Staying alert to stay ahead

Managing today's challenges; building for tomorrow's opportunities

Alternative Investments

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Introduction

"We see 2017 as a year of opportunity for alternative investment firms. We understand that there are uncertainties surrounding economic and regulatory issues. And, we realize that a sizeable portion of the organizations in the industry still need to step up their leverage of data and technology tools to attract customers and grow revenues, and they must maintain their focus on new tax and risk regulations. But, nevertheless, we remain optimistic that organizations that embrace agility and focus on fundamentals will reap rewards."

— **Jeffrey Kollin**
Lead Advisory Principal, KPMG's Alternative Investments Practice

Creating strategies to manage emerging technological and economic forces poised to reshape the future of our industry would be a very powerful capability for any firm. Prediction is risky, and sometimes expensively inaccurate.

More often than not, firms committed to a culture that embraces change and firms that possess the agility to move quickly when opportunities arise tend to increase their odds of getting ahead of competitors. They learn to handle the here-and-now issues and turn challenges into opportunities.

In offering this annual trends publication, we focus on fundamental current issues we see having the most immediate impact and suggest that acting with dispatch can put organizations in the position to prepare to take on emerging issues of profound importance in the not-too-distant future.

When we look at the months ahead, we expect yet another year when fund managers face heightened compliance, risk, and tax-transparency demands. What's more, customers expect more attention and faster transactions … not to mention strong investment returns.

As it is with other financial services businesses, alternative investment firms still must confront the convergence of forces from governments and customers. Even as these forces mount, firms must also continue to reduce costs, stave off new competition from emerging technology firms, and leverage oceans of data sloshing through their systems so they can make quicker, better operational decisions.

There is no question that there are nimble, leader-of-the-pack organizations in the industry. Candidly, they are the exception. Many firms are doing a lot of studying and remain with their feet in the starting blocks for a race that already has begun.

Some barriers to getting in the race are technical in nature; there are prohibitive information technology investments that make joining the race difficult. But, we suspect cultural barriers are there, too.

We believe leaders recognize that they are operating in an environment where boundaries are no longer defined by technology alone. In offering this report, we provide details on opportunities we believe can be realized through the following diverse yet critical business imperatives:

— Gathering and analyzing data can streamline operational processes and benefit customer relationships through the creation of products that customers demand.

— Enabling information transparency about income earned on alternative fund investments by individuals and organizations. While transparency is necessary for compliance with the Common Reporting Standard, transparent investor data can help funds increase capital inflows, build better relationships with investors, and create better operational controls.

— Creating robust means to comply with collateralized loan obligations risk-retention rules, which will be complicated and carry the potential for managers to demonstrate that they support shared investor risk.

We see a current landscape that will require new approaches and bold action to meet existing challenges. Yet, we expect there to be real opportunity in those current challenges, and we foresee that the learnings coming out of managing today's issues will have powerfully positive impacts on the new opportunities that now sit just over the horizon.

We invite you to read on. Please reach out to us. We welcome your ideas and feedback.

Jim Suglia

Jim is the national practice leader for KPMG's Alternative Investments practice and is also a member of the firm's Global Investment Management Executive Leadership team. With more than 20 years of industry experience, Jim has served an extensive roster of both mutual fund and alternative investment clients.

Jeffrey J. Kollin

Jeffrey is the lead Advisory principal for KPMG's Alternative Investments practice. He focuses on the firm's resources in the hedge fund and alternative investments market, including all activities for business and practice development, professional development, technical support, and market activity.

Dig for valuable data to build your strategy

Managers expecting to win in the ultracompetitive marketplace are going to have to master the ever-more complicated art and science of analyzing data and applying it to the creation of new business models. Doing so could greatly improve customer experiences and connectivity, and align with fintech organizations to take advantage of new technologies and attract different talent.

Our point of view on these issues arises out of detailed interactions with senior executives at the world's most influential firms, government regulators in the United States and abroad, and insightful industry analysts.

