Keeping up with Tax – AIF

September

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Welcome

Welcome to our October edition of Keeping up with Alternative Investment Funds, hopefully you have managed to have a relaxing break over the summer.

In our first article **Rob Mellor** and **Pete Witton** explore how the landscape of liquid trading and private asset investment strategies is being further opened up to individual investors through a combination of regulatory change, investor appetite and the development of digital-based distribution and investing platforms.

Christopher Neill and **Lach Roos** then consider three key trends relating to the transformation of in-house legal functions to enable them to become key strategic partners within their organisations.

In the final article of this edition, **Rob Mellor** reviews the themes emerging from PwC's report on "The AWM Revolution 2023" and offers some reflections on the impact to alternative investment fund managers.

We would also encourage you to look at our broader suite of Keeping Up with Tax publications this month, including an article on the tax transparency rules for crypto-asset transactions from our AWM team, an update on HMRC nudge letters from our disputes team, and much more.

Please continue to reach out to your usual PwC contacts if you would like to discuss any of the content in this newsletter.

Save the Date - In Person Conference Coming Soon…

Following a deferral due to various strike action earlier this year, our annual AIF conference will now take place on **Thursday 12 October 2023**.

Invitations will be sent out in the near future so if you're not already subscribed to our mailing list and want to receive your invitation, please reach out to your usual PwC contact or drop us an email at **uk_alternative_investment_funds@pwc.com**.

This years conference will include a plenary session exploring the 5 key megatrends that PwC has identified including a panel discussing operational and cultural considerations for managing recurrent crisis. There will also be breakout sessions covering industry M&A and IPOs, tax disputes, strategy and governance and also the carried interest landscape.


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Retailisation and democratisation of Liquid Trading and Private Asset investment strategies

Both retail and private asset managers are expanding their product development focus on bringing alternative and private assets to individual client investors. Whilst a limited route to private asset investing has always existed for such individuals through listed investment vehicles (e.g. Investment Trusts and listed REITS) the landscape is being further opened up through a combination of regulatory change, investor appetite and asset manager product development.

"Individual investors" are a group that includes retail investors (investable assets of up to £100k, mass affluent (investable assets between £100k and £1m) and HNWI's (investable assets of above £1m). Once above the HNWI threshold it is also likely Family Offices could become targets, although family offices have been involved in investing in hedge funds and private assets for some time.

Some key drivers of this renewed focus on individual investors and Alt asset classes

- Governments need private capital to fund the transition to Net Zero and the decarbonisation of the economy given the high Govt debt levels following the global pandemic. Governments are also looking for private capital to drive economic growth through corporate investing.
- Individual investors have become more used to fund investing through their use of passive and active ETFs.
- Institutional investors are increasingly finding themselves "capped out" in terms of their commitments and allocations to Alternative asset classes.
- Digital based investment platforms are creating product distribution opportunities for Alternative asset classes to individual investors.

Regulatory developments helping access to alternatives

Below we have set out some jurisdiction specific developments which are helping to broaden access to alternatives.

United Kingdom

- Long Term Asset Funds (LTAFs) are broadening opportunities for individual investors, such as HNWI, and sophisticated retail and professional investors, by allowing access to alternative solutions that were once restricted.
- The LTAF has been available since 2021 and has attracted interest from several asset managers, with Schroders and Blackrock being early adopters of the new fund vehicle.
- A new proposal could extend this to more categories of retail investors, provided they receive appropriate disclosures and allocate under 10% of their investable assets in LTAFs.

European Union

- Europe's recently adopted European Long Term Investment Fund (ELTIF) 2.0 regulation improves access to alternatives for individual investors by removing previous barriers to entry, such as the 10,000 euro minimum investment and net worth requirements. The distribution regime has also been harmonised by aligning the ELTIF suitability assessment with MiFID II.

United States

- In 2020, the SEC broadened the definition of "accredited investor" to allow more individual investors to participate in private fund offerings.
- The US Department of Labor has also recently issued guidance on including private equity funds in 401(k) retirement plans
- It remains to be seen whether recent SEC changes will stall activity in this regard as managers grapple with potential changes required to be implemented, such as increased reporting, over the next few years.

The rise of digital-based distribution and fractional investing platforms

The proliferation of online investing and the emergence of new distribution channels has resulted in the widespread adoption of digital assets, particularly among retail investors and HNWIs, pushing the asset class to new heights.

