companies with high capital expenditures because depreciation is not indexed to inflation. Fourth, unexpected inflation could serve to increase risk premiums (increase discount rates) reducing equity prices. Finally, similar to bond markets, high-duration stocks (particularly growth stocks that promise dividends far in the future) are especially sensitive to increased discount rates.

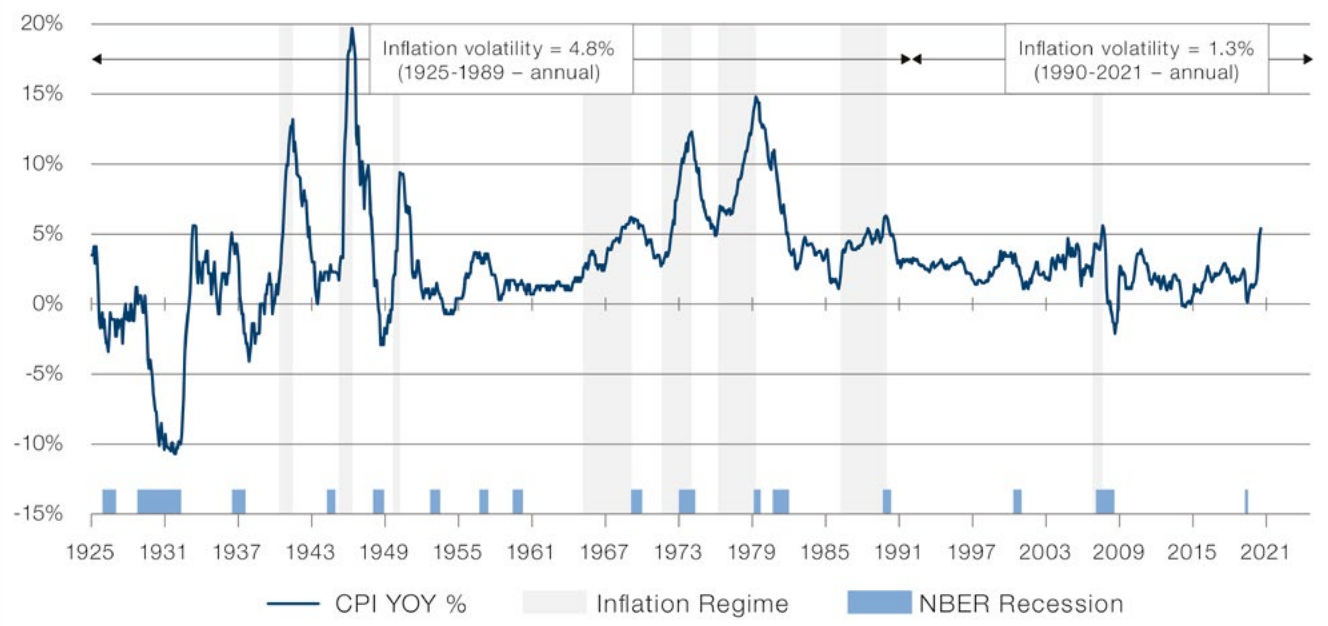
The inflation mechanism for commodities, like bonds, is relatively straightforward. Indeed, commodities are often a source of inflation.

Defining inflationary regimes

We are interested in episodes where the speed and the acceleration in price rises are both high; in other words, where the rate of year-over-year inflation is elevated and rising. Such environments are the most sensitive to the effects we have described above.

Thus, we define inflationary regimes as periods where the year-on-year realised inflation rate rises materially beyond 2%. Today, this level is often targeted by central banks across the world and, even when not explicit, is considered a psychologically important threshold. For instance, James Bullard, President of the Federal Reserve Bank of St. Louis, has described the 2% target as an “international standard”. We define ‘materially beyond 2%’ as reaching 5% or more. Our definition yields the eight US inflation regimes shaded pink in Exhibit 1. To assemble a critical mass of evidence, we use data from 1926 to 2021 across three continents.

Exhibit 1: US Year-Over-Year CPI and Inflation Regimes



Source: Man Group, National Bureau of Economic Research; as of 1926-July 2021. Note: The blue rectangles at the bottom of the chart are periods where the US economy was in recession as defined by the National Bureau of Economic Research.

Main results

In Exhibit 2, we show a summary of how a selection of assets perform through the eight US inflation regimes. For a more detailed look at other assets and geographies, readers are directed to peruse the full academic paper, *The Best Strategies for Inflationary Times*, which can be downloaded for free.

Exhibit 2: Summary Performance of Assets in US Inflation Regimes

	Specific inflation regimes								Combined regimes		
	US enters WW2	End of WW2	Korean War	Ending of Bretton Woods	OPEC oil embargo	Iranian Revolution	Reagan's boom	China demand boom	Inflation (19%)	Other (81%)	All (100%)
Strategy	Real return (total)								Real return (ann.)		
(P) Commodities – Energies	-3%	-2%	-6%	-16%	264%	57%	201%	68%	41%	-1%	3%
(A) Trend – All assets	20%	23%	19%	135%	196%	100%	65%	17%	25%	15%	16%
(A) Trend – Commodities			1%	54%	173%	33%	132%	25%	20%	8%	10%
(P) Commodities – Industrial				115%	38%	-6%	306%	3%	19%	4%	7%
(A) Trend – Bonds				79%	54%	149%	6%	6%	15%	9%	10%
(P) Commodities – Aggregate		12%	6%	26%	85%	38%	84%	21%	14%	1%	4%
(P) Commodities – Gold					166%	154%	-18%	27%	13%	-1%	1%
(P) Commodities – Precious				28%	29%	185%	-27%	33%	11%	-2%	1%
(A) Trend – Equity	20%	23%	24%	77%	23%	-13%	13%	-3%	8%	11%	10%
(P) Commodities – Softs				-41%	243%	15%	11%	15%	8%	-3%	-1%
(A) Equity Factor – Cross-sectional Mom.	-15%	-18%	7%	35%	38%	44%	41%	26%	8%	4%	5%
(P) Commodities – Agri		12%	6%	-23%	197%	-21%	6%	33%	7%	-3%	0%
(A) Trend – FX					-14%	16%	42%	6%	4%	4%	4%
(A) Equity Factor – Quality (QMJ)				14%	-1	-12%	40%	7%	3%	3%	3%
(P) Fixed income – TIPS				-3%	13%	-2%	11%	6%	2%	3%	3%
(A) Equity Factor – Investment (CMA)				-7%	31%	-9%	24%	-10%	2%	2%	2%
(P) Long Equities – Energy Sector	-14%	-10%	25%	-19%	-19%	31%	31%	2%	1%	8%	6%
(A) Equity Factor – Profitability (RMW)				4%	-24%	-8%	18%	6%	-1%	2%	2%
(A) Equity Factor – Value (HML)	-4%	-17%	3%	-8%	36%	-11%	-3%	-7%	-1%	2%	2%
(P) Real Estate – Residential	-17%	4%	-4%	-2%	-7%	11%	0%	-13%	-2%	2%	1%
(A) Equity Factor – Low vol (BAB)	-24%	-6%	-3%	28%	-13%	9%	-7%	-22%	-3%	8%	6%
(P) Fixed Income – 2Yr. Treasury	-13%	-17%	-6%	-1%	-7%	-17%	11%	0%	-3%	2%	1%
(A) Equity Factor – Size (SMB)	-11%	-23%	-4%	45%	-43%	32%	-26%	-4%	-4%	1%	0%
(P) Fixed Income – 10Yr. Treasury	-11%	-17%	-6%	-13%	-12%	-31%	8%	5%	-5%	-4%	-2%
(P) Fixed Income – High Yield	-4%	-11%	0%	-18%	-21%	-38%	-10%	-8%	-7%	6%	4%
(P) Long Equities – Market Composite	-24%	-27%	24%	-7%	-46%	-14%	12%	-17%	-7%	10%	7%
(P) Fixed Income – Investment Grade	-7%	-12%	-3%	-23%	-20%	-43%	-5%	1%	-7%	6%	3%
(P) Fixed Income – 30Yr. Treasury	-17%	-17%	-6%	-20%	-28%	-41%	13%	2%	-8%	5%	3%
(P) Long Equities – Consumer Durables	-16%	-32%	24%	-30%	-62%	-27%	-28%	-36%	-15%	13%	7%

Source: Man Group, National Bureau of Economic Research; as of 1926-2020.

Note: A summary table of real total returns to assets analysed across this paper, through the eight US inflationary regimes shown in Exhibit 1, as well as the annualised return during inflationary, other, and all periods. In the first column, the strategy is denoted as active or passive by '(A)' or '(P)', respectively. Returns for energies and gold in grey italics are spot returns where we do not have futures data. These are not included in the combined regime calculation.

In what follows we provide some brief comments on some of the key results.

Equities do poorly during inflation surges. The inflation-adjusted or real return on equities is -7% on an annualised basis.

Bond investors are also punished during inflationary surges with a -5% annualised real return for the US 10-year Treasury bond. The longer maturity bonds do even worse. Consequently, the 60-40 equity-bond portfolio disappoints during inflationary regimes, with a 6% real annualised return.

Commodities are an inflation winner amongst passive strategies over our 95-year sample. In aggregate, they produced a 14% real annualised return during our inflation regimes, compared with just 1% in normal times. However, our analysis shows there is considerable variation amongst the different commodity components.

US residential real estate has a small negative annualised real return of -2% during inflationary regimes, while it is +2% at other times. So, the asset does not seem to vary much inflation, as commodities do.

Collectables, and in particular art, wine, and stamps, have lived up to their reputation as a store of value in inflationary times. Real returns are positive for all three assets, with art at +7%, wine at +5% and stamps returning +9%.

With active equity strategies, smaller companies underperform in inflationary regimes. In real terms, the premium for being long-small companies and short-large companies is -4% a year in inflationary periods, compared with +1% in normal times. This fits with intuition. Economies of scale are important in mitigating the costs of inflation. The Profitability and Value factors roughly hold their own during inflationary periods. The value performance might be surprising to some, given that higher-duration growth stocks are often assumed to be adversely sensitive to unexpected inflation as discount rates increase. Still, a value long-short significantly outperforms a passive long-only equity strategy. Cross-sectional equity momentum performs well with real inflation regime performance of +8% on average. While the average return difference is high, we show in the paper that the difference is not statistically significant. In addition, this strategy has a very high turnover.

Active trend strategies across equities, bonds, FX and commodities performed impressively. A hypothetical 'all-asset trend' portfolio realised a real CAGR of 25% during the US inflationary regimes.

International inflation

We perform a similar analysis for the UK and Japan as we have done for the US and find that equities tend to perform worst during their own country's inflationary periods. US equities, for instance, achieve +6% and +9% real annualised return in UK and Japan inflation periods, compared to -7% in US regimes. The results also suggest benefits to international diversification. For example, taking the UK perspective, the US and Japanese equities generate +6% and +9% real annualised returns during UK inflation regimes, respectively. Bonds clearly perform the worst during their own country's inflation period.

Structural change and the rise of cryptocurrencies

As with any historical analysis, we are faced with the usual question: is this time different? For example, the inflation surge in the early 1970s was influenced by an exogenous event: the OPEC oil embargo. At the time, the US economy was highly dependent on that source of oil. Today is different in that the US is not as dependent upon foreign oil sources. Moreover, while electric vehicles do not have critical mass today, such technological change in the future may make it much less likely that a surge in oil prices would have the same inflationary effect. Hence, caution needs to be exercised in interpreting the data.

There are other factors that need to be carefully weighted given the structural evolution of the US economy. In the 1950s and 1960s, the US was a manufacturing economy. Today, only 11% of GDP is driven by manufacturing.[1] The nature of companies has changed. Much of the capital deployed is not physical but intangible, including trade secrets, proprietary software, patented and unpatented R&D, client relationships and legal rights. These may be more resilient to inflation.

Finally, we are in the midst of another technological disruption in the form of the cryptocurrencies, including bitcoin. Some have advocated the inclusion of bitcoin into a diversified portfolio as an inflation protection asset. However, caution is warranted given that bitcoin is untested with only eight years of quality data – that lack a single inflation regime. Moreover, bitcoin is more than five times as volatile as the S&P 500 or gold. This high volatility could lead to bitcoin being an unreliable hedge. In addition, there is increasing evidence that bitcoin is a speculative asset and it has a positive beta against the US market.

Conclusion

Our analysis spans nearly a century. The long sample is particularly important because inflation surges in developed economies have been rare in the past 30 years.

Some of our work reaffirms what we already know. For example, Treasury bonds do poorly when inflation surges. Commodities, often being a source of inflation, do well. However, we offer additional insights. Commodities, for example, are a diverse set of assets and the inflation hedging properties depend on the individual commodity. Most importantly, we show that historically, high and rising inflation has been very bad news for equity investors and risk parity portfolios.

Less is known about active strategies. We show that trend-following strategies have done particularly well in inflation episodes. We also find that a number of active equity factor strategies, such as a quality strategy, provides some degree of risk mitigation during inflation surges.

This has been a whistle-stop tour of our findings. To find out more, please click here and select 'Download this paper'.

1 Source: Man Group calculations

Through a new lens: Evolving asset management regulation

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KPMG

The past two years have fundamentally changed the way regulators approach key issues. The impact on alternative investment managers will be significant.

Recent market events in 2020 and ongoing concerns about stability in the capital markets are causing regulators to reassess risks and redefine resilience. Of paramount importance are the financing of a sustainable recovery and adjusting regulation for an increasingly digital world and hybrid working models.

However, regulation is also enabling new market opportunities. New fund vehicles are being introduced as jurisdictions compete for share of market growth, and newer capital markets are opening further to foreign investment and firms.

KPMG's annual Evolving Asset Management Regulation report – *Through a new lens* – suggests that regulators are not only widening their focus on the hedge fund sector, they are also starting to look at the risks and benefits through a new, pandemic-tinted lens.

Sustainability to the fore

The issue currently at the top of regulator agendas is sustainable finance. Regulators are focused on sustainability risks, especially that of climate change. Investors – particularly sovereign wealth funds and large institutional investors – are increasingly asking managers and investment funds about their environmental, social and governance (ESG) credentials. Both regulators and investors are keen to see more data and more consistent reporting on the topic.[1]

The pace of this evolution remains mixed around the world, with the EU currently focusing on imposing detailed rules on asset owners and asset managers about their processes and regarding disclosures to investors and beneficiaries. Others are also moving quickly; regulators in other jurisdictions are now proposing new requirements, and supervisory scrutiny is increasing.

Regulating in a digital world

The pandemic served as a technological catalyst. Hedge fund managers moved quickly to digitise processes and adopt large-scale remote working. Policymakers accelerated their plans towards digital

1 Evolving Asset Management Regulation, page 11. KPMG International 2021

finance and the widening use of technology. That left regulators thinking about the new and emerging risks, as well as the benefits, of operating in a digital environment. Perhaps not surprisingly, data and infrastructure are key focus points for regulators. In part, this is about protecting customer information and reducing bias in new technology-enabled models. But it is just as much about protecting market confidential information in an era where data often transfers between entities and across borders. Organizations like the International Organizations of Securities Commissions (IOSCO) are already hard at work assessing the risks of AI and machine learning on the securities and futures markets. Others are watching carefully.

Crypto-assets, an area of increasing activity for hedge fund managers, have also been a focus of regulators around the globe, with initiatives focused on the assets themselves, the trading of them, or both. The debate as to the role fund administrators should play regarding crypto-assets and digital currencies continue.

Reassessing the risk

While the hedge fund sector has remained broadly resilient, despite the extreme market conditions in living memory, regulators are keen to understand how the sector responded to the economic crisis that accompanied the pandemic.[2]

For the most part, their focus is on areas of less interest to hedge fund managers – open-ended funds, with bond funds, exchange-traded funds and real estate funds experiencing the greatest scrutiny. However, highly-leveraged funds are not out of sight for policymakers.

Sir Jon Cunliffe from the Bank of England recently spotlighted funds that undertake arbitrage trades on the price differences between the value of derivatives and the value of the cash instrument upon which the derivative is based. In 'normal' market conditions, these trades are generally viewed as important to stabilizing market prices. However, various pressures meant that some of these funds had to undertake massive sales of government bonds (almost US$90 billion during March 2020), causing further falls in bond prices.[3]

Exploring the risk landscape

Another imminent risk to capital markets stability is the likely demise of the widely-used London inter-bank offer rate (LIBOR) at the end of 2021 and the challenge of transitioning to risk-free rates . The Financial Stability Board is developing a roadmap that includes a smooth transition away from LIBOR to more robust benchmarks. The pressure is now on firms to implement transition plans.