At its core, the industry is being shaped by the mammoth amount of data that businesses must gather, interpret, and leverage for their benefit. The job at hand is finding the means and the tools to gather the right data and make sense of it.

We hold the strong belief that fund managers who place strategic focus on gathering accurate data and on the masterful manipulation of data stand a much better chance of staying ahead of the pack. (Judging by findings from our July 2016 data and analytics (D&A) study, there is a lot of work to be done across industries on gaining trust in their data.)

Those who dally or who are not aggressive in leveraging the right tools, the right people, and the right data in creative and artful ways almost certainly will lose their stride and run the risk of falling far behind in the race for growth — and even survival.

While there are almost limitless ways to leverage data to gain a meaningful edge in the business, we expect industry participants to step up their D&A usage in areas of data visualization for operational and customer-experience enhancement, software as a service (SaaS) for day-to-day functional tasks, robotic process automation, and even distributed ledgers — so-called "blockchain" technology.

If nothing else, however, today's story about data ultimately is a story of people: At their core, the people who steer these businesses are becoming much more devoted to a data-driven culture. They embrace the idea of change. They understand the implications of data driving the disruptive technologies roiling industry incumbents. And, they believe in the necessity of moving beyond the mere examination of numbers formed neatly in columns and rows. They examine trends in faster ways, they make more-informed decisions, and they use the information to speed up and increase the accuracy of compliance demands.

Data analysis for strategic direction

In our view, a growing portion of the leaders in today's alternative investment organizations are true believers in mining signals of positive change that is in data about the marketplace, its customers, and industry operations.

In the marriage of computer science, engineering, and research, the desired outcome is knowledge compression. Because the amount of data is multiplying at a pace that is almost incomprehensible, winners will find ways to condense the scope of their most important data into manageable pieces.

How much data is produced daily?

IBM estimates that 2.5 quintillion bytes of data are created every day. A quintillion is a 1 followed by 18 zeros. IBM also reports that 90 percent of the data in the world today was created in the past two years.

In 1992, about 100 gigabytes (GB) was created every day. By 1997, it was 100 GB per hour. In 2002, the figure was 100 GB per second. The estimate for 2018 is that 50,000 GB will be created per second, most of it unstructured.

Source: "What is Big Data?," IBM; Vouchercloud.net

Whether they use data visualization tools for internal operation purposes or for customer-retention or customer-attraction purposes is almost irrelevant. What is material in this discussion is that these people and their organizations are using tools, techniques, and individuals to build strategies and operating and business models that are designed to gain an edge — and then doing all they can to keep that edge.

It was not long ago that data-crunching tools, due to their high costs, were only affordable to the largest organizations. But, just as computing power has drastically increased for use by consumers (think the smartphone being the supercomputer of 15 years ago), so too has the cost for data visualization and machine-learning applications.

Today, some of the smaller asset management houses may be able to do much of the same work at the same cost as some of the biggest businesses. In effect, these tools of today provide the ability to scale, which has broken down the barrier to entry.

Some executives, who have not kept pace with knowledge about the application of D&A, may only focus on it for regulatory reporting purposes. As critical as regulatory compliance is to any business, so too is it for strategy creation aimed at improving operations, increasing sales, upgrading marketing campaigns, and identifying trends that can improve their interaction with clients.

Realizing the promise of proper analysis of data affecting a business does not begin with software and hardware. Instead, it starts with organizations doing an inward examination of their commitment — and the willingness to spend the time and resources — required to build D&A capabilities.

In our view, it's not all about the numbers behind the strategy, it's about the strategy behind the numbers. Organizations need to understand the key drivers of value in their business, make sure they have a clear line of sight between data and their strategic priorities, and be certain they have the processes needed to convert data into actionable insight.