As part of the wave of digital platforms and technologically enhanced asset management services, there has been a surge of robo-advisors capable of providing tailored advice to individual investors. These advisors can offer better performance and help manage risks while minimising transaction costs through features such as optimal portfolio creation, risk management and financial data processing, with some robo-advisors even having integrated trade execution capabilities. Moreover, the influx of robo-advisors has made investing more accessible to retail investors as they provide a simplified interface and lower fees compared to human advisors.

Retailisation and democratisation of Liquid Trading and Private Asset investment strategies (continued)

As a result, the proportion of AuM being handled by robo-advisors has been increasing steadily. The AuM managed by robo-advisors grew at a CAGR of 66.8%, reaching USD 2.5tn in 2022, up from USD 19bn in 2017.

Digital-based solutions are also servicing the individual investor and alternative asset class market, for example, Moonfare , a European based digital platform allows individual investors to access private market asset classes. It has enabled over 3500 retail investors to allocate more than EUR 2bn to private equity managers. Other similar examples, although with slightly different models, include iCapital, DarkSquare Capital and Sprout.

Operational Impacts for AWM industry

The AWM industry stands at an interesting cross-roads, the traditional retail fund industry has the legacy capability to deal with the volume processing needed for individual investors, their reporting (including tax) needs as well as the wider regulatory issues (such as pricing, charges, customer duty etc). But, has not necessarily had the Alternative asset class expertise in-house to now manage such products and to deal with operational challenges (such as liquidity management and the management of alternative asset portfolios) that come from these different investment styles.

What we have seen therefore is a steady M&A activity flow of traditional asset managers acquiring Alternative asset class managers to bring the investment strategy expertise and capability into their businesses.

On the other hand, Alternative asset managers may not be used to dealing with individual investors (beyond employees, friends and families) on a mass scale, so face the challenge as to how to access and distribute to these investor groups. Equally, the new emerging fund types will carry different reporting and liquidity rules than the alts manager may have been used to when dealing with closed ended private funds.

This has led to Alternative managers either looking for distribution through traditional retail manager alliances, joint ventures or M&A transactions or through the alignment of Alts managers with private banks and wealth managers. Increasingly we are seeing private banks and wealth managers (PBWM) gear up their advisory capability around alternative asset classes and acting as a conduit for HNWI wealth into Alternative fund asset classes, with PBWM's creating aggregation pooling vehicles to gather assets for allocation into new Alts fund launches.

On the horizon

PwC will be discussing these themes further at their upcoming Alternative Investment Funds conference on 12 October 2023. We will also be exploring how tokenisation can further democratise alternative assets and funds via fractionalising alternative assets, with further thoughts on this included in our next publication.

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Transform your legal function now, and become a strategic partner to the business

Within our industry, the rapid changes in regulation, technology, client expectations, and market dynamics are demanding more agility, efficiency, innovation, and value from your legal team every day. How can the inhouse legal function transform itself to meet these demands and become a true strategic partner for the business?

There are three key trends which we are seeing develop at immense pace:

1. The Adoption of Legal Technology and the excitement of Generative AI (GenAi);
2. The shift of the legal function from risk monitor to business and strategic partner of the business; and
3. A transformation of talent and culture changing the way people want to work in a legal function.

The big moving and overarching trend is the rapid adoption of legal technology. The legal function is in many businesses the last bastion of untouched transformation, still operating in a manual and inefficient manner. Here, clients are now focusing on and talking about artificial intelligence (AI), contract automation and lifecycle management (CLM), data analytics, and blockchain, to enhance efficiency, quality, and value. Legal technology can help legal teams automate routine tasks, streamline workflows, reduce errors, and generate insights. As an example, GenAi can help with document review, term or data extraction, due diligence, compliance, and risk management, while contract automation can help with drafting, negotiating, and managing contracts. Blockchain can help with verifying transactions, enforcing smart contracts, and facilitating cross-border collaboration.

Within the last 12 months, we have experienced an explosion of this activity with asset managers all wanting to equip themselves with GenAi capability, and needing to understand how to push that button. In order to be ahead of the game, PwC has acquired the exclusive rights within the Big 4 to Harvey (a legally trained GenAi platform), as well as other legal tech business relationships, providing us with a leading advantage to service the market, and to be the tip of the sword for the changing landscape.