The cost of and access to market data, and the need for consolidated market data is also in the spotlight. Several jurisdictions, including Australia, the EU and the US, are contemplating whether regulatory changes are necessary. Also, by end-2021, IOSCO will report on the findings of its thematic review of conduct-related issues in relation to index providers.

Other, newer risks are also rising up the regulator agenda for the hedge fund sector. Additional demands on systems and processes arising from prolonged and large-scale remote working, and an increasingly digital world, has increased the focus on firms' technological resilience. The prevention of money laundering also remains high on the agenda, with new provisions and compliance requirements being promulgated in markets from Canada through to Saudi Arabia.

Reinforcing good governance

While governance has always been a headline topic for regulators and supervisors, the experience of the pandemic and ensuing economic volatility has catalysed supervisors to reinforce the need for good governance of firms, including board composition and engagement, clear management responsibilities and individual accountability.

Regulators suspect that traditional risk management, oversight and controls are being challenged by large-scale remote working. The trends towards sustainable investment strategies, alternative asset classes and digitalisation bring with them added complexity to business models and challenges to current operational processes.

2 Evolving Asset Management Regulation, page 22. KPMG International 2021

3 [Jon Cunliffe: The impact of leveraged investors on market liquidity and financial stability (bis.org)]

Product governance is also under the spotlight, together with firms' behaviour in the capital markets and stewardship of client assets.

Widening the investor pool

While much of the regulatory attention on investor protection is focused on the retail markets, hedge fund managers will note that some regulations are being eased for professional investors and regulated market counterparties. In the US, for example, the Securities and Exchanges Commission (SEC) adopted amendments in August 2020 to the definitions of accredited investors and qualified institutional buyers.

The amendments did not change the minimum income or wealth thresholds for individuals. But they did update and improve the definition of 'accredited investor' to more effectively identify investors that have sufficient knowledge and expertise to participate in investment opportunities, without all of the rigorous disclosure and procedural requirements (and related investor protections) provided by registration under the 1933 Securities Act.

For some hedge fund managers and alternative investment funds, this should lead to an opportunity to reach slightly different investor profiles than they would have been able to in the past, thereby potentially widening the investor pool.

Redrawing borders and products

Many jurisdictions continue to open their markets to overseas firms and investment, and more international financial recentres are being established. New or amended fund structures are being introduced to enable jurisdictions to compete with well-established fund domiciles.

KPMG's recent Evolving Asset Management Regulation report devotes most of a chapter to identifying some of the key markets that are currently undertaking initiatives to make their markets more attractive places for fund managers to set up, manage and administer their funds. From the UK, Germany and Ireland through to Brazil, South Africa and China, the report notes increasing opportunities for hedge fund managers to expand and grow.

Through a new lens

Regulators and supervisors are looking at the hedge fund industry through a new lens. Fund managers must do the same. Indeed, KPMG's Evolving Asset Management Regulation report comes to one defining conclusion: firms now need to reconsider all aspects of their business models to ensure they are fit for purpose in the evolving new reality.

To learn more about the evolving asset management regulatory environment, download KPMG's most recent report.

Have you asked yourself...

1. Do we have a clear, robust and nimble environmental, social and governance strategy, supported by our governance arrangements, risk management, investment process, data capabilities and disclosures?
2. Are we identifying, measuring and managing risks arising from new technologies and increased digitalisation? Are we using technology effectively, to enhance client services and run our business more efficiently?
3. Have we critically analysed experience during the 2020 market stress and reassessed liquidity risk management for each open-ended fund? Do our policies, controls and documentation meet supervisory expectations?
4. Do we have effective board engagement and supporting governance arrangements? Are our risk management framework and controls fit-for-purpose given continued remote working? Are our product governance arrangements subject to robust and objective challenges, and delivering good customer outcomes?


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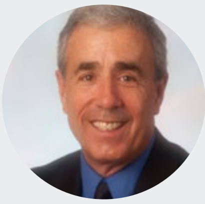
Impact of the SEC's new marketing rule on private fund advisors



Les Abromovitz
Senior Director
Foreside

The US SEC's Marketing Rule, adopted on 22 December 2020, expressly applies to certain communications with private fund investors and not just advisory clients of a registered investment advisor (RIA). As many of these communications now fall within the definition of 'advertisement', the rule will significantly impact the marketing efforts of private fund advisors. An SEC risk alert reported that over 36% of investment advisors registered with the Commission manage private funds.[1]

The Marketing Rule replaces the Advertising and Cash Solicitation Rules, found in Sections 206(4)-1 and 206(4)-3 of the Investment Advisers Act of 1940 (Advisers Act). Once private fund advisors implement the Marketing Rule, they are permitted to compensate promoters, publish testimonials and use social media with clear compliance standards to follow. Nevertheless, there are pitfalls that may trip up these advisors.

Definition of 'advertisement'

The Marketing Rule amends the definition of 'advertisement', which includes two prongs: (1) traditional advertising communications; and (2) compensated testimonials and endorsements, as well as solicitation activities previously regulated by the Cash Solicitation Rule. Generally, the second prong applies to any endorsement or testimonial for which an advisor provides cash or non-cash compensation, directly or indirectly.

The amended definition of 'advertisement' includes any direct or indirect communication that an investment advisor makes to more than one person for the purpose of:

- Offering the RIA's investment advisory services regarding securities to prospects or private fund investors; or
- Offering new investment advisory services regarding securities to current clients or private fund investors.

To be an advertisement, the direct or indirect communication must be made by an investment advisor to more than one person. If a communication to one person or more includes hypothetical performance, it generally falls within the definition. Nonetheless, there is an exclusion from the definition for communications that include hypothetical performance provided (1) in response to an unsolicited request from a prospective or current client or investor in a private fund or (2) to a prospective or current investor in a private fund in a one-on-one communication.

1 https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf

The first prong of the definition of 'advertisement' excludes most one-on-one communications, including presentations to existing clients regarding funds in which they have already invested. Nevertheless, even if a one-on-one communication to existing investors is not an advertisement, it may still violate the antifraud provisions found in the Advisers Act.

The second prong of the definition, which applies to testimonials and endorsements and solicitation activities, does not exclude extemporaneous, live, oral, or one-on-one communications.

Private Placement Memorandums (PPMs)

Both prongs of the definition of 'advertisement' include promotional materials sent to prospective investors in private funds managed by an advisor. Although PPMs, account statements, transaction reports and annual reports are not viewed as promotional materials, pitch books are subject to the Marketing Rule. For example, if a PPM contains related performance information of separate accounts managed by the advisor, that performance data is likely to be treated as an advertisement subject to the general and the performance-related prohibitions of the Marketing Rule.

Prohibitions in the Marketing Rule

The Marketing Rule contains the following principles-based general prohibitions on advertisements:

1. Making an untrue statement of a material fact, or omitting a material fact that is necessary to make the statement made, not misleading under the circumstances;
2. Making a material statement of fact that the advisor does not have a reasonable basis for believing it will be able to substantiate if requested to do so by the SEC;
3. Including information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the advisor;
4. Discussing any potential benefits without providing fair and balanced treatment of any associated material risks or limitations;
5. Referencing specific investment advice provided by the advisor that is not presented in a fair and balanced manner;
6. Including or excluding performance results, or presenting performance periods, in a manner that is not fair and balanced; and
7. Including information that is otherwise materially misleading.

Performance advertising raises special concerns that warrant additional requirements and restrictions. Inaccurate presentations of performance can cause reasonable investors to reach unwarranted assumptions. If so, the advertisement is misleading.

The Marketing Rule prevents RIAs from circulating the following performance-related advertisements:

- Gross performance, unless the advertisement also presents net performance;
- Any performance results, unless they are provided for specific periods in most circumstances, usually a one, five, and ten-year time frame;
- Any statement that the SEC has approved or reviewed any calculation or presentation of performance results;
- Performance results from fewer than all portfolios with substantially similar investment policies, objectives, and strategies as those being offered in the advertisement;
- Performance results of a subset of investments extracted from a portfolio, unless the advertisement provides, or offers to provide promptly, the performance results of the total portfolio; and
- Predecessor performance unless there is an appropriate similarity between the personnel and accounts at the predecessor RIA and the personnel and accounts at the current firm.

Advertisements of private fund returns must comply with the gross and net-of-fees requirements. Unlike other performance advertisement requirements, private fund advisors are not required to present one, five and ten-year returns. The SEC did not impose this requirement because presenting very recent performance would be misleading in some instances.

Nevertheless, private fund advisors may not cherry-pick favourably performing periods, since the advertisement would not be fair and balanced.

Prohibitions on advertising hypothetical performance

Hypothetical performance may not be advertised unless:

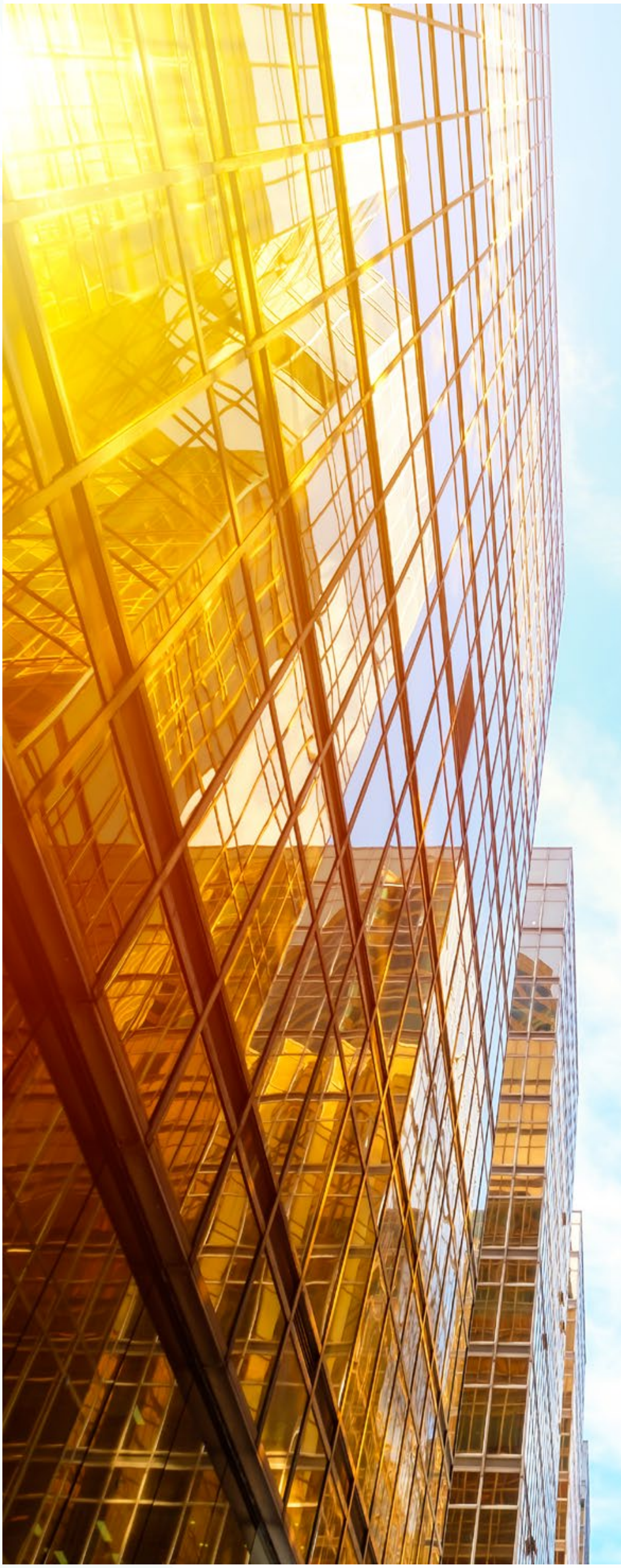
- The advisor adopts and implements policies and procedures that are reasonably designed to ensure that the performance is relevant to the likely financial situation and investment objectives of the intended audience; and
- The advisor provides certain information underlying the hypothetical performance. When the intended audience is an investor in a private fund, the advisor's obligation is to offer to provide this information promptly.

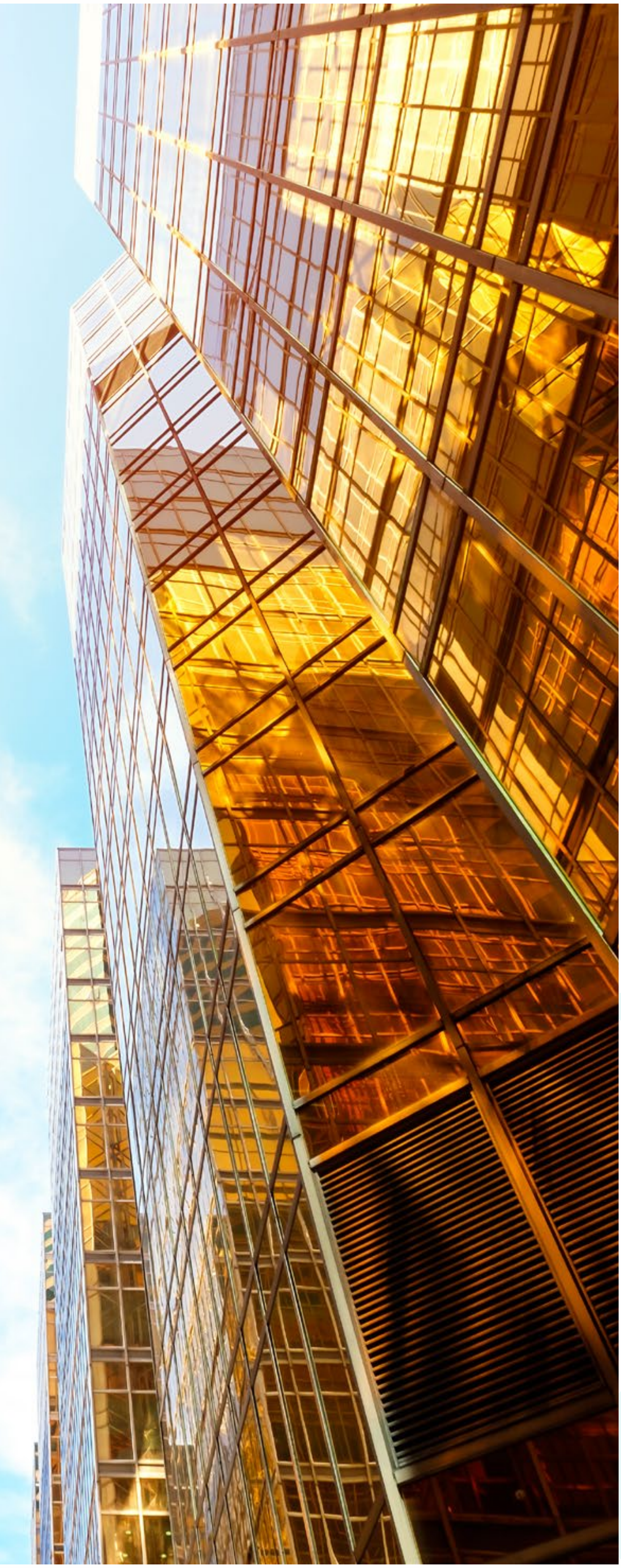
Hypothetical performance encompasses performance results that were not achieved by any portfolio (or fund) managed by the advisor. This includes model performance, targeted or projected performance, and back-tested performance.

Policies and procedures relating to the use of hypothetical performance should address how the advisor will limit dissemination of the advertisement to the intended audience, and how the advisor will determine whether the hypothetical performance is relevant to the likely financial situation and investment objectives of that audience. To make that determination, private fund advisors should consider experience raising money from investors. For example, their experience might indicate that prior investors valued a certain kind of hypothetical performance to assess the advisor's strategy and investment process. New advisors can rely on other resources such as questionnaires, surveys, conversations, and academic research.

Solicitation activities

The Marketing Rule introduces the term, 'promoters', which replaces 'solicitors'. Because the Marketing Rule now applies to the solicitation of private fund investors, placement agents, consultants, capital introduction groups, and other parties involved in marketing a private fund will likely be viewed as promoters.





'Promoter' also refers to a person providing a testimonial or endorsement, whether compensated or uncompensated. An RIA that uses testimonials or endorsements must oversee compliance with the Marketing Rule. The RIA must also enter into a written agreement with promoters unless the promoter is an affiliate or receives de minimis compensation, which is defined as US$1,000 or less, or the equivalent value in non-cash compensation during the preceding twelve months.