Jeffrey Kollin, the lead Advisory principal in KPMG's Alternative Investments practice, said the best organizations "use the latest tools for two distinct reasons: They focus on the highest level of productivity as possible by reducing manual processes, and they analyze data to produce the best return on investment possible for their clients."

Despite the advantages of data analysis, KPMG learned in a recent survey report that it is a tool not used widely, primarily because of trust issues. "Given the power that it holds, trust in D&A should be a non-negotiable business priority. Yet our survey reveals that this may not be the case. In fact, 60 percent [of 2,000 business organizations across the world] say they are not very confident in their D&A insights."[1]

"Leveraging the power and knowledge that comes from analyzing data is essential for alternative investment funds. The organizations that are using these tools in the most productive ways are the businesses that are winning. And, that's what this is all about.

"This is a very competitive business, and fund managers need to use every tool available to them to help them win."

— **Ben Lewis,**
Director, KPMG,
Advisory, Strategy

[1] "Building trust in analytics," KPMG International, 2016.

Enabling growth through SaaS

SaaS continues to assist in the automation of day-to-day functional tasks, from finance to human resources, freeing up more professionals in fund operations to build the client base and bring in more assets under management.

As important, SaaS is enabling funds to make important changes across the enterprise.

"While SaaS is assisting in the change challenge, it also is an enabler of productivity," Lewis says. "It frees up bandwidth so that many more people can be more involved in the actual business of building the client base."

It works primarily as a tool to outsource human resources and similar functions to the cloud and cuts down on certain infrastructure costs, which can help smaller operations compete with larger funds.

Specialty SaaS applications have been introduced into the industry as fintech has taken root in the alternative investment industry. Consider how it is now being used in commercial real estate: One business, CrediFi, has aggregated data on 10 billion square feet of commercial real estate in the United States. It landed $8 million in additional funding to expand its cloud service and provide data on property loans, occupancies, real estate investments, and compliance and legal issues.[2]

"In this case, the SaaS product is designed to remove friction from a fund business, and then the business can become quantitatively oriented," Lewis says. "When you think about quants [quantitative analysts], you typically think about them at the really large funds. But, with more software like this coming into the market, it lowers the bar in terms of being able to scale, and that helps with competition. That's a trend I think we'll see in the industry into the next few years."

Blockchain/distributed ledger technology

As with so many aspects of innovation in the industry, there are many buzzwords used but few that are actually understood. "Blockchain," "distributed ledger," and "consensus mechanism" are a few examples.

Each day, we hear more references to blockchains and other distributed ledgers, and with good reason.

Blockchain's distributed ledger technology uses consensus mechanisms, which offer the potential to drive efficiencies, reduce reconciliation time, and be leveraged to execute real-time transactions in discreet, secure, and highly cost-effective ways. It represents a shift in how organizations can manage transactions and appears to be on the road to becoming the destination platform for financial services companies.

[2] "CrediFi Scores $8 Million to Mine Commercial Real Estate Data," *The Wall Street Journal*, May 11, 2015.

Entrepreneurs and financial services companies, including fund managers, as well as some of the world's biggest banks and technology firms, already have invested billions of dollars, a considerable amount of talent, and other resources to explore and develop this technology for a wide range of potential applications.

"It's a complex concept in the alternatives business, but the blockchain/distributed ledger technology in the alternatives business is real," Lewis says. "Underneath the hype, a distributed ledger is improving productivity in a variety of different processes — whether it is because it is a distributed database without a central server or because it speeds up the sharing or dissemination of critical information. In effect, this is a forcing mechanism to replace some legacy infrastructure and legacy business models."

In 2017, we expect alternative investment fund management firms to expand reliance on blockchain technology, although that does not necessarily mean they want to build the technology. We expect blockchain start-ups that already have traction in the industry, to accelerate pilots and seek out more industry participants who will need to decide if they will participate or not.

Key considerations in alliances with fintechs

- Do we sign a partnership agreement?
- Do we invest or take a minority position in a start-up or two?
- Can we structure deals that don't preclude us from working with start-up competitors if necessary?
- If we execute a partnership agreement, do we know what part(s) of our business we would give up if we take the plunge?