Another key trend is the shift from a risk monitor, to a more strategic and proactive role for the inhouse legal function, as a trusted advisor and partner to the front office business. Legal teams can leverage their expertise, experience, and perspective to provide guidance and solutions on complex and emerging issues, whether it be specifically deal focused, or other key business matters such as ESG, cybersecurity or data privacy to name just a few. The legal function can also contribute to the Manager's innovation, growth, and differentiation, by supporting new products, services, and markets, and by fostering a culture of creativity, agility, and ethics. The question though becomes one of real capacity, as most legal teams are already underwater when it comes to available time. As such, while many legal teams would certainly enjoy the ability to partner with their business teams, most don't have the time to free themselves from the BAU. This has therefore become a main focus of PwC, where we work with many clients now on a PwC Managed Legal Service basis, taking the pain away, to enable inhouse to refocus on the high priority issues. The ability for clients to utilise our skilled people, technology advancements, and scale up and down depending on which way they need to turn the tap has been game changing for many.

A third key trend is the transformation of the legal talent we are seeing in the market and the culture, struggling to align with the changing needs and expectations of the asset manager and its clients. Legal teams, more than ever before, need to develop new skills and competencies, such as digital literacy, business acumen, and client focus, to effectively use legal technology and deliver value-added services. Legal teams also need to embrace new ways of working, such as agile, collaborative, and flexible methods, to foster innovation, diversity, and engagement.

The inhouse legal function is undergoing a significant and exciting transformation that offers both opportunities and challenges. Legal teams that can embrace and harness the change and innovation, can enhance their performance, reputation, and impact, and become a key driver of the asset manager's success.

PwC, over recent years, has established a market leading legal business, where we are focused on legal technology, managed legal services and legal consulting. By combining these skill sets, with qualified and highly skilled lawyers, we are now able to partner with clients to enable true transformation of their legal operating model. Be it tech advancement or scalability of function through managed services, we have the leading solution.

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PwC's 2023 report on "The AWM Revolution 2023 – The New Context" what does it mean for AFMs

PwC recently published its 2023 research piece on the global Asset and Wealth Manager (AWM) landscape, in this article we will explore how the themes emerging from the 2023 research will impact Private Assets and Liquid Trading (including hedge funds) fund managers (AIF managers).

From a global macro perspective, the PwC 2023 report was published at a time when AIF managers faced the triple headwinds of inflation, geopolitical conflicts and rising interest rates. Over the last 18 months financial markets have been particularly affected with weakened stock and bond prices leading to declines in portfolio valuations, further aggravating apprehension among investors.

In response to rising inflation, central banks have ramped up their monetary policy, increasing rates throughout 2023. This has led to a trend of rising bond yields after almost two decades of declining yields.

Against this backdrop, global mutual funds, mandates and alternatives collectively suffered a significant drop in AuM in 2022, falling 9.7% from 2021 highs to USD 115.1 tn. Mutual funds bore the brunt of 2022's turmoil, as market declines and sharp outflows hit AuM by USD 8.7tn worldwide. Alternatives, on the back of strong growth until to 2021, were the least affected asset classes in 2022, with global alternatives AuM increasing by 10.0%.

Private market AuM has expanded steadily since 2017, reaching USD 12.0tn in 2022. Lower valuations and declining fundraising have negatively impact revenue pools for AIF managers. Although overall private markets' AuM witnessed growth, fundraising dropped significantly by USD 132bn in 2022.

Amid the current high-interest rate environment, we are seeing a shift in asset allocation trends by investors, as decreasing risk premiums cause them to rethink their existing portfolio model. Longer maturity profiles and a cash squeeze (from reduced exit environments) in private markets has seen many institutional investors turning to public market bonds, in a bid to preserve capital and de-risk.

Nevertheless, in our survey of asset managers, 66% of asset managers expect a moderate or significant increase in net in-flows in the coming 12-24 months with 84% anticipate this increase to come mainly from North America. We expect the largest asset managers can continue to attract the majority of asset inflows, amplifying existing pressures on medium and small sized asset managers.

Investor demand for heightened liquidity has continued through 2023, particularly in relation to Money Market Fund (MMF) inflows; as heightened market uncertainty, low-yielding bank deposits and interest rate hikes boosted the appeal for money market funds. The collapse of SVB further accelerated inflows, which reached nearly USD 350bn in March 2023, and pushed total MMF AuM to record highs of USD 5.3tn, according to the Investment Company Institute (ICI).