The Marketing Rule generally prohibits bad actors from acting as promoters. Broker-dealers registered with the Commission must not be subject to statutory disqualification under the Exchange Act. Compensated promoters covered by Rule 506(d) of Regulation D with respect to a Rule 506 securities offering are exempt from the disqualification provisions of Rule 206(4)-1 provided their involvement would not disqualify the offering under Rule 506.

There are no disqualification provisions for providers of uncompensated testimonials and endorsements. Advertisements must clearly and prominently disclose whether the person giving the testimonial or endorsement is a client and whether the individual is compensated.

Disclosures must be at least as prominent as the testimonial or endorsement itself and must be included within the advertisement containing the testimonial or endorsement. Promoters of oral testimonials or endorsements must provide the disclosure at the time the statements are made. Required disclosures may be delivered to clients and/or investors by either the advisor or the person providing the endorsement or testimonial. If the advisor does not provide the disclosures, it must hold a reasonable belief that the promoter is satisfying this requirement.

Takeaways

The Marketing Rule does not require review or preapproval of advertisements by a designated employee. Nevertheless, internal pre-review and approval can serve as an effective component of an advisor's compliance programme. Another option is to spot-check advertisements, including social media, and conduct periodic reviews. Private fund advisors may wish to mandate preapproval until personnel are fully trained and all policies and procedures have been implemented. The compliance date for the rule is 4 November 2022.

Investors are paying more attention to Sensitive Industries requirements and discovering a complex web of rules

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Shareholding rules, such as long and short shareholding disclosures and position limits, are well known to professional investors such as investment fund managers and institutional investors. Sensitive Industries, another category of shareholding rules, has traditionally received less attention. That is now changing.

'Sensitive Industries' is a common term used to describe shareholding rules for industries considered critically important or 'sensitive'. A rule might be from a large regulator or a small government agency, it might cover listed or unlisted issuers, and it might apply to all shareholders or just foreign ones. It might require that a shareholder seek pre-trading approval before crossing an ownership threshold, or it might have a simple hard stop, outright prohibiting a shareholder from owning a certain percentage of a company or industry. The commonality is that the rules are based on geopolitical sentiment and are focused on protecting critical industries from unwanted controlling interests, but without stifling investments.

Accordingly, ownership limits have traditionally been set high enough that non-activist investors can trade without concern about crossing thresholds. Two recent trends, however, are causing more investments to be in scope, and more investors to take note. First, governing bodies are expanding the scope of industries considered 'sensitive'. Second, thresholds are tightening, especially with foreign investors.

Shareholders paying closer attention to sensitive industries are discovering overwhelmingly complex rules that are difficult to monitor and that come with little guidance on how to comply. Here are five reasons these shareholders are turning to experts for help.

1. A complex web of rules

The number one challenge with sensitive industries is the breadth and complexity of coverage. There are more rules to manage than investors are used to with standard shareholding disclosure requirements—as of mid-2021, SEI's Global Regulatory & Compliance team covers more than 800 Sensitive Industries rules across nearly 100 jurisdictions, versus approximately 600 shareholding disclosure rules. There are (1) rules related to specific industries, (2) rules related to specific issuers, and (3) rules based on the investor. For each of these three categories, there are additional complexities—a seemingly endless matrix of sub-categories, with different rules for each. A single investment can be subject to more than one rule. See the table below for a simple example of the complexity involved.

1. ***Rules by industry*** - Classic sensitive industries include defense, banking, energy, transportation, aerospace, telecommunications, and media. What is deemed 'sensitive', however, varies by jurisdiction. For example, some jurisdictions have rules for fishing industries. In some jurisdictions, industries are broken down into sub-categories. For example, 'utilities'

might include different rules for nuclear generation versus electricity transmission, gas, or water. Even more challenging, some rules focus on an activity, regardless of industry. For example, a rule might apply to any company that handles sensitive personal data. In these situations, investors must have a clear understanding of a company's activities to determine applicable restrictions.

It is up to the investor to determine whether a company—listed or unlisted, public or private—operates in a protected industry. Some industries, such as banking, will have a well-defined list of issuers that are in scope. But others may have no such list and also offer no guidance. In these cases, many investors turn to industry codes, such as the Global Industry Classification Standard (GICS).

But mapping issuers to industries in this way has limitations, as companies can fall within more than one industry. For example, the GICS code will code an automobile manufacturer as 'automobile', but the company might also have a financial services subsidiary that is not captured by the GICS code.[1] It is the obligation of the investor to research how individual rules apply to complex corporate structures.

2. ***Rules by issuer*** - Some rules set ownership limits on specifically named companies. For example, some apply a 'hard stop' on investing in specific banks or defense companies. It's important for the investor to remain vigilant as the lists may change as geopolitical conditions change.

3. ***Rules by investor*** **-** There are two ways that rules are linked to investor type. First, some rules are for all investors, while others are for just foreign investors. 'Foreign' can be defined in different ways. For example, in European jurisdictions, it can mean non-EU, non-EEA, or non-national. Second, a restriction might apply per individual investor, or to investors in the aggregate (e.g., a rule that foreign ownership in the aggregate cannot exceed 40% of voting shares). If it is per individual, the investor needs to understand what is included (e.g. does it include entities in the investor's control?). If it is in the aggregate, the investor needs to know the current status of foreign investment before trading.

1 The GICS methodology, developed by S&P Dow Jones Indices and MSCI, "assigns each company to a sub-industry, and to a corresponding industry, industry group and sector, according to the definition of its principal business activity. Since the classification is strictly hierarchical, at each of the four levels a company can only belong to one grouping." See Guiding Principles and Methodology for GICS, available on both S&P Global and MSCI websites.

To illustrate the complexities noted above, this table sets out South Korea Sensitive Industries rules for the utilities sector.[2]

SUB-INDUSTRY and SCOPE	RULE
GENERAL (*Overriding rule under the Foreign Investment Promotion Law (FIPL)*)	Pre-acquisition reporting obligation for 10% individual foreign ownership.
NUCLEAR *(any Korean nuclear generation issuer licensed in South Korea, whether listed or unlisted, public or private)*	Foreign direct investment rules apply.
ELECTRICITY *(any Korean electricity transmission issuer licensed in South Korea, whether listed or unlisted, public or private)*	1. 50% aggregate foreign ownership restriction 2. A foreign investor cannot own more voting shares than the largest domestic shareholder 3. Additional issuer-based rule for Korea Electric Power Corporation: • Individual shareholder (domestic or foreign) is limited to 3% of total shares issued • Aggregate foreign ownership is limited to 40% of total shares issued
GAS *(no specific restrictions, except for an issuer-based rule for Korea Gas Corporation)*	Issuer-based rule for Korea Gas Corporation: • Individual shareholder (domestic or foreign) is limited to 15% of voting shares • Individual foreign ownership is further limited to 5% per share class • Aggregate foreign ownership is limited to 30% of issued shares
WATER *(no specific restrictions, except for an issuer-based rule for Korea Water Resources Corporation)*	Issuer-based rule for Korea Water Resources Corporation: • Hard stop (domestic or foreign). No private investment permitted

2 The data set out for South Korea has been extracted from the aosphere Rulefinder Shareholding Disclosure product as at 28th July 2021. The information supplied does not constitute legal advice and aosphere LLP have not reviewed or verified any of the content of this article.

2. The rules are hard to find

With shareholding disclosure, there are one or two known authorities at whom to look. But with Sensitive Industries, oversight is not centralized. Investors may find rules by canvasing individual governing bodies, such as a ministry of agriculture or a ministry of defense. This is a challenging '*you don't know what you don't know*' exercise, as one might research classic protected industries and miss a nuanced rule that is buried in a resolution about something else.

3. The rules change

Sensitive Industries rules are based on geopolitical sentiment, and governments can quickly change course. As the COVID-19 pandemic intensified in 2020-2021, some jurisdictions lowered thresholds with little warning, some set limits on foreign investments in health care and technology, and some implemented temporary thresholds, set to expire at a later date.

4. What is the requirement and who must report?

Investors need to determine what is required for each threshold. For example, do they need pre-trade approval before crossing a threshold, or is disclosure to the regulator enough? Is the disclosure before or after the threshold is crossed? Who must report—the fund manager? In some cases, the investor discloses its holding to the issuer, and it is the issuer that reports to the regulator.

5. Lack of instructions to calculate the thresholds

A rule might limit ownership to X% but not state X% of what. It can take substantial work for the investor to determine the appropriate calculation. For example, for the numerator (the investment), should all shares be included, including derivatives and indexes? For the denominator, is the threshold a percentage of voting shares outstanding, total shares outstanding, or some other figure? Should the information be calculated at month end, or must the investor check shares outstanding in the interim during the month? Too often, the rule does not provide this information. Some investors run different calculations and set a trading alert for the most conservative result.

Conclusion

Given recent trends in Sensitive Industries, investors can no longer assume that the rules will not apply to them. The rules are complex, complying can be a drain on resources, and the sanctions range from fines to criminal penalties. As such, investors are increasingly turning to service providers to map holdings to applicable requirements, monitor for rule changes, and to provide accurate and timely reporting to all relevant parties.

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New pre-marketing rules for alternative investment funds in Germany

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On 2 August 2021, a new pre-marketing regime for alternative investment funds (**AIFs**) promoted and distributed in Germany came into force with the Fund Domicile Act[1] making changes to the German Capital Investment Code.[2] The new rules implement EU Directive (EU) 2019/1160[3] on the Cross-Border Distribution of Collective Investment Undertakings into German law, and they are relevant for EU and non-EU asset managers that promote and distribute AIFs in Germany. In this article, we outline these new marketing regulations and describe some practical scenarios and questions.

Pre-marketing of AIFs – what changed?

Under the old regime, the German regulator BaFin provided some guidance as to what constitutes 'pre-marketing' of AIFs as opposed to 'marketing'. To be deemed marketing, offering or placement activities must have related to: (i) an existing investment fund; or (ii) an investment fund that is at least ready to be offered (e.g., template investment terms that still contain gaps, or other aspects that need to be negotiated are not generally considered to 'be marketing'). Also, according to BaFin's guidance, as a general rule, where an investment fund operates under a specific name, this indicates that the fund is already set up or is ready to be offered (although this presumption can be rebutted). Further, where institutional investors are actively involved in the structuring of the fund in certain situations, marketing does not take place.

As a consequence, some flexibility was provided, since any activities that did not fall under the definition "marketing" by missing the qualification aspects to be deemed 'marketing' according to BaFin's guidance, were not subject to a notification or registration requirement with the BaFin.

The Fund Domicile Act implemented a new regime by adopting the EU definition and rules of pre-marketing into German law. Pre-marketing is defined as:

- A direct or indirect provision of information or communication on investment strategies or concepts
- By or on behalf of an alternative investment fund manager (**AIFM**)

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1 Full title of the German act: *Gesetz zur Stärkung des Fondsstandorts Deutschland und zur Umsetzung der Richtlinie (EU) 2019/1160 zur Änderung der Richtlinien 2009/65/EG und 2011/61/EU im Hinblick auf den grenzüberschreitenden Vertrieb von Organismen für gemeinsame Anlagen (Fondsstandortgesetz – FoStoG).*

2 (Kapitalanlagegesetzbuch - KAGB)

3 Directive (EU) 2019/1160 of the European Parliament and of the Council of 20 June 2019 amending Directives 2009/65/EC and 2011/61/EU with regard to cross-border distribution of collective investment undertakings.

- To potential professional or semi-professional investors domiciled or with their registered office in Germany, or professional investors domiciled or with their registered office in an EU/EEA member state
- With the intention to determine their interest in an AIF or a compartment thereof that is not yet established, or established but not registered for marketing purposes
- Without, in each case, constituting an offer or placement of the units or shares of the AIF or compartment

The introduction of the new pre-marketing rules added a layer of regulation to the German regime. While any pre-marketing under the old regime was "unregulated", if conducted following the BaFin guidance the new regime requires the observation of defined rules.

The new pre-marketing and marketing distinction

The new pre-marketing provisions differentiate between pre-marketing and marketing activities using the following three criteria. Activities are deemed to be pre-marketing (rather than marketing) if the information provided to prospective professional and semi-professional investors:

- Is not sufficient to enable investors to commit to subscribe units or shares of a particular AIF
- Does not include subscription forms or comparable documents, whether they are in draft or in final form
- Does not include constitutional documents, prospectuses or offering documents of an AIF not yet authorized in final form

Also, to be considered pre-marketing, in cases where the AIFM provides any draft prospectuses or offering documents, these documents must not contain information that can be deemed sufficient for investors to make an investment decision and must clearly state that:

- It does not constitute an offer or an invitation to subscribe for units or shares of an AIF;
- The information presented therein should not be relied upon as it is incomplete and subject to change.
- If these requirements cannot be met, the activities are deemed marketing and the AIF must be registered for marketing in Germany.
- The new rules do not provide any further guidance as to what "sufficient for investors to make an investment decision" actually means, and how this requirement applies to such things as term sheets, slide decks, etc.

Obligations for EU AIFMs under the pre-marketing regime

Any EU AIFM must ensure that the pre-marketing of AIFs in Germany is appropriately documented, and within two weeks after the commencement of the pre-marketing activities, EU AIFMs must notify BaFin through the AIFM's home state regulator. The same applies to German AIFMs, who must notify BaFin of any pre-marketing activities of AIFs and request that the notification be forwarded to the regulators of the EU countries in which the German AIFM performs pre-marketing activities.

Pre-marketing activities can only be rendered by the AIFM and certain third parties on behalf of the AIFM such as other AIFMs, UCITS ManCos, MiFID firms, banks as well as tied agents.

Non-EU AIFMs

Is pre-marketing registration also possible for non-EU AIFMs?

Non-EU AIFMs can perform their pre-marketing activities in Germany, but since 2 August 2021, must also register them with BaFin. The German legislator has implemented a mandatory notification procedure for non-EU AIFMs with respect to pre-marketing. There is no clear legal basis in the Directive (EU) 2019/1160 other than in recital 12, which states that *"National laws, regulations and administrative provisions necessary to comply with Directive 2011/61/EU and, in particular, with harmonised rules on pre-marketing, should not in any way disadvantage EU AIFMs vis-à-vis non-EU AIFMs."*

The requirement for non-EU AIFMs to register for pre-marketing in Germany could be seen as a form of "gold-plating" – on the other hand, it makes it possible for non-EU AIFMs to render any pre-marketing activities in Germany at all. Otherwise they would be limited to mandatorily register their AIFs for marketing before rendering any activities or would need to strictly rely on reverse solicitation.

As a consequence, non-EU AIFMs must also notify the BaFin of the commencement of pre-marketing of AIFs in Germany within two weeks and provide the following information:

- The periods during which the pre-marketing is taking or has taken place
- A brief description of the pre-marketing, including information on the investment strategies presented
- Where relevant, a list of the AIFs and compartments of AIFs that are or were the subject of pre- marketing

Effects on Reverse Solicitation

The explanatory memorandum of the Fund Domicile Act explicitly states that the concept of reverse solicitation remains available and is not replaced or removed by the pre-marketing rules in general. Therefore, where an investment in an AIF is solely based on the investor's initiative, neither the marketing nor pre-marketing rules apply. Further, where an AIFM meets with potential investors and merely promotes its general expertise and capabilities as an AIFM, this does not preclude any reverse solicitation being available regarding a specific fund.

However, any investment made in an AIF within 18 months after the commencement of its pre- marketing is deemed to be the result of a marketing activity, which means that the AIF must be registered for marketing with the BaFin before accepting any investors. The wording in the Fund Domicile Act is not completely clear on this point, however, and creates some uncertainties. It states that:

- The AIFM management company must ensure that investors do not acquire units or shares of an AIF through pre-marketing
- That investors, contacted in the course of pre-marketing, must acquire units or shares of this AIF exclusively within the scope of marketing permitted under the German Capital Investment Code. This means after the AIF has been registered for marketing with BaFin
- An investment by professional or semi-professional investors in the first 18 months after the AIFM has commenced pre-marketing of units or shares of an AIF mentioned in the information provided in the pre-marketing, or of an AIF registered for the purposes of pre-marketing, shall be deemed to be the result of a marketing activity, and the AIF must be registered for marketing with BaFin before accepting the investor
- The AIFM must appropriately document any pre-marketing

In this context, the question arises whether the 18-month restriction is limited to the group of investors that the AIFM or its agent has contacted during the pre-marketing activities, or to all future investors, including those that made the investment on their own initiative.