Terminology

Blockchain, distributed ledgers, and consensus mechanisms are sometimes used interchangeably.

Blockchain: A type of distributed ledger database that maintains a continuously growing list of transaction records ordered into blocks with various protections against tampering and revision

Distributed ledger: A digital record of ownership that differs from traditional database technology, since there is no central administrator or central data storage; instead, the ledger is replicated among many different nodes in a peer-to-peer network, and each transaction is uniquely signed with a private key

Consensus mechanism: A method of authenticating and validating a value or transaction on a blockchain or a distributed ledger without the need to rely on a central authority; consensus mechanisms are central to the functioning of any blockchain or distributed ledger

Based on recent experiences, KPMG suggests seven recommendations to optimize blockchain agreements:

Understand strategy first	— Understand the scope of the opportunity and implications to the partnership agreement and required investment — For example, smart contracting scope would likely require new system architecture investments while digital ledger features would require less technology investment — Signal gain-share/revenue-sharing desires early in the negotiation
Consider negotiating style	— The potential partner's negotiating style will likely be a signal of post-agreement interactions — Carefully consider the implications of style and cultural issues
Protect core business	— Ensure partnership agreement includes language to protect unique knowledge (e.g., state–level nuances) and barriers to entry (e.g., relationship with customers) — Identify specific data elements that will be exchanged between systems
Avoid exclusivity	— Avoid exclusivity given that the blockchain competitive landscape is dynamic and fragmented with a large number of start-ups — Deciding to exclusively partner with a single vendor in the early days of blockchain technology development would preclude involvement with other vendors that may prove to be more competitively positioned
Protect intellectual property	— Clearly define contributed intellectual property (e.g., use case requirements) and require protections (e.g., auditable destruction of materials) if the partnership is dissolved — Agree on ownership of derivative works — Define intellectual property indemnification, warranties, and liabilities
Code escrow	— Define approach and agent for code escrow so that, in the event of bankruptcy/disputes, the code/software can be accessed
Define metrics	— Define service expectations such as system response times, deliverable due dates, etc.

KPMG observations

Data's power to enable growth, efficiency, and production of alpha is difficult to understate. That said, if there is a common (and sometimes valid) criticism of the alternative investment—and of the broader asset management—industry, it is that the use of spreadsheets and other manual processes remains very common.

Given the upside that D&A presents, it can be difficult to reconcile that seeming contradiction. Yet, it is real. With those comments as a backdrop, we would recommend a few steps for management to consider:

- At funds where the establishment of D&A capabilities remains a topic of conversation rather than action, it is time for the chief executive, chief operating officer, and chief information officer to lay out a time line for the investment in tools and people that are proficient in the discipline:
  - The intended results should include a "customer-first" mentality that builds capabilities for the tens of millions of customers and potential customers to use the variety of mobile devices they already use for other purposes.
  - Data visualization capabilities are a must for customers, whose expectations already exceed many firms' capabilities. Users expect real-time tools, and they will migrate away from firms that do not offer such tools.
  - Provide customers with real-time interaction capabilities with advisors and other staff, and immediately invest in training so that customers and staff can seamlessly interact.
- If the firm has not done so already, immediately examine business and operating models. Fast and profound changes in the industry, along with the ways customers want to be treated by their fund manager, have rendered many models obsolete.
- Focus on what is now known as "regtech," a term that relies on managing data tools to not only more-quickly correspond with regulators, but also hold the potential to gather and analyze the data faster and with more clarity.
  - But do not simply use regtech tools as a means to comply with government agencies; leverage the findings to enhance efficiencies and gather powerful trend data scattered inside the firm in order to avoid duplicating data production and losing it in hidden silos.

Tax innovation in alternative investments

The curtain has been opened. Tax transparency is center stage for alternative investment fund managers.