In terms of the trends which AIF managers should be aware of, there are 7 key messages from the PwC Global AWM survey:

1. HNWIs and SWFs to see the fastest growth within client assets

We are likely to see a surge in individual investor inflows as asset managers increase their efforts to target mass affluent and HNWIs as this investor segment seeks to diversify risk and access alternative and tailored investment opportunities.

Within investor segments, HNWIs are expected to experience the strongest and fastest increase in wealth, growing to hit USD 139.6tn in 2027 from USD 107.3tn in 2022.

During 2022, HNWIs' interest in AIF assets continued to increase, with 62% of respondents in PwC's 2022 HNWI Survey indicating demand for this asset class, surpassing any other product or strategy. Despite the growing demand, investors still face challenges in accessing these non-traditional investment products. In fact, PwC's 2022 HNWI survey found that 27% of HNWIs who changed their advisors in the past three years did so to gain access to a broader range of solutions.

The emerging retailisation of private assets is set to enable mass affluent and retail investors to invest in non-traditional assets. Recent regulatory advancements, such as the SEC's updated definition of an accredited investor, the UK's LTAF regime, the EU's proposed ELTIF 2.0 legislation and tokenization of private assets, are poised to widen access to non-traditional assets. However, running open ended products, dealing with liquidity management and administrating for HNWI (including investor tax reporting) requires a different set of skills from those which many traditional AIF managers have.

PwC's 2023 report on "The AWM Revolution 2023 – The New Context" what does it mean for AFMs (continued)

2. The growing need for diversification will prompt investor calls for widened product offerings

Diversification remains a priority for many investors, leading to a surge in demand for wider product offerings from asset managers as a way of weathering market volatility and unlocking new return potential. Investors are seeking to increase their exposure to both AIF and traditional asset classes through tailored investment solutions.

The growing importance of customisation, flexibility and innovation is applying pressure on asset managers that struggle to deliver novel investment solutions, as 61% of investors expect more innovative and tailored products from their managers in the coming 12-24 months.

3. Tokenisation and blockchain will disrupt traditional fund structures by 2027

Asset managers are increasingly noting a growing demand for tokenised fund structures and asset classes. With the securities tokenisation market regarded as having one of the highest potentials for growth by the OECD, this comes as no surprise.

Blockchain, distributable ledger technology and the use of smart contracts will allow the automation of the capital and investment return flows between the underlying asset class and ultimate investor.

Tokenisation can provide real-time and efficient transactions, decreased costs, liquidity, improved transparency and security. In terms of liquidity, tokenisation can have a positive effect on access to illiquid assets, such as participation in the capital of private SMEs, Real Estate and Private Credit (and beyond into metals, art, intellectual property and sporting rights).

Tokenised securities are democratizing access to traditional capital raises by allowing investors to invest smaller amounts through a more efficient and cost-effective process. In particular, for the AIF market, the transferability of tokenised participations could improve portfolio flexibility when investing in closed-end funds.

Improving the transferability and liquidity of traditionally illiquid AIF assets will require significant upskilling, operational alignment and careful due diligence by AIF managers but also across the AWM ecosystem. As a part of this, a range of tokenisation platforms have already emerged which offer a range of solutions to investors across a variety of asset classes in both public and private markets.

4. We expect market concentration of the largest managers to further increase by 2027

As asset managers continue to seek ways to increase efficiencies, it is expected that the largest asset managers will actively invest in developing more streamlined platforms, targeted solutions, innovative product offerings, and building more robust brands; including growing their AIF offerings. In the long term, we expect consolidation and concentration to increase within the industry, spurred by strategic alliances and M&A deals involving asset managers. Our survey highlights this, showing that 73% of asset managers are considering a strategic consolidation (M&A deal or joint venture) with another asset manager.

This will continue the trend towards consolidation within the industry, potentially resulting in the top 10 traditional asset managers controlling approximately 49.7% of global AuM by 2027, and the largest AIF managers in charge of 16.1% of private market AuM.

5. Insurance companies will leverage partnerships with AMs to strengthen their industry presence

In the face of low asset yields and rising inflation, the insurance industry has been adopting more complex investment strategies to mitigate risk and improve the efficiency of their investment management. This has led to an increase in partnerships, alliances and M&A activity between insurance companies and AIF managers. For AIF managers insurance company life insurance and annuity assets are attractive as a form of permanent capital. Private equity firms are drawn to the stable, long-term funding that these products provide, enabling them to make investments that generate value over time, without the pressure of short-term returns.