As discussed above, the explanatory memorandum of the Fund Domicile Act clearly states that the concept of reverse solicitation remains available and is not replaced or removed by the pre-marketing rules. In any event, it seems advisable to carefully and adequately document any pre-marketing activity.

Conclusion

The updated pre-marketing rules for EU-AIFMs provide a harmonised approach throughout Europe instead of the diverging treatment of pre-marketing in different national legal systems. Germany, however, already had a well-functioning method of distinguishing marketing from pre-marketing – or better, from non-marketing. Both EU and non-EU fund managers will therefore need to adapt to the new rules. It remains to be seen how the new regime will work in practice, and whether the BaFin will provide more guidance.

Cross-border made coherent

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EEA firms in the TPR: Navigating FCA authorisation and what it means to be FCA-regulated

Martin Lovick
Director
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Email Martin Lovick

In the run-up to the UK leaving the European Union, the UK's FCA introduced the Temporary Permissions Regime (TPR) for European Economic Area (EEA) firms that had previously been allowed to offer their investment services in the UK under the passporting regime, without the need for FCA authorisation. Firms who signed up to the TPR may continue to offer these services for a temporary period, pending the FCA inviting them to apply for full authorisation (known as a "landing slot").

Getting a landing slot

Firms in the TPR are now starting to be contacted by the FCA on the timing of their landing slot, typically (but not always) with a few months warning to prepare their applications. These correspond to a quarter of the year starting in Q3 (July – September 2021), with the last slot expected to be October – December 2022.

The FCA has confirmed that landing slots can, in theory at least, be altered by written request and explanation. However, it is apparent that this will be offered only in exceptional circumstances. Firms are warned that not submitting their applications by the closing date will likely lose their temporary permissions. Their only recourse at that point would be to submit a fresh FCA application and they would not be permitted to carry out new regulated activity in the meantime.

It is worth pointing out to firms who missed joining TPR still have the option of applying for FCA authorisation afresh – however, they will be unable to carry out regulated activity in the UK until authorised.

The FCA authorisation process

One point to underline is that FCA authorisation for firms in the TPR has not been expedited in any way. EEA firms who may have been doing business in the UK through the passporting route for many years may find it odd that they are now effectively back to square one.

It also cannot be emphasised enough that FCA authorisation, also referred to as Part 4a Permission, is not a straightforward process. There may be strategic and commercial considerations about the legal form and governance structure of the UK entity to consider, as well as a number of bespoke documents such as a business plan and detailed financial forecasts to start drafting. Planning and preparation of these requirements will facilitate the process considerably.

The FCA assesses applicant firms, and their intended business activities, against the five Threshold Conditions set out in the FCA Handbook. All five must be satisfied both at authorisation and throughout the regulated life of the firm:

1. **Location of offices:** the body corporate (or other appropriate legal form) must have a principal office located inside the UK.
2. **Effective supervision:** the firm's ownership and control structure (including its close links to other entities) must ensure that it can be effectively supervised by the FCA.
3. **Appropriate resources:** the firm's financial and operational resources must be sufficient in terms of quality, quantity and availability.
4. **Suitability:** the key individuals running the UK business must be fit, proper and competent to carry out the roles required of them.
5. **Business model:** the firm's business must be conducted in a sound and prudent manner and pose no threat of harm to consumers or the integrity of the UK financial system.

Applicant firms should expect several rounds of questions scrutinising certain aspects of their application – this is completely normal. It is relatively rare for smaller firms to be interviewed, but in instances where this happens the FCA will generally give some prior warning.

The FCA's processing fee for an investment manager, deemed moderately complex, is currently £5,000. The fee must be paid during the process of submitting the application via the FCA's Connect system. There will also be the cost of the consultant or law firm engaged - this will vary across providers.

The FCA is required by its statutory objectives to make a determination within six months of receipt of what it refers to as a 'complete' application. In the case of an incomplete application (i.e., where one or more elements have to be resubmitted or were omitted from the original submission), the FCA can take a maximum of 12 months. Our recent experience is that the FCA is using these limits to the full although they are also committed to increasing their capacity.

Legal form: branches vs subsidiaries

The FCA has provided guidance in 'Our Approach to International Firms' that is relevant to TPR firms seeking authorisation. The regulator warns that it will pay particular attention to the key risks applying to international firms such as the legal form of the UK entity, its relationship with other group companies, and supervisory standards of the home state regulator. It is clear that the FCA has a preference for applications from legally incorporated subsidiaries of third country firms over branches, particularly because of the difficulty of ring-fencing a UK branch from a prudential perspective.

There are no specific requirements or different forms for an application from the branch of an EEA (or other third-country) firm. However, we expect such applications to be the subject of particularly heavy scrutiny by the FCA and many may end up being rejected. Given the FCA's concern over incoming third-country branches, it is recommended that such applications include a detailed justification of why this is deemed the most appropriate, particularly if this is based on legal advice.

Being regulated by the FCA

There are important features of the UK regulatory regime that may be unfamiliar to EEA firms. Large parts of the FCA rulebook are, of course, still based on EU Directives and Regulations which were directly applicable prior to 1 January 2021. The extent to which UK and EU regimes will diverge over time is a matter of conjecture. An early example of this is the EU's Sustainable Finance Disclosure Regulation (SFDR) which the UK chose not to implement but has now responded (in kind) with a consultation on climate-related disclosures.

Senior Managers and Certification Regime (SM&CR): One key difference in the UK is the increased liability falling on individual senior managers. SM&CR is designed to raise levels of accountability for poor behaviour. Senior Manager Functions (SMFs) must maintain Statements of Responsibility which describe the aspects of the firm's operations for which they are held accountable.

SMFs and other front-line staff must be regularly assessed for their fitness and propriety. And all staff are required to uphold a new Code of Conduct – with the threat that serious or repeated breaches of these rules may prevent them from being employed in other financial firms.

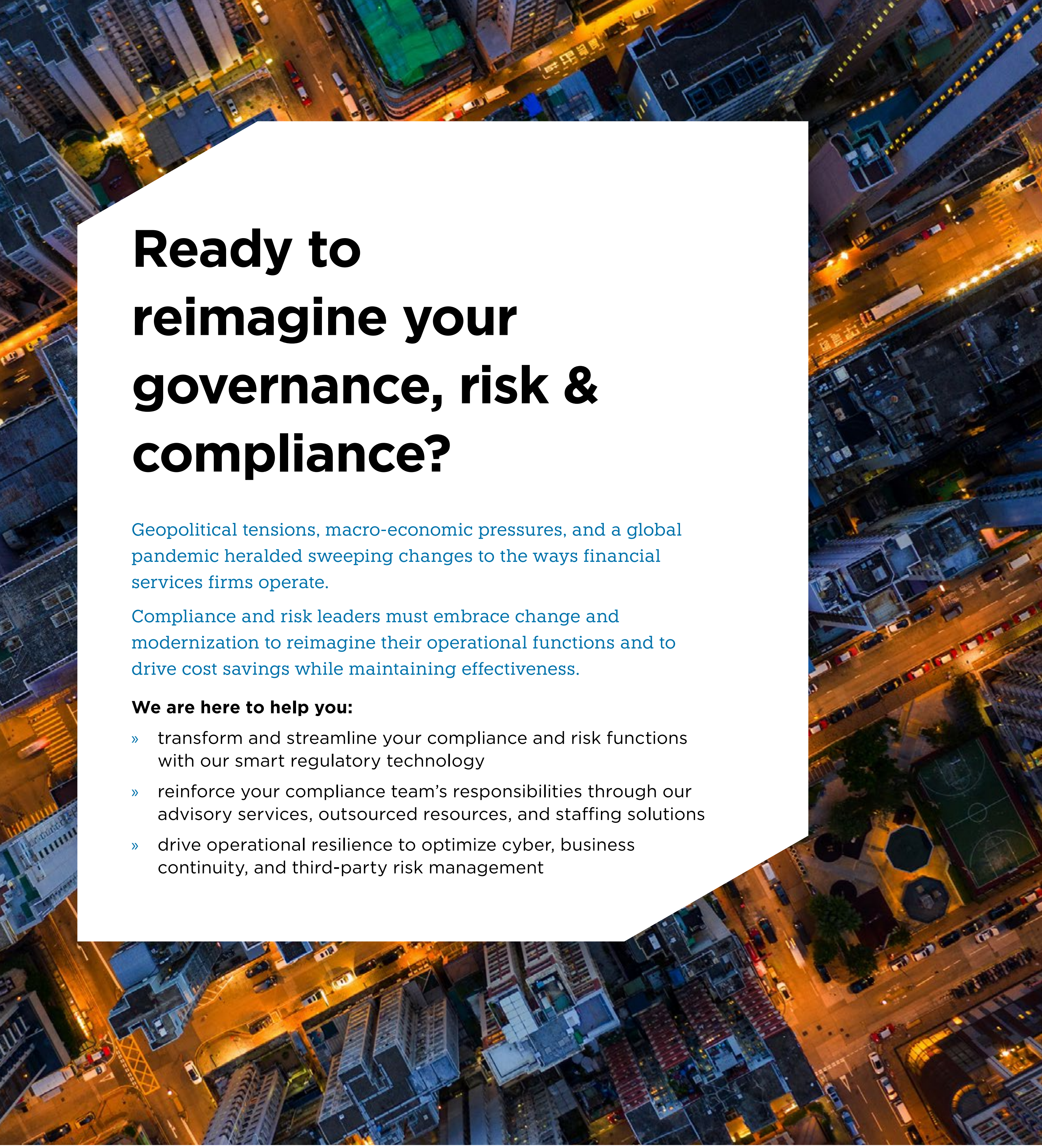
Investment Firm Prudential Regime (IFPR): The FCA is introducing its new IFPR for all UK firms carrying out MiFID investment activities from 1 January 2022. Although based on the EU's own Investment Firm Regime which came into effect in June 2021, it is different in several important respects. All firms will be required to maintain the new Internal Capital Adequacy and Risk Assessment (ICARA) and will be subject to some requirements in respect of their remuneration policies.

Regulatory reporting: FCA-regulated firms are required to submit certain financial and non-financial returns via its RegData system. These are either on a quarterly or annual cycle based on the firm's financial year-end.

Enforcement: FCA supervision, and enforcement action when things go wrong, can happen at two levels: the firm and the individual. The firm is likely to be held responsible for serious failings in management controls, but increasingly, under SM&CR, the FCA is seeking to hold individual senior managers to account for breaches within their area of responsibility. Firms can be fined or ultimately have their authorisation revoked. Individuals can be fined or have their FCA approval withdrawn for a fixed term or permanently. Market abuse can also be prosecuted under the UK's criminal regime, potentially leading to terms in prison.

In conclusion

As underlined in their recent Business Plan, the FCA is keen to present the UK as being open for business. At the same time, a big influx of international firms poses a significant threat to their regulatory perimeter and, in turn, to the integrity of the UK financial markets. Firms negotiating this entry point should not underestimate the challenges of a successful application.



Investment firms should prepare now for big changes under the FCA's new prudential regime

Michael Chambers
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Executive summary

Prudential regulation for firms with one or more MiFID permission (investment firms) is set to undergo major changes with the introduction of the new prudential regime (IFPR in the UK, and IFR/IFD in the EU). The UK's implementation date is 1 January 2022, while a near-equivalent regime commenced on 26 June in the EU.

There are clear similarities between the two regimes; in fact, they share much of their DNA. This article explores how the practical work undertaken by Wheelhouse Advisors to prepare firms for the new regimes can assist firms when trying to understand the impact on their own businesses.

What is it and how might you be included?

The new regime was designed for investment firms, after it was agreed by regulators and the industry that the extant regime, designed originally for banks, does not adequately or proportionately address the risks faced or posed by such investment firms. The objective of the new regime is to simplify and create a more relevant and proportionate framework for investment firms to which the Markets in Financial Instruments Directive (MiFID) applies.

Initially an EU-driven initiative, the FCA is exercising its post-Brexit independence to consult on a UK-specific version of the regime, effective from 1 January 2022. So, whether you're an adviser/arranger, investment manager, broker, dealer, fund manager or anything in-between – or in prudential category terms: Exempt-CAD, BIPRU, IFPRU and collective portfolio management investment (CPMI) firms all need to pay attention – changes in the prudential rules are afoot and you will need to take action to be ready.

The Investment Firm Prudential Regime (IFPR), proposed by the FCA covers a number of core areas:

Categorisation	Capital
Liquidity	Reporting
Consolidation	Governance
Risk	Remuneration
ICARA	Public disclosure

Categorisation

The first challenge for investment firms is to identify where they fit into the new framework. 'Exempt-CAD' and 'BIPRU' categories will cease to exist and the 'IFPRU' category will only apply to those investment firms deemed systemically important or sufficiently bank-like to remain under the existing CRD/CRR framework. The CPMI category will endure, but the way the MiFID rules apply will be tweaked.Under the new framework, firms will see themselves included under new categories: 'small and non-interconnected investment firms' (SNI) and 'non-SNI' for those who do not fall under the below parameters or are credit institutions.

Criteria to determine SNI/non-SNI status (relevant to AIFMs) are:

- Assets Under Management < £1.2 billion
- Client Orders Handled < £100 million/day cash or £1 billion/day derivatives
- Balance sheet assets < £100 million
- Revenue < £30 million
- No client money or assets held
- No dealing on own account or underwriting transactions

SNI is a good news story for most firms; requirements are less strict. Failing any one of the criteria does, however, mean that you are categorised as a non-SNI firm. Wheelhouse Advisors' extensive impact assessment work has shown that the effort required for data gathering should not be underestimated (for AuM and COH in particular). Mapping business activities to regulatory permissions is particularly complex for AIFMs conducting a mix of AIFM and MiFID business, as the new regime applies only to the MiFID aspects.

Capital requirements

The table illustrates how capital requirements will apply under the new regime:

	Requirement	SNI firm	Non-SNI firm
Total Own Funds Requirement (TOFR) = HIGHER OF	PMR Permanent Minimum Requirement	£75,000	Applicable based on activities • £75,000 • £150,000 • £750,000
	FOR Fixed Overheads Requirement	1/4 of overheads, less (inter-alia): • Discretionary bonuses • Expenses directly linked to income • Non-recurring, non ordinary items	
	KFR Sum of K-Factor Requirements	N/A	Sum of: • Risk-to-Customer (RtC) • Risk-to-Market (RtM) • Risk-to-Firm (RtF)

Base requirements have nominal, non-problematic increases (the base requirement for AIFMD is already higher in any case). The fixed overheads requirement (FOR) is likely to be the biting point for most investment firms. For many, including adviser/arrangers, it is new and is the cause of large capital requirement increases. For non-SNI firms, the entirely new requirements will come from the K-Factor requirements (KFR). When considering K-factors, it is highly likely that only RtC would be relevant to AIFMs (although it is still imperative to check this assumption) on the basis that AIFMD precludes firms from undertaking the MiFID activities which trigger the RtM and RtF requirements.

The RtC requirements should be considered and, if MiFID portfolios under management or advice are high enough, or client orders are handled in sufficient volume, the resulting capital requirements could exceed the AIFMD capital requirement. In any event, those metrics need to be monitored by appropriate, regular and timely processes.

Capital resources

The recognition and calculation of capital resources is closely aligned to the CRR/CRD framework, which is already borrowed by the AIFMD. So, CPMI firms may not see a change to the way their capital resources are calculated.

However, investment firms should note the deductions required from capital resources. Many of these are not new compared to existing regimes, but we have found, for investment firms that have managed their own prudential affairs, certain deductions that already applied have not been made.

Liquidity

Under the IFPR, firms' liquidity requirement will be 1⁄3 of the FOR plus 1.6% of guarantees to clients. This is more lenient than the AIFMD liquidity requirement.

However, the definition of liquid assets has become stricter and means much of the requirement should be met with either cash or highly liquid assets.
Any receivables on the balance sheets are subject to certain haircuts and restrictions. Firms managing their liquidity on a centralised group basis (informally), need to formalise those arrangements to ensure that receivable meets the definition.

Consolidation

If the firm is in a banking group, then the IFPR consolidation rules need not be applied.
If the firm finds itself in an 'investment firm only group', then it could be subject to prudential consolidation. This results in consolidated capital adequacy, liquidity, reporting and potentially ICARA. Consequently, the regime provides a good opportunity to reassess the group structure with reference to the definitions of UK parents, as defined by the FCA.

Of particular interest is the inclusion of 'connected undertakings', which could result in two entities that share common management/ownership being supervised on a consolidated basis, even when not being part of a parent/subsidiary relationship.