Tax authorities across the globe, in a coordinated approach, are ramping up demands for disclosure of income earned from alternative fund investments held by individuals and organizations. Leaders of alternative fund organizations consequently would do well to examine their processes to meet those demands.

In our opinion, taking the long view on transforming compliance processes not only would meet authorities' demands, but also could help organizations create greater tax efficiency, build better investor relationships, improve organizational culture and processes, and address current capability limitations of information technology (IT) systems and the people who manage them.

This new age of transparency is the direct result of the Organisation for Economic Co-operation and Development's (OECD) Common Reporting Standard (CRS), which has just now gone into effect.

At its core, the CRS is a powerful measure to counter tax evasion through automated information exchange among the tax authorities, and it builds upon other information-sharing legislation, such as the U.S. Foreign Account Tax Compliance Act (FATCA).

We focus this tax section of our paper on three initiatives, each having separate but somewhat related impacts. Although CRS is front and center, its implementation inevitably, we expect, will create new impetus within the OECD on the Treaty Relief and Compliance Enhancement (TRACE) tax program. This initiative is meant to benefit investors through a reduction in effective tax rates on cross-border investment strategies.

And, taken together, organizations that study the opportunity attendant in CRS and TRACE programs can leverage the technologies needed for compliance as a means to streamline other operations, which could create significant data-reporting process benefits and improve controls and transparency efforts.

Our purpose in examining these tax developments is not necessarily to define the elements of the CRS and TRACE rules. Fund managers have been girding for the implementation of those standards for several years.

Instead, we believe fund managers can pivot from a singular mind-set on compliance to one of seeking opportunities for growth, efficiency, and innovation. Success of these goals hinges on fund managers adopting a proactive approach to planning and commitment to execution in order to realize future benefits.

We believe leverage of investor data collected as the central demands of these rules helps funds increase capital inflows, build better relationships with individual and institutional investors, and create the potential to establish more efficient operational control across the enterprise.

Highlights of CRS

The desire by taxing bodies from dozens of nations for greater tax transparency and for exchanging data automatically with other nations means the job ahead for funds will be complex.

There will be significant additional reporting and due diligence responsibilities centering on disclosure of financial and personal details about account holders. There are potential penalties for institutions that do not fully comply with CRS.

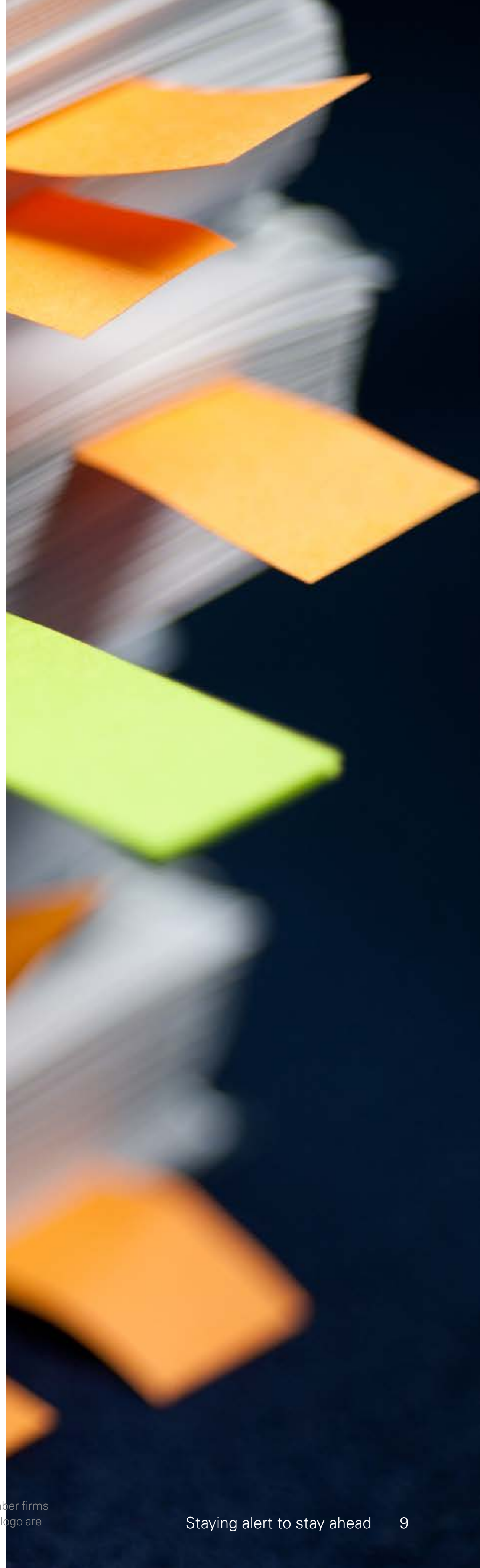
In addition to having to review their existing customer base, institutions also must create new client onboarding procedures to identify reportable accounts. Further, the funds must report interest dividends, account balances, and income and sales proceeds from certain financial assets.