6. Build a compelling brand to stand out in a highly competitive market

Asset managers must showcase their value proposition through a compelling brand. Through a comprehensive brand-building strategy, asset managers can enhance their recognition and emphasise their client-centricity and attract and retain greater market share in a fiercely competitive industry.

PwC's 2023 report on "The AWM Revolution 2023 – The New Context" what does it mean for AFMs (continued)

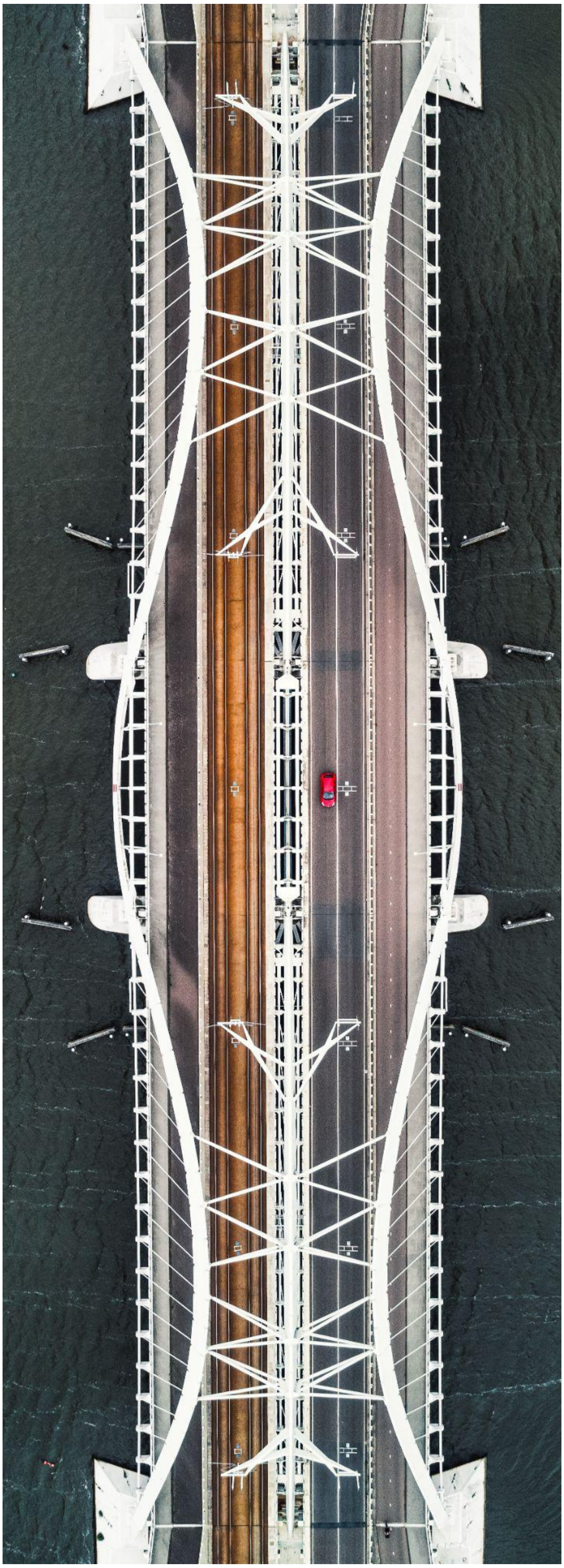
7. **Optimise operating model to increase efficiency, competitiveness and enhance profitability, including through product rationalisation**

   As asset managers reassess their business models and operations for viability in the current environment and beyond, rationalisation of costly and underperforming products comes to the fore as a valuable measure to reduce costs, improve product strength and maximise overall profitability.

   To thrive in an increasingly complex business environment marked by stringent regulatory requirements, digital and AI disruption, technology and data platform upskilling, sustainability concerns and mounting margin pressure, asset managers must focus on strengthening their businesses' efficiency and competitivity by implementing a comprehensive Target Operating Model strategy.

Finally, asset managers should prepare to meet the expectations of a new generation workforce by integrating digital and AI enhanced work models, committing to social responsibility and impact, promoting transparency and enabling employee training and development.

One key forecast in the survey was that given the expected increasing M&A, market concentration and competitive, we expect 16% of current asset managers to be extinct by 2027. ***How does your current strategy ensure your are one of the 84% survivors?***



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Thank you

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