A silver lining is the availability of the group capital test as a substitute for full prudential consolidation. This is available to investment firm groups that are sufficiently simple and where the FCA agrees that there is no significant risk that would otherwise require consolidated supervision.

Please note: it is not a substitute for appropriately capitalising parent companies; the test is that UK parents hold sufficient capital to cover the holdings in their subsidiaries.

Regulatory reporting

All reporting will be quarterly, with new reports to consider:

- FSA001 and FSA002 (balance sheet and income statement) will be replaced by FSA029 and FSA030 (now quarterly rather than semi-annually).
- FSA003 will be retired in favour of separate returns covering capital, liquidity, monitoring metrics, concentration risk (non-SNI firms only) and group capital test.
- FSA019 will be replaced by an ICARA questionnaire (MIF007)
- All firms will have to provide remuneration reporting (MIF008).

The FCA has remained silent on the topic of the reporting language for these reports. It remains to be seen whether extensible business reporting language (XBRL) or similar will be mandated.

Governance and remuneration

Most governance changes only apply to larger non-SNI firms and the AIFMD remuneration rules will continue to apply unaffected. The existing non-AIFMD remuneration rules that are currently followed will be superseded with the IFPR remuneration.

At a high level:

- SNI firms will follow a 'Basic RemCode' which includes high-level standards on remuneration policy, governance, and oversight. It also includes principles on fixed and variable remuneration.
- Non-SNIs will follow the 'Standard RemCode'. (Basic RemCode plus further standards on performance assessment, risk adjustments e.g. malus, clawback, etc. and setting of fixed vs variable ratio.)
- There will be even stricter requirements for larger non-SNI firms in the 'Extended RemCode'.

ICARA

The FCA has provided further ICARA-related guidance in their second consultation paper (CP21/7), further to their previous publications in June 2020. This cements the direction of travel that the FCA expects investment firms to take regarding the assessment of the adequacy of their financial resources. The ICARA document (as well as the thinking behind it) replaces the current ICAAP and will apply even to those who had no previous internal capital adequacy assessment process (ICAAP) requirement (e.g. exempt-CAD firms).

Some key aspects are below:

Please note: the ICARA document itself is not the entirety of the activity and is not what the regulator will use to make its assessments.

Potential harm is associated with the propensity of a business to detrimentally affect its customer, the market and itself. These follow through to a potential need for additional capital and liquidity rather than following predetermined calculations. This is driven by the firm's owned business model rather than being mapped unnaturally to a Basel framework designed for banks.
There will be stricter recovery and wind-down planning requirements; previously guidance, this has shifted towards a hard-and-fast rule. The ICARA process will, for most, require the greatest amount of time and input from senior stakeholders, management and those charged with governance.

Summary

Wheelhouse Advisors has been working with firms to address the issues above and to prepare firms to meet the obligations of the new regime. The impact can vary from firm to firm, with some seeing only minor changes in the way they will run their business, to others who will need to address significant increases in their capital, liquidity, governance, and reporting requirements.

An initial impact assessment helps identify areas where effort should be focused, where further work will be required, or to bring assurance that a firm's arrangements need minimal changes. Planning and preparation will make all the difference.

Once appropriate changes to capital, liquidity and group structure are identified, senior management engagement and governance is paramount to implement the changes and support the development of a successful ICARA process.

Mark Wolff
Consultant
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FCA sets out proposals to extend climate-related disclosure rules as countdown to COP26 begins

The UK's FCA recently published two consultation papers setting out its proposals to extend the climate-related disclosures rules for companies with premium UK listings, to companies with a standard listing (CP21/18) and to asset managers, life insurers, and FCA-regulated pension providers (CP21/17). Importantly, the new rules will apply to:

- UK AIFMs (full-scope and sub-threshold)
- UCITS management companies and self-managed UCITS funds
- Discretionary portfolio managers

However, the new rules will not apply to UK-based asset managers that have less than £5 billion of assets under management (calculated on a rolling three-year basis). Nevertheless, this would be a significant extension of the scope of disclosure rules, and we are likely to see firms investing in significant resource to ensure compliance.

The publication of these consultation papers comes as part of a recent flurry of ESG-related activity ahead of the UK's hosting of COP26 in Glasgow in the Autumn and ties into the UK government's overarching net-zero carbon emissions by 2050 commitment.

The new disclosure rules are designed to align with the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) recommendations, published in 2017, and with HM Government's intention to make TCFD-aligned disclosures mandatory across most industries and include all listed companies, large private businesses and regulated financial services companies by 2025. Many requirements will be in place by 2023 – as described in the government's roadmap to mandatory climate-related disclosures document, published in November 2020.

The FCA's climate-related disclosure regime overlaps with the EU's Sustainable Finance Disclosure Regulation (SFDR), the main entity-level provisions (the Level 1 provisions) of which came into force on 10 March 2021 in the EEA. This, however, was not onshored into UK law post-Brexit. Though compliance with the provisions of SFDR are not required by the FCA, UK firms are still required to comply with its provisions when marketing products and services into the EEA. In contrast, the UK climate-related disclosure requirement will not apply to non-UK firms which market relevant products and services on a cross-border basis into the UK.

Though both the SFDR and UK climate-related disclosure regimes are concerned with sustainability disclosures, the UK regime is considerably narrower in scope, as it only deals with climate-related issues. In contrast, SFDR imposes disclosure requirements in relation to the wider environmental, social and governance (ESG) aspects of sustainability.

In addition, the approach that the UK has taken in relation to disclosure is markedly different than that of the SFDR. While the SFDR piggybacks on the EU Taxonomy Regulation, which attempts to classify all or most economic activities in terms of ESG factors and is highly prescriptive, the UK regime (and TCFD) is principles based, allowing more flexibility in how it is employed by firms. Though the contents of the disclosures under the UK regime are more prescriptive than the SFDR counterparts, it is likely be a more universal (and potentially useful) standard for disclosure because TCFD has been largely embraced by many countries around the world.

In practice, the new UK climate-related disclosure regime will mean that asset managers, life insurers and FCA-regulated pension providers will need to publish (on their website) an entity-level annual report which describes how they take climate-related risks and opportunities into account in managing or administering investments on behalf of their clients and consumers.

This report, called the entity-level disclosures, will also need to be accompanied by a product or portfolio-level disclosure report that contains a minimum baseline set of consistent, comparable disclosures, which include a core set of metrics.

The purpose of the entity-level disclosures will be to provide information to firms' clients (as well as consumers) on how firms go about managing climate-related risks and opportunities for the firm itself and its clients – and hence make relevant decisions when selecting products and services.

The entity-level disclosure report will require firms to cover (in a manner consistent with the TCFD recommendations) how their governance arrangements, corporate strategy, risk management systems incorporate climate-related issue as well as the metrics and targets used to measure the firm's performance in these areas (including scope one, two and, if appropriate, three greenhouse gas emissions levels).

Furthermore, firms will also need to disclose how they use scenario analysis to evaluate the risks/rewards presented to the firm. Finally, a senior manager of each firm will be required to sign a compliance statement that confirms the disclosures meet the new requirements.

In terms of the product or portfolio-level disclosures required under the new UK regime, the focus is on reporting of core greenhouse gas and carbon emissions metrics according to recommended TCFD methodologies. Total greenhouse gas emissions, total carbon footprint and weighted average carbon intensity need to be computed and disclosed in accordance with both TCFD and SFDR methodologies. Though product/portfolio level disclosures must be made to investors of in-scope firms, firms will not have to make these disclosures public for portfolio management services or unauthorised and unlisted AIFs.

The UK climate-related disclosures are set to be phased in over the next few years. While the rules will first apply on 1 January 2022, the deadline for publishing the first disclosure reports will not be until 30 June 2023 for asset managers with more than £50 billion in AuM. Firms with more than £5 billion under management, but less than £50 billion will have until 30 Jun 2024 to publish their first disclosure reports.

The FCA has acknowledged that firms will likely need to comply with multiple ESG disclosure regimes in relation to their international businesses – indeed, one of its aims in adopting a TCFD-aligned regime is to promote compatibility with the most common global approach. Nevertheless, it will likely take considerable resource for firms to ensure compliance with each disclosure regime that they are subject to.

Tackling the talent war

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The challenging environment of the past 18 months has resulted in significant consequences for many businesses and industry sectors, with their primary focus being on survival over anything else. While certain industries have been affected more than others, many asset managers have experienced incredible levels of growth during this period.

And with that growth we're seeing the emergence of a new challenge.

While those firms that are continuing to grow are actively seeking to bring in new talent, at the same time their peers are desperately trying to keep hold of the talent that they have. Helping employees feel different about work is the principal challenge now facing hedge fund CEOs.

Investment talent will no doubt continue to be a key hiring focus, as firms look to secure those who can generate revenue and help the business grow. The investment industry has largely operated successfully in a remote working environment. The hedge fund sector saw strong performance in 2020, returning +16.63% for the year.[1]

As we look ahead to the remainder of 2021 and beyond, the question is how long can this performance growth continue if firms fail to attract or hold on to the talent they require? Our research indicates that, in the long term, culture and purpose matter more than any other indicators. Winning the talent war will depend more on a firm's culture than its pockets.

The capacity to earn significant income will always rank towards the top of the list of reasons to join one firm over another, but retaining those people will likely be short-lived if the culture of those top-paying organisations is not right. Increasingly employees are seeking an environment where they can thrive and where their employer has fostered a culture of trust, collaboration, understanding and empathy.

The hiring firm should be able to articulate and demonstrate the entire employee value proposition (EVP) - what it means to be an employee in their company over and above what they are paid. The focus should not be solely on the perks and benefits that an employer provides, from the level of healthcare to the amount of retirement savings they contribute, but also on the "why".

1 2021 Preqin Global Hedge Fund Report

It is said that: *"People will forget what you said, people will forget what you did, but people will never forget how you made them feel".*

When looking at ways to attract people to an organisation, we must consider what is important to the employees as well as what matters for the business. As one asset manager said to me recently, *"When we're hiring talent, we're no longer just being compared to other investment firms, we're now being compared to the likes of Google and Amazon".* And he was right.

The employer/employee relationship has evolved to be two-way, where employees are now making demands of the employer, whether explicit or not. Employees want to work in an environment where they can learn, work collaboratively with their colleagues and experience professional growth. They want to work for an organisation that puts its people at the heart of everything it does. Ultimately people want to feel different about work and move closer to that ideal of truly loving their job.

How can firms differentiate themselves to win the talent war?

An article from HBR[2] in early 2021 stated: *"The pandemic has given business leaders increased visibility into the personal lives of their employees, who have faced unprecedented personal and professional struggles over the last year. It's become clear that supporting employees in their personal lives more effectively enables employees to not only have better lives, but also to perform at a higher level."*

The article goes on to cite that by late March of this year, 68% of organisations had introduced at least one new wellness benefit to aid their employees during the pandemic. Mental health-related absence has been on the rise for some time, however over the past 18 months this has been a key focus for all businesses. The firms that take a more progressive approach to managing people noticed this increase early on and have taken steps to address it.

How big of an issue is it?

The demanding work environment and performance pressures, lack of commute time to de-stress and mentally offload, and the inability to switch off and separate work from home have all contributed to this 'always on' culture, which has understandably led to stress and burn out. Some may have believed that not having to commute would put more time back into people's lives, but 90% of employees have reported swapping their commute time for additional work time.[3]

No organisation has been immune to the effects of the pandemic and mental health-related concerns are now right at the top of businesses' agendas. For the asset management sector, employees have gone from being predominantly office-based to being 100% based at home. This was a huge culture shock that took hold during the most severe of lockdown restrictions and will likely alter long-term working patterns.

The value of culture, collaboration and face-to-face interaction should not be underestimated.

2 Harvard Business Review | 9 Trends That Will Shape Work in 2021 and Beyond, January 2021

3 Gallagher, 'Tackling Risk' research based webinar October 2020

In AIMA's paper "How alternative investment managers are managing organisational culture during COVID-19"[4] Rosie Reynolds, Chief Commercial Officer at Aspect Capital, commented *"Collaboration really underpins our culture. Without a fulfilled and content group of employees, it would be hard to maintain productivity".*

Many spend upwards of a third of their day at work, so we must make an effort to ensure that the work environment we create for ourselves and our people is both positive and enjoyable. Aside from the obvious wellbeing benefits this has for employees, there is a crystal clear link between employee happiness and their engagement, productivity and output. When employees are happy and engaged, productivity soars. When employees are unhappy and disengaged, it can contribute to an unpleasant working environment and a toxic culture. This can extend way beyond the four walls of the office. It is a reason many people choose not to join an organisation, or why they choose to leave one.

What's in store in the future?

Leading hedge fund managers are now turning their thoughts toward how they will respond and lead in the near future. Whilst how the remainder of 2021 plays out will largely depend on the coronavirus and its impacts on the economy, our people, investment activity and asset valuations, the talent war problem is not going away.

Although many things remain unknown, one thing is certain. The way employers position themselves and the messages that they deliver to the talent they want to attract and retain will be led by the culture that exists in their organisation. And that culture, good or bad, will ultimately determine their success or failure. Our research demonstrates that asset managers recognise the importance of culture and understand the need to adapt. Over 70% of asset managers who are planning changes to their employee benefits offerings will be enhancing the benefits they offer, and 43% are looking to improve flexibility to give people more choice.[5]

Culture is attributable to our values, both as individuals and as a business, and every organisation has its own unique culture, whether deliberate, specified or otherwise. Businesses that get the culture piece right will be able to communicate a clear set of values that should be shared by every person in the organisation – not just influencing what they do, but also how they do it.

When company values are well-communicated and understood by all, they will be adopted. This helps foster a positive culture that not only attracts the right employees and clients, but also turns your employees, investors, suppliers and service providers into true advocates of your business. The secret will then be to offer company benefits, rewards and incentives that embody and promote those values to ensure performance and rewards are aligned with business values.

Will your extra perks or employee benefits make the difference when hiring and keeping hold of talent? Probably not. But will your overall employee value proposition, which shapes and defines your organisation, set you apart? Absolutely!

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4 https://www.aima.org/educate/aima-research/how-alt-investment-managers-are-managing-culture.html

5 Gallagher 2021 Benefits Strategy Benchmarking Survey

As the Cayman Islands expands the scope of its economic substance regime to partnerships and the CRS compliance form due date has been and gone: What does it mean for you?

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Changes to the Cayman Islands Economic Substance Regime

From 30 June 2021 the Cayman Islands economic substance regime has been extended to include partnerships established in the Cayman Islands as well as foreign partnerships registered in the Cayman Islands. What does this change mean for Cayman Islands partnerships and what must asset managers be aware of when seeking to comply?

The Cayman Islands is a member of the OECD Inclusive Framework on Base Erosion and Profit Shifting (BEPS) and, along with all OECD-compliant jurisdictions with no or nominal tax, enacted economic substance legislation on 1 January 2019 in response to OECD BEPS requirements. The International Tax Co-operation (Economic Substance) (Amendment of Schedule) Regulations, 2021 (the 2021 Amendment) came into force on 30 June 2021 and amended the Schedule to the International Tax Co-operation (Economic Substance) Act (the ES Act) to bring Cayman Islands general partnerships and exempted limited partnerships as well as foreign limited partnerships that are registered in the Cayman Islands within scope of the ES Act.

How has the ES Act changed?

The definition of 'entity' and 'relevant entity' have now been expanded to include a partnership under the Partnership Act (2013 Revision), an exempted limited partnership as defined under the Exempted Limited Partnership Act (2021 Revision ELP Law) and a foreign limited partnership registered under the ELP Law. Conversely, a new specific carve-out from the definition of relevant entity has been included for 'local partnerships', i.e. a partnership that is, among other things, not part of a multinational enterprise group, is only carrying on business in the Cayman Islands in compliance with and licensed under the Trade and Business Licensing Act. Importantly, if a partnership qualifies as either an 'investment fund' or is 'tax resident outside the Cayman Islands' the normal rules apply and such entity will not be regarded as a relevant entity.

The 2021 Amendment also includes revisions to the definitions of 'ultimate beneficial owner', to include general partnerships, exempted limited partnerships, foreign limited partnerships and limited liability partnerships.

Transitional provisions in the 2021 Amendment broadly provide that a partnership formed on or after 30 June 2021 will need to satisfy the Economic Substance Test (ES Test) from the date it starts carrying out a relevant activity.

Partnerships already in existence prior to 30 June 2021, will not need to start satisfying the ES Test until 1 January 2022 onwards.

What do you have to do?

The broad effect of the 2021 Amendment is that all partnerships established or registered in the Cayman Islands and foreign limited partnerships registered under the ELP Law will be required to file an Economic Substance Notification (ES Notification) and, where such partnership conducts a relevant activity and falls within the definition of a 'relevant entity' it will be required to satisfy the ES Test and file an Economic Substance Return (ES Return) with the Cayman Islands Department for International Tax Cooperation (DITC).

Against this backdrop, for asset managers, the expectation is that the majority of their Cayman Islands registered partnerships will qualify as 'investment funds' under the ES Act[1] and will not need to take any steps beyond filing an annual ES Notification. However, partnerships that are conducting a relevant activity (in particular those carrying out 'fund management business' or 'holding company business') will as a result of the 2021 Amendment now be subject to the ES Test and have to satisfy full economic substance requirements and reporting obligations.

For those partnerships registered with the Cayman Islands Monetary Authority (CIMA) pursuant to the Securities Investment Business Act (2020 Revision) (SIBA) that are conducting fund management business, expect ongoing and closer scrutiny from the DITC and also by CIMA(e.g. by way of an onsite inspection).

It is important to remember that the DITC has the power to assess a relevant entity that is required to satisfy the ES Test for a particular financial year. Such an assessment can be made within six years of the end of that financial year or, in the event of any misrepresentation, bad faith or fraud, an unlimited period. A failure to satisfy the ES Test attracts discretionary financial penalties (up to US$12,196 for the first year and US$121,952 in the subsequent financial year if the prior failure has not been remedied) and the power to require the relevant Cayman Islands Registrar to strike off the entity.

CRS Compliance Form due 15 September 2021

The CRS Compliance Form must have been completed and lodged through the DITC portal by no later than 15 September 2021. The scope of the form was expansive and went beyond CRS alone.

How is this relevant to you?

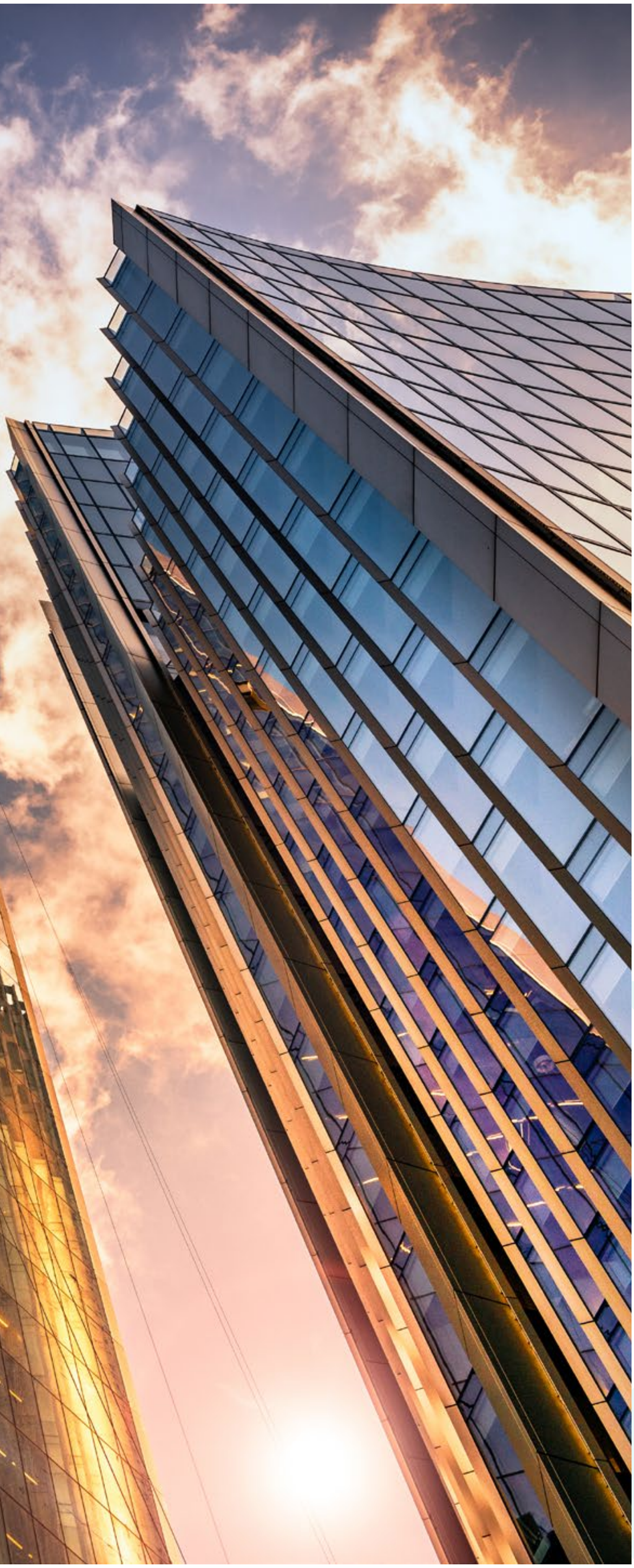
In April 2020, the Tax Information Authority (International Tax Compliance) (Common Reporting Standard) (Amendment) Regulations, 2020 came into force pursuant to which all reporting Financial Institutions (FIs) that maintain Financial Accounts and Trustee Documented Trusts are now required to provide additional information annually (through the CRS Compliance Form) to the DITC. The only exception to completing the CRS Compliance Form is where a FI has indicated that it is an investment manager or adviser that has no financial accounts.

1 An "investment fund" is an entity whose principal business is the issuing of investment interests to raise funds or pool investor funds with the aim of enabling a holder of such an investment interest to benefit from the profits or gains from the entity's acquisition, holding, management or disposal of investments and includes any entity through which an investment fund directly or indirectly invests or operates (but not an entity that is itself the ultimate investment held), but does not include a person licensed under the Banks and Trust Companies Act or the Insurance Act, or a person registered under the Building Societies Act or the Friendly Societies Act.

The CRS Compliance Form is a component that has come out of the Cayman Islands' on-going OECD Global Forum's AEOI Peer Reviews, to ensure data collection, analysis, and effective implementation of the CRS. The implementation of the new CRS Compliance Form is designed to ensure that these factors are addressed so that the Cayman Islands can demonstrate effective implementation of CRS locally. The CRS Compliance Form will be used as a risk management tool to assign risk profiles to FIs based on the additional information obtained, which will also allow a targeted audit selection.

In particular, the CRS Compliance Form collects data on each FI's non-reportable accounts, requires FIs to confirm the nature of their business, whether or not they are regulated by CIMA, whether they have prepared audited financial statements, whether they are subject to the Cayman Islands anti-money laundering regulations and details of any service providers engaged by the FI to assist it with its CRS compliance obligations.

The form also reaffirms the need for an FI to prepare and implement written CRS compliant policies and procedures (the form asks for confirmation that such policies and procedures are established, maintained and implemented) and asks for confirmation that the FI complies with such policies and procedures. The FI is also asked to confirm it has complied with the requirements of Regulation 7(3) of the CRS Regulations, which deems a FI to have contravened its policies and procedures relating to self-certification where it knows (or has reason to believe) a document is inaccurate in a material way and files a CRS Return that relies on that document's accuracy.



What did you have to do?

The CRS Compliance Form must have been completed and lodged through the DITC portal **no later than 15 September 2021**. As this was the first time that the CRS Compliance Form needed to be filed, the deadline for this year applied to both the 2019 and 2020 reporting years. For asset managers, the expectation is that the majority of their Cayman Islands registered entities will have qualified as Reporting Financial Institutions and therefore should have completed and submitted the CRS Compliance Form. The form did not need to be completed for any entities that have been classified as non-Financial Institutions (commonly referred to as NFEs) or where such entity does not have any Financial Accounts on the basis it is an investment manager or advisor.

Where an FI has failed to submit the CRS Compliance Form by the 15 September deadline, this is a breach of the CRS Regulations and an automatic administrative penalty may be issued by the DITC to such entity.

It should be remembered that the CRS Compliance Form is a new annual requirement, and so will need to be prepared and submitted again, with respect to the 2021 reporting years, by no later than 15 September 2022.

Why is joining the 'culture club' so hard?

Ranjeet Sahni
Director, Head of Business Compliance
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"Whosoever desires constant success must change his conduct with the times."

Niccolò Machiavelli

We are no longer allowed to hide behind the façade of 'culture' being a random, abstract term that cannot be measured. Culture is the way people do things. Culture is not a static concept and therefore it must be constantly monitored and improved upon. This is the expectation from global regulators. Firms are being asked to inspect their own cultures through the lens of individual accountability regimes. The litany of previous scandals, coupled with the disproportionate lack of individual sanctions, created an uproar amongst society. Regulators have decided to act, to hold individuals more accountable to their actions, as well as others at their firms. Individuals are potentially liable to receive a variety of sanctions including fines, bans from working within the financial industry and even imprisonment in the most extreme cases.

To demonstrate the strength of a firm's culture, firms will be assessed as to how they manage 'conduct risk', which, in simple terms, is the risk associated with the bad behaviour of individuals linked to the firm that can cause detriment to other individuals at the firm, the firm itself and potentially to the wider industry (including investors). Commonly cited examples of conduct risks materialising include insider trading/market abuse, conflicts of interest and fraud, to name a few. The reason why conduct risk matters so much is that it goes beyond compliance and regulatory risks. There are no sections of regulatory rulebooks that specifically focus on culture and conduct risks. Everyone reading this article will be aware of the plethora of rules and regulations that govern this industry. That said, there are not (and cannot be) rules and regulations for *every single type of behaviour*, so firms are expected to establish a robust culture of promoting good behaviour whilst discouraging misconduct.

How do you evidence culture?

There are various ways to demonstrate what the culture of one's firm is: policies, procedures, registers, terms of reference, organisational charts and other documents can support a firm's strong culture and mitigation of conduct risks. These are undoubtedly important, given the scrutiny of regulators, investors and auditors alike. To cherry-pick a few:

- **Tone from the top** – clear and constant messaging and behaviour from senior management to the rest of the firm, demonstrating how seriously they take shaping the firm's culture. This can be evidenced via firm/fund board meetings and regular business updates/townhall calls/meetings. Some firms even ask their leadership teams to take personality and/or intelligence tests (including the use of psychologists – think Wendy Rhoades from the TV show Billions)
- **Providing a safe space to speak up** – creating an environment where people can raise issues about work or work-related behaviour without fear of retaliation. If employees have this freedom, more issues are likely to be addressed earlier than before (where someone may have sat on it because they did not have the confidence to come forward), thereby being beneficial for the employee and the firm.
- **Surveillance** – given the hybrid work environments we are now living in, it is harder to track how everyone is behaving, but firms are still expected to do this. What are people saying to each other on a day-to-day basis? How does this reflect how the firm wants to be portrayed? If you have the resources, you can even go down the natural language processing path to discover personality traits (although beware that there are Machiavellians out there who will try to 'game the system' and deliberately be nice when it comes to writing emails and chats).
- **Remuneration** – considering good conduct when rewarding/promoting people and showing that bad conduct can be detrimental (e.g., not promoting someone who would have been promoted because they have been very good at their job – what they were strictly employed to do - but who repeatedly breaches compliance policies).

The running theme for the four points above is they all focus on behaviour – i.e., how we act and the consequences of our actions. Changing policies to adapt to the times is important but arguably, changing behaviour is even more important. What is the point of having an excellent suite of policies if nobody abides by them? Changing behaviour rarely happens instantaneously and can sometimes not happen at all, so how does one proceed to solve this inherently tricky problem?

How does one try to change a firm's culture?

As humans, we do not like change. Change makes us anxious. We like sticking to doing the same thing day in, day out, even when we know those actions do not benefit us. We constantly seek confirmation bias. So how do we change our routine and therefore our behaviour of our firms' leaders in particular? An interesting take on this comes from Dr Jonah Berger, a marketing professor at the University of Pennsylvania's Wharton School of Business, in his book T*he Catalyst: How to Change Anyone's Mind*. His overarching thought is that instead of using the brute force of facts and figures to change people's minds, it's more efficient to figure out the catalysts to reduce the barriers to change in the first place.

He talks about five key roadblocks, via the acronym REDUCE, which I have attempted to frame within the context of our industry:

The REDUCE roadblocks	Potential solutions for reducing those roadblocks
Reactance – when pushed, people push back	**Get people to persuade themselves** – e.g., provide case studies on conducting risk-related scenarios within training sessions and get the audience to answer for themselves what they should do
Endowment – people are used to their way of doing things so unless it is terrible, they do not want to switch	**Explain that there is a cost to doing nothing** – if you change nothing, nothing changes. Investors, auditors and regulators (as key external stakeholders) as well as employees themselves, all have expectations that the firm must continue to change with the times. Doing nothing can lead to bad outcomes for the firm (e.g. lack of future subscriptions, redemptions of current investments, high employee turnover or even an increased number of audit points and increased regulatory action). The latter two points would have to be disclosed to investors anyway, as part of operational due diligence, thereby creating a vicious cycle.
Distance - if new information is within people's zone of acceptance, they're willing to listen; if it is too far away, in the region of rejection, everything flips	**Agreeing to a small, related ask moved people in the right direction so that the final ask (previously too far away) was now within the zone of acceptance** – e.g. so this could be focusing on providing training to employees who come across as more compliance-friendly first and then others later.
Uncertainty – change introduces uncertainty	**Lowering the barrier to trial something** – this is arguably quite difficult to achieve because firms do not have the luxury of trialling out regulations (unless firms adopt the proposed behaviours that regulators would like when they release consultation papers). However, discussing the change in collaboration with others (see below) can provide clarity about what needs to change.
Corroborating Evidence - the more people you can get to provide corroborating evidence, the more likely it becomes someone will choose to join their ranks	**Getting more people on board, depending on the size and nature of the change** – as an industry, we rely so much on our peer networks as a great source of corroborating evidence and should continue to do so, when change is abounding. There are clearly also benefits from broadening that network to include service providers such as lawyers, consultants and auditors. The bigger the change, the more time, the greater the number of people required and the broader the media required to persuade others to follow suit.

I have said that we are all generally immune to change and leaders are no different. Leaders have been specifically targeted by regulators because they are those that demonstrably represent the culture of their firm. Leaders have a disproportionate impact on their firm's culture. When they adapt their behaviour and thinking, they can communicate their messages to the rest of the firm with greater sincerity and authenticity. Middle managers can then pick up the baton from senior leadership teams and use the power of stories to promote ethical behaviour throughout the firm. Even employees that really do not like change will tend to follow their leaders, due to a preference to conform, instead of standing out.

Future outlook

Evidencing one's culture through documentation is undoubtedly important. In my humble view (these views are not representative of anyone else or Dymon Asia generally by the way), the greater challenge is ensuring that mindsets (especially those of leaders) are actually aligned to the culture the firm is trying to portray. The focus on changing behaviour regarding conduct and individual accountability is a microcosm of the fundamental shift in behaviour we have all had to make since the beginning of 2020, so it can be done.

Crypto modelling: an institutional framework

Bitcoin DV01 and Crypto Risk Management Introduction

Coremont's digital assets team
Email Coremont

Search the internet for 'cryptocurrency portfolio management' and a wealth of well-meaning enthusiasts are cementing misconceptions about the appropriate valuation and risk treatment of digital assets. By addressing a few of the more common misunderstandings in this article, we hope to help advance the evolution of cryptocurrency investments as an institutional asset class.

Yes, there is an implied Bitcoin interest rate curve

In fact, it is possible to calibrate an implied interest rate curve specific to every exchange that offers active futures strips for each currency. Multiple exchange-specific rate curves lead naturally to basis between curves, or Bitcoin ("BTC") and Ethereum BR01s (the value of a 1 basis point move of a spread on a portfolio).

Let's examine a simple example. If the one year interest rate is 1%, our expectations are that the present value of US$101 in a year is US$100. Similarly, if the one year future price on a particular exchange indicates a price of US$60,000 versus today's US$55,000, then 1 BTC is the present value of 0.92 BTC in one year. The implied rate difference in between BTC and USD is -9.09%. By aggregating the implied rate differentials back to USD interest rates we obtain an outright BTC implied discount curve (this is an oversimplified calculation; please reach out if you would like a discussion on how to bootstrap the discount curves for institutional purposes).

This is foundational finance and not new, commodities practitioners have relied on this construct for decades. Yet there are numerous derivatives papers and blogs promoting their version of derivative code in R and Python that set the interest rate 'r' at '0', as well as credible systems suggesting that an equity option model 'will do'. Can we ignore interest rate curves in an institutional setting? The greatest growth in the digital space stems from (i) lending-based activity, where an important driver of loan valuation is interest rates and (ii) derivatives where implied volatility levels and Greeks will be inaccurate if relying on a rate of 0. Ignoring interest rates curves may therefore lead to inaccuracies in official NAVs, risk measure, collateral calculations and investment-decision making.

Yes, implied crypto interest rates are negative. Why?

Negative implied interest rates are consistent with BTC Futures trading at a significant premium to spot. Explanations for this could be that market players do not have access to the spot market, or that achieving a leveraged position in BTC spot is difficult given the large haircuts required when posting it as collateral. Futures may be the only way to access crypto for certain pools of capital (e.g., US regulated persons) and are considered safer given there is exposure without the security or data storage risks. Perpetual futures also imply a high cost of carry when funding costs are taken into account. For example, when Deribit perpetual futures trade more than 0.05% above spot, the long holders have to pay the short holders a funding charge. A basis between the perpetual future and spot of about 0.14% corresponds to a deposit rate of -10%.

Black-Scholes is not the right model for options on crypto futures

The Black-Scholes model is a useful framework for European options, despite many of the underlying markets contradicting the list of assumptions that the model is founded on. The model assumes lognormal distributions whereas many markets, especially crypto markets, have leptokurtic properties that are often overcome from a modelling perspective by creating implied volatility surfaces rather than a single figure.

Retail investors that don't have the systems to bootstrap implied rates curves, and just trade listed options on crypto futures should use the Black-76 (not Black-Scholes) option pricing model. The Black-76 model does not need a crypto interest rate curve. However, if you are an institutional market participant, it is imperative that your platform is backing out the correct implied volatility surfaces, and that this is being done with the right implied rate curves per exchange. If calibrating prices from one exchange to value instruments to another counterparty of different credit quality, fair value pricing further requires the credit risk of that new counterparty to be considered.

Managing changes in volatility as the market moves is also essential. It is appropriate to choose a model that can switch (or better still blend) the choice between sticky-by-strike and sticky-by-delta properties so that changes to Vega (Vanna and Volga) are accurately managed in the portfolio alongside delta slides. This cannot be done with a simple equity option framework. A further nuance is required to cater for the fact that BTC is traded 24/7. For most assets it is appropriate to calibrate volatility surfaces that allocate volatility on a business day basis with only a small residual amount of volatility allotted to weekends. This means that option theta endured from Friday to Monday is roughly the same as from Monday to Tuesday. For cryptocurrencies this is not appropriate as they experience significant moves at the weekend.

The table below compares realised volatility by weekday for BTC vs EUR/USD over the past five years:

	EURUSD	BTC
Friday to Monday	0.38%	5.89%
Monday to Tuesday	0.43%	4.15%
Tuesday to Wednesday	0.41%	4.50%
Wednesday to Thursday	0.48%	4.72%
Thursday to Friday	0.46%	3.48%

Source: Coremont
Data as at 4th May 2021

A properly calibrated volatility surface will reflect the extra weekend volatility.

Stable coins cannot be discounted with fiat USD rate curves

Stable coins are a digital representation of the US dollar. They have different supply/demand, liquidity, operational and safekeeping risks, risks directly linked to the quality of the stable coin issuer. The US dollar has numerous liquid rate curves, specific different index fixing/funding. It is extremely tempting to apply US dollar discount factors to PV USD coin. Just as an equity warrant has a different price to a listed equity option due to differences in the credit quality of the issuer, so too is the valuation of a derivative with US dollar different to one with a digital version of US dollar. Given there is no visibility into what the implied default rates are, it is tempting use the US dollar fiat rate curves for discounting. Assuming some small level of default is better than assuming none to manage the US dollar to stable coin basis appropriately, and not offset these in risk stresses.

Correlations rarely assist risk management

Correlation matrices are fun, but have limitations in risk management. Firstly, correlation is a single number representing how two-time series move together 'on average'. For risk management, a field typically interested in multiple layers of how to mitigate losses in extreme events, looking at a figure representing the average provides less useful content.

For example, the treasury and equity markets have a correlation on a longer time horizon of around 10%, yet correlations in shorter time frames range between +90% or -90%. It is the more extreme or 'tail' properties of underlyings that will allow risk managers better calculation power for decisions in this market, such as how much BTC collateral should be put forward for a five month loan in ETH. Secondly, correlation is planar, uses backwards looking data, and does not capture the multiple dimensions that drive all considerations of the potential loss.

VaR doesn't capture all the risks

As cryptocurrencies become more institutional, traditional risk measures such as VaR are being increasingly used. There are two main calculation approaches, the VaR-Cov suite and historical VaR, each has their pros and cons. The VaR-Cov uses 'average correlations' rather than tail correlations, and as just discussed, these methods remove the valuable scenarios of how a portfolio of tokens behave in more extreme movements. As a result, VaR will be understated and is more pronounced where there are relative value trading strategies across tokens, exchanges, and tenors. Historical VaR methods are generally the preferred approach for a liquid portfolio, cryptocurrencies included. Results from historic methods do include the empirical correlations but are also at risk of being understated in certain circumstances, albeit such biases are easier to monitor.

The most relevant bias is where instruments have a history that is a long positive or negative trend. Let's examine an extreme example. If a token has increased 0.2% every day in the horizon of data being used, the resultant Historical VaR will be positive 0.2%, an unlikely projection of future potential losses. VaR monitoring is more informative when it is not a single number, but a table comparing VaR across multiple look-back horizons, examining both the 1% and 5% alongside the 99% and 95% one day VaR to extract the upside biased. Further, if VaR is amalgamating both cryptocurrencies and traditional assets, breaking the results out per asset class will also assist in highlighting skewed results, and encourage better decision making.

Also, systematic risk is real. The entire crypto ecosystem is supported by numerous and key institutions whose existence and credit quality are heavily dependent on crypto maintaining the value it has. In no other time has a 'same-way risk' been so concentrated across an industry of comparable size. Regulators refer to this as 'systemic risk' and will require very small stepwise enhancements and oversight to manage the industry without spooking the market and creating the downfall.

Conclusion

We hope that by applying the sound risk management principles of financial markets to the digital assets sector, including an understanding of the multiple new risk dimensions that characterise the market structure, Coremont can help crypto become institutional in class.

Financial services industry outlook: Secondary funds will become a bigger feature of private capital funds

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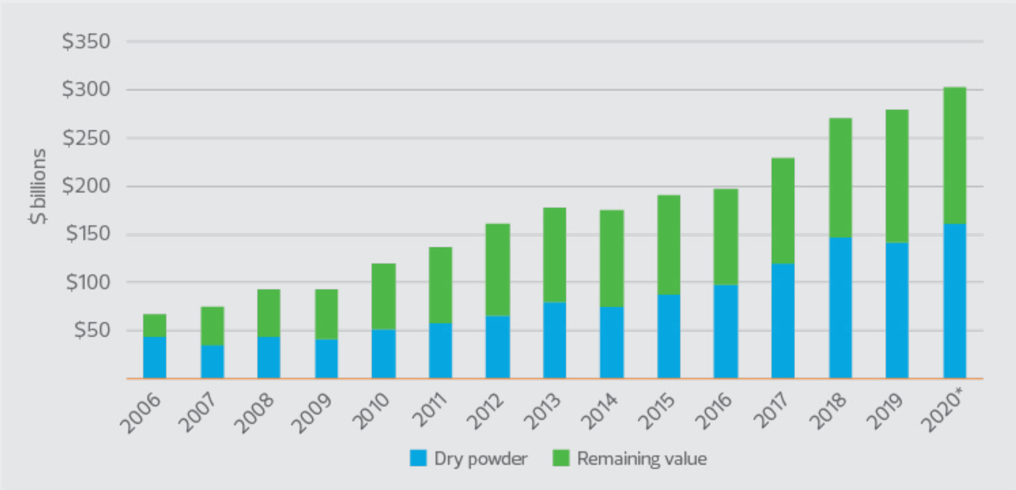
RSM US

Private equity is generally recognised as an illiquid investment strategy best left to those with investment horizons distant enough to tolerate the lockup period. Secondary funds (known as 'secondaries') that acquire private equity interests from limited partners in private equity funds who wish to exit their investment before the end of a fund's term have long been a feature of private equity investments. As assets in private equity have grown, secondaries have also gained popularity, but they have continued to be a small segment of private capital assets. This is expected to change going forward as the evolving landscape of private equity makes secondaries a more prominent feature of private capital markets.

Secondary fund assets under management



Source: PitchBook

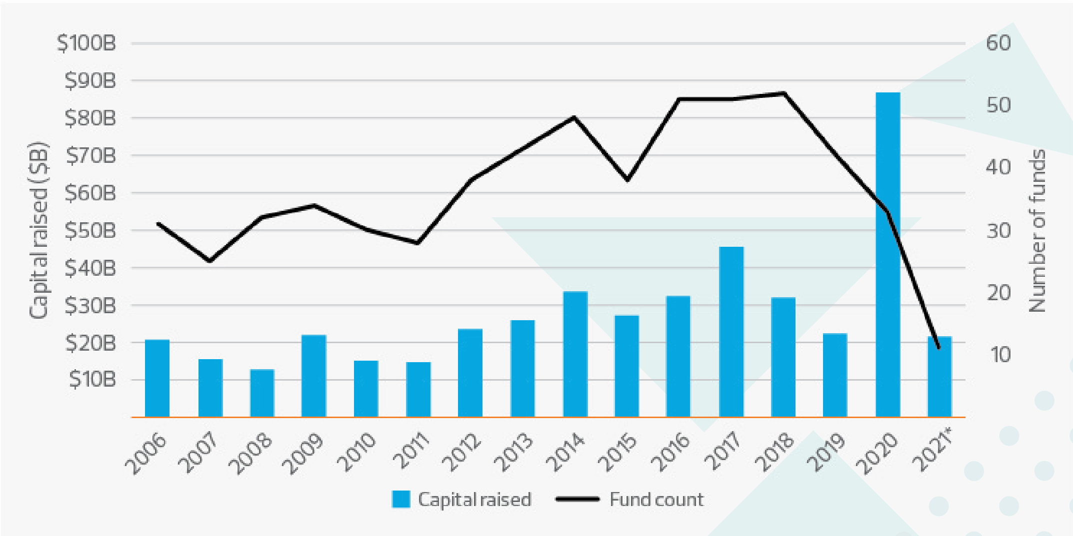
*As of September 2020

Capital flowing into private capital funds should continue to increase given its track record of outperforming public markets and the current low interest rate environment. On a transient basis, however, the recent concern is about inflation. As more investors seek exposure to private capital funds, the growth in assets will be accompanied by an increasingly diverse profile of investors which can only spur a greater need for more liquidity in the asset class. Secondary funds meet this need by providing liquidity to investors in primary funds. An established secondary market in private equity should be the culmination of a maturing marketplace as private capital markets continue to grow and evolve.

Secondary funds also cater to investors with different needs for the timing of cash flows because relative to primary funds, they generate cash sooner. By investing in primary funds that are in the later stages of their life cycle, secondary funds acquire interests that are typically in the harvest stage and are already returning cash to underlying investors. This alters the risk-return, duration, and cash-flow profile of exposure to private equity, which can be attractive to a different universe of investors.

Secondaries had a record fundraising year in 2020. COVID-19 may have had some part to play in this. Given that secondary funds can provide liquidity to investors who may be forced to sell in a distressed environment, the aftermath of the pandemic may have attracted investors to this type of strategy. The large publicly traded private equity asset managers have increased their focus on secondaries in recent years and drove much of the fundraising success in 2020 with several mega-fund launches, resulting in the growth in capital raised while the fund count dropped.

Secondary fundraising



Source: PitchBook

*As of March 2021

The quick economic recovery has meant that the opportunities that secondary funds may have been expected to cash in on might not have materialised as expected. However, the increasing popularity of secondaries should endure as focus shifts to secondary funds that are led by GPs of private funds (GP-led secondaries) instead of secondary funds created by independent fund managers to buy interests from limited partners wishing to liquidate their holdings in existing private funds (LP-led secondaries).

GP-led secondary funds have gained in popularity, primarily through the creation of continuation funds by GPs seeking to achieve two goals. The first is to give liquidity to existing limited partners that cannot go beyond the fund's term in a maturing fund and need to cash out their investment. The second goal is to allow investors that can endure a longer holding period to renew their commitment to a portfolio of companies that would benefit from staying in the general partner's portfolio for a while longer.

GPs with high-performing or high-potential assets in their portfolio that have room to appreciate further may find themselves forced to sell these assets prematurely if the fund is nearing the end of its life. Continuation funds and GP-led secondary processes have gained in popularity as they solve this problem by allowing the general partner more runway to capture this additional value for themselves and their limited partner base. For example, companies that have strong long-term prospects but were severely impacted during the pandemic and are expected to rebound as the economy recovers would be prime candidates for a GP-led secondary process via a continuation fund.

Secondaries bring liquidity to private equity investment, an alternative way of gaining exposure to private equity and faster access to some prized private equity assets. These features make this strategy an important supporting feature of a growing asset class and a compelling investment proposition for investors with a certain profile. As a result, growth in secondary funds is expected to persist.

While currently dominated by larger asset managers, this trend is also expected to take hold among midsize asset managers driven by the increasing flow of capital into private equity across the size spectrum and as the type of investors seeking exposure to private equity as an asset class continues to expand and diversify.

Private credit through the pandemic and beyond

Belle Kaura
Chair of AIMA Canada
VP Legal & Chief Compliance Officer
Third Eye Capital

Private credit has been tested, there was uncertainty early in the pandemic about how the asset class would fare. Fears of a global loan default crisis were quickly cast aside as liquidity flooded the market. After the initial shock, financial markets rallied on the back of massive monetary and fiscal stimulus. Despite an early pause, private credit prevailed, bouncing back and deploying over US$100 billion in 2020.

Private credit held strong through the global crisis, resoundingly proving its resilience and value as a vital part of the financial ecosystem. Lenders acted swiftly and decisively to support borrowers, providing flexible and creative financing to survive and grow. Deploying capital with speed and scale to meet new situations. Critics were silenced as the question whether the asset class could withstand a downturn was unequivocally answered. Performance through the pandemic solidifies private credit's place in investor portfolios and demonstrates its vital role in the real economy.

The pandemic sharpened focus on performance and manager selectivity. Private credit had a strong start to the year gaining 3.24% in Q1 bringing trailing four quarter returns to 14.41% - a complete turnaround from a loss of 6.80% in Q1 2020.[1] Funds raised in the US in the first quarter of this year declined sharply to 34, the next lowest number was 56 in 2019. Capital raised in North America was US$29 billion, only slightly lower than first quarters dating back to 2018, signalling an end to the worst of the pandemic. There is a trend toward larger funds with established managers who can write big tickets. Average fund size hit the US$1 billion mark, more than double 2016 figures. Larger deal sizes are driven by the sheer volume of capital flowing into private credit. Scale matters, leading to enhanced returns through access to better quality investments, more control, and the ability to invest across the capital structure.

The pandemic-induced dislocation was short-lived. Deal pipelines ballooned at the onset but markets quickly normalised. There was a brief window to capitalise on opportunity sets and pick up other lenders' sell-offs, in contrast to the Global Financial Crisis (GFC) which lasted around fifteen months. Opportunistic firms with flexible capital took advantage of the deal window, but most sat on the sidelines playing defence when the crisis hit to assess impact and nurse portfolios back to health. The middle was left out in the cold as support targeted very large and small businesses. Lenders gave stressed borrowers relief through covenant waivers, amendments and re-sized financial commitments. Defence has now shifted to offense for managers with dry powder to seize on the influx of deals. Patience and prudence in capital deployment will be key.

The pandemic's impact was bifurcated, from complete loss of demand to the positive effect of new trends (e.g. healthcare, technology). User activity spiked for home-based services. Forced innovation

1 Cliffwater Index 2021 Q1 Report on US Direct Lending

drove some to gain from new dynamics. In a post-COVID world, new normal sustainable structural changes will serve some industries but exacerbate the decline of businesses negatively impacted by shifts in consumer behaviour.

For many, the disruption is temporary and business will return to normal in the aftermath of the pandemic. Hard-hit sectors still have a long road to recovery. Even high-quality, viable businesses are stranded, in need of short-term help or patient value-add capital. Businesses suffering from continued disruption need capital to survive while others need capital to grow. Loans to grow sectors (ie. technology and healthcare) will be return enhancers. Some managers may turn to defensive and counter-cyclical industries. Distress is in high demand but all-weather perennial investing is tried-and-true at providing steady returns without relying on fleeting episodes of market distress that demand impeccable quick reaction to a crisis.

Insolvencies and delinquencies rose last year. Net equity worsened as debt cushions fell leading to lower credit recoveries. We witnessed the most severe tightening of lending conditions and the largest decline in business growth since the GFC. Loan documentation was tighter and borrowing costs soared making spreads higher. US bankruptcies were up 20%, surpassing 600 and reaching their worst levels since 2009; more than a third of Russell 3000 companies were unable to service debts.[2] Middle-market defaults neared GFC levels. Similarly in Canada, CCAA filings doubled, energy restructurings doubled and retail tripled.[3] Business loan growth at banks fell six consecutive months. Banks provisioned loans at 20x the pre-pandemic run rate but are now reversing loan loss provisions as economic duress eases.

Defaults are down as the economy rebounds due to easing monetary policy and subsiding COVID concerns. Defaults fell to 2.4% in Q1, down from 3.6% Q4 2020 and a high of 8.1% for senior secured loans mid-2020.[4] Outlook for small business and households is better than forecasted. Pent-up consumer demand is driving a bounce in revenues making most loans perform.

Formidable government stimulus and lender forbearance successfully minimised delinquencies and staved off a massive default crisis. The scale of rescue financing plays originally forecasted have not materialised. The pandemic should have forced some businesses to close up shop and exposed weaknesses of troubled companies. Central bank rescue efforts created false security, impeding real price discovery by putting an artificial floor on asset prices. If it were not for tremendous amounts of stimulus we would be witnessing a tsunami of defaults.

Liquidity pumped into the market could delay the default cycle by as much as two to three years.[5] Non-performing loans are expected to start rising next year. 92% of investors expect insolvency and restructuring opportunities over the next twelve months, 22% believe they will be significant.[6] What was thought to be a once-in-a decade distress opportunity could span a few years. The credit reckoning has been postponed not cancelled. Leverage multiples are up significantly. Artificially low default rates and high asset prices are masking true creditworthiness. Businesses are relying on the low cost of debt and turning to more financing to survive. In the US 20% of heavily-leveraged businesses cannot meet their debts through cash flow.

There was latent distress in the market pre-COVID. Record high debt levels, low operating margins, and poor interest rate coverage ratios globally could lead to long-term impacts. Sectors most impacted by the pandemic could suffer permanent erosion in enterprise value even after full economic recovery. Businesses have a temporary reprieve but will face pressure when fiscal support stops and underlying stresses surface. The backdrop of major sector disruptions, weak credit fundamentals, and greater amend and pretend activity will eventually overwhelm companies with excessive

2 S&P Global Market Intelligence “US Bankruptcies surpass 600 in 2020 as coronavirus-era filings keep climbing”

3 Office of the Superintendent of Bankruptcy Canada – Insolvency Statistics

4 Proskauer Q4 Private Credit Default Index; Proskauer Report “Warning Companies Not Out of The Woods Yet”

5 Bloomberg, Liquidity Will Delay Default Spike for 2-3 Years, Ares CEO Says, April 13, 2021

6 Proskauer Q4 Private Credit Default Index; Proskauer Report “Warning Companies Not Out of The Woods Yet”

leverage and pose existential threats to businesses and their capital providers. Businesses unable to handle higher debt loads will undoubtedly face restructuring. Once stimulus fades a windfall of distress, rescue financing and M&A opportunities will befall private credit.

Confidence in lender recovery is low. Less than half of investors are confident lenders can manage loss recoveries, that number is even lower for lenders with under 10 years of experience.[7] Competition precipitated entry into complex pre-pandemic loans. Conflict among lenders is escalating as they seek to enforce loan security. Not all managers are created equal, simple liquidity providers will be challenged.

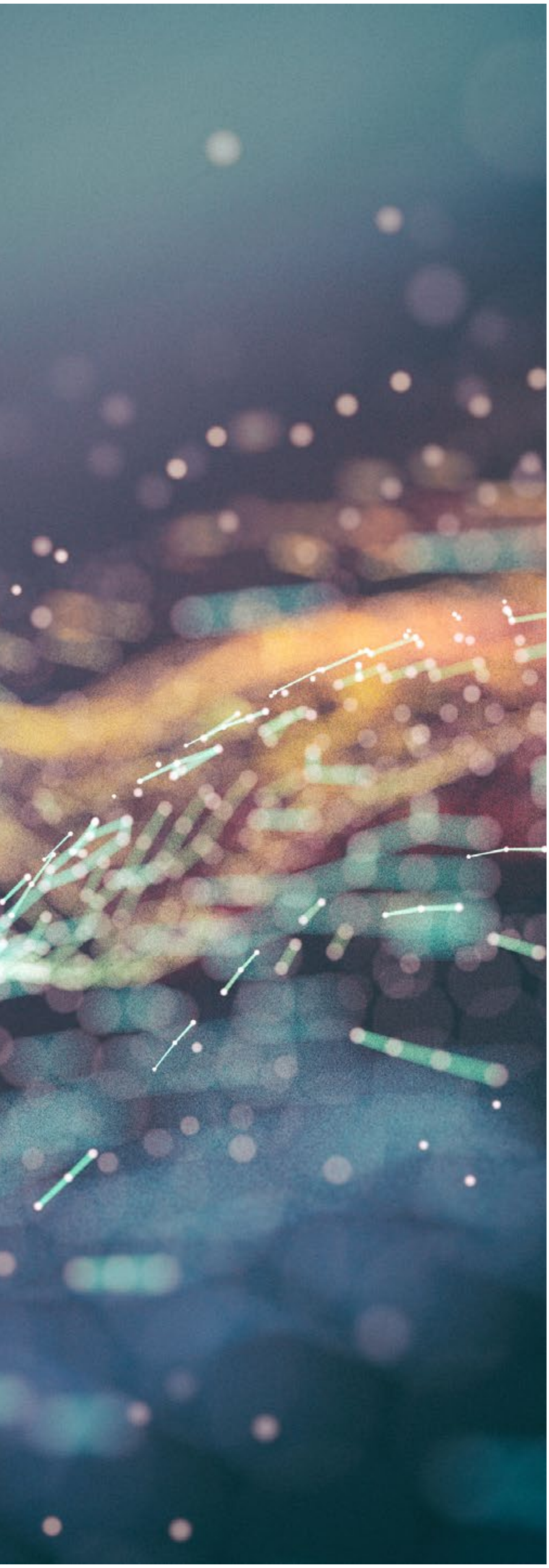
Lenders unequipped for contentious, lengthy, expensive restructuring and court battles will be tested, giving experienced counterparts an opening to purchase their credit exposures. The right lender can unlock unharnessed enterprise value and engage in active value creation to deliver outsized returns. This has ancillary positive effects on other stakeholders and the real economy.

Retrenchment of banks is a global theme. Banks are getting more conservative. This creates a void that private lenders can fill as businesses adapt and rebuild in the aftermath of COVID. Secondary market opportunities are emerging as banks cut supply and de-risk by offloading non-performing credit at a discount. A known loss being preferable to the risk of a fire-sale. Capital charges and high-risk weightings inhibit banks from being rescue financiers and debtors-in-possession.

US banks are facing increased regulation. Private lenders don't face the same regulatory constraints. Cycle-tested lenders with turnaround skills are more suited for distress situations being relationship-minded, creative and expedient. This is a pivotal inflection point for Canada, where private debt makes up only around 5% of the market. The lower risk appetite of banks is paving the way for expansion and evolution of the asset class. Private credit assuming a larger market share will create a more diverse and vibrant financial system.

The outlook for the asset class is bullish. There is a movement away from the risk and volatility of public markets. Private markets afford a respite from market flux and immunity from monetary policy and reactionary fund flows. Longer duration and lock-up of capital allows investment in higher return opportunities and

7 Ocorian Study, May 2021



yields significant illiquidity premiums. Private markets are an ever-increasing component of the economy with half the number of public companies as a decade ago. Private debt is primed to grow in tandem with private equity.

Investors are hunting for yield in private markets driven by a need for higher absolute returns and diversification. Market conditions are calling investors to action with over-inflated equities, long-standing low yielding bond markets and failure of absolute return buckets to meet expectations. Private debt is the logical solution, historically outperforming other asset classes. After historical lows for a decade, interest rates are experiencing upward pressure. Reflation signals economic growth. Private credit acts as a hedge to inflation, pricing can be fixed, and rising rates are positive for floating rate debt.

The pandemic revealed shortcomings in credit underwriting and monitoring. There is a reversal of pricing pressures, yield compression and cov-lite trends that shaped the market pre-COVID. The intense competition that created a buyer's market is waning amid consolidation. The pendulum has swung to a lenders market where they call the shots. Lenders are in the drivers' seat, enjoying better terms and more protective covenants as they raise the bar on underwriting. As economic confidence is restored, spreads are tightening from crisis-highs as lenders start to reward borrowers, but yields are still much higher than pre-pandemic.

Capital raising is at record levels, on track to hit US$1.4 trillion by 2025. This could be conservative as it assumes only an 8% share of alternatives. Canadian pensions' private credit allocation is 14-18%. Private debt is growing at almost double the rate of private equity. It is a maturing asset class. Globally, only a third of institutions are invested, allocations are rising. The US is dominated by sponsored lending, a fraction of available business. Trillions of dollars of generational wealth transfer over the next decade means vast financing opportunities.

Compelling features are attracting new investors. Untapped investor pools present growth avenues as investors build global direct lending portfolios. Private credit is entering its golden age on the back of solid tailwinds propelling expansion. It will continue its upward trajectory as positive credit conditions persist.

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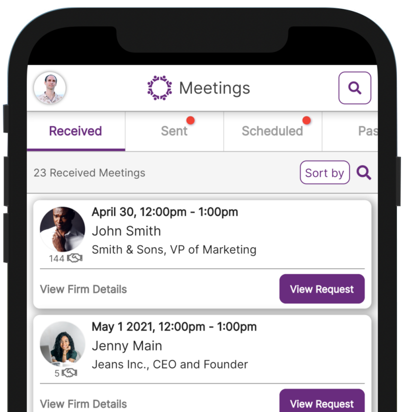

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AIMA Events 2021/22

AIMA
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AIMA continues to deliver a varied programme of events for members through virtual platforms. Hosting over 270 complimentary events annually, there is a wide selection of educational and thought leadership content for peer-to-peer learning.

12-15 October
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21 October
AIMA Singapore Annual Forum 2021

19 November
AIMA Australia Annual Forum 2021

30 November
AIMA Japan Annual Forum 2021

9 December
AIMA China Live 2021

24 January
AIMA & ACC Private Credit Investor Forum 2022

Visit our video library of event replays for continued learning here

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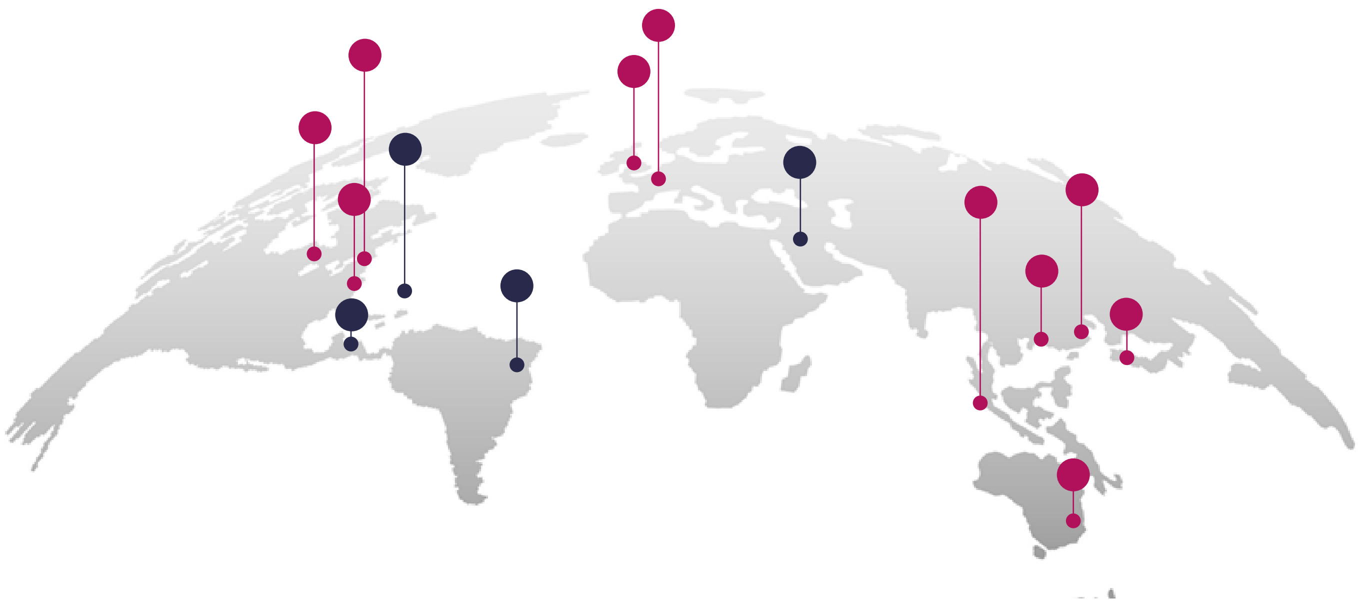

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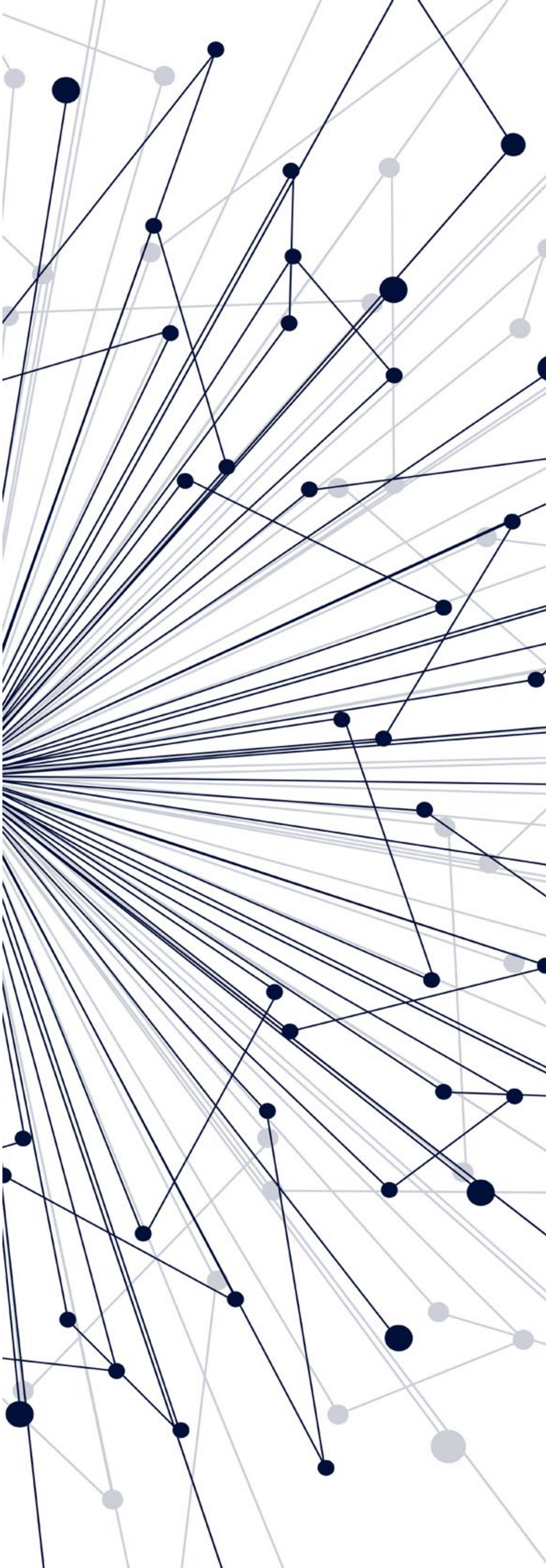

PUBLICATION PLAN 2021

Q4 Edition 128

Deadline for submission 29th Oct
Publication 30th Nov

Please confirm by the 8th October if you wish to contribute to the Edition 128 of the AIMA Journal.

We might not be able to include any last minute submission.

AIMA JOURNAL EDITORIAL GUIDELINES

Thank you for reading the Edition 127 of the AIMA Journal.

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