Perhaps most critical in gathering data, residency or tax residency with a particular country, is the decisive factor — not citizenship.

The CRS relies heavily on local anti–money laundering (AML) and Know Your Customer (KYC) requirements and on self-certification by account holders, although it includes some documentation remediation. While the intention is to have a single global standard, requirements may vary across nations, making it more difficult for institutions to standardize their approaches.[3] Consequently, agility and adaptability of people and IT systems may very well separate well-functioning organizations from those just getting by.

	Due diligence on new accounts	Reporting
Wave 1 Many key fund domiciles and most of the European Union, ranging from the Cayman Islands and Bermuda; to Ireland, Luxembourg, and the United Kingdom; to Korea and India	Due diligence on new accounts came into effect 1 January 2016	Reporting to begin in the first half of 2017 based on 2016 information
Wave 2 Includes China, Singapore, Hong Kong, and Mauritius	Due diligence on new accounts commenced 1 January 2017	Reporting to begin in the first half of 2018 based on 2017 information

[3] "Automatic Exchange of Information: The Common Reporting Standard – How Financial Institutions Can Adapt to new Global Standards," KPMG International, 2014.



CRS considerations

- Institute programs that can help ensure that CRS and other data-sharing rules and regulations are understood by key employees across the organization. Education seminars must be regularly scheduled, and any new developments in rules should be immediately communicated across the organization.
- Consider ways to manage relationships with all tax authorities that will have an impact on all of the funds offered by the organization.
- Above all, the organization must be sensitive to how its customers might react to requests for additional investment and personal information. To that end, establish fact-finding procedures that are designed to understand how customers could react, and then adapt any future requests based on the findings.
- Given that the CRS will have a significant impact on the organization's IT systems and processes, stay focused on how to enhance controls to remain in compliance.
- Update prospectuses to reflect the CRS reporting requirements so that investors are appropriately notified that account and personal information is required and how the data will be stored and shared.

A win-win situation … provided data is leveraged

Now that funds have gone through preparation for reporting and due diligence processes necessary for CRS compliance — and thus improving their understanding of their investors' identity and where they reside — fund managers may expect that the OECD will soon revisit its TRACE tax program.

TRACE, still in the formative stage as guidelines, is designed to allow investors to realize reduced effective tax rates or in some cases be exempt from withholding tax on their cross-border investment, which is very common in alternative investment funds.

The TRACE program is primarily aimed at simplifying a process for investors to receive tax treaty benefits relating to income from cross-border investments. Though there is no timeframe for implementation of TRACE guidelines, we expect the program to receive more attention in the months ahead, and we suggest fund managers prepare accordingly.

If TRACE is put into effect, and fund managers prepare, some funds could become attractive to more investors who would realize a lower tax in the future than is currently available.

That scenario might be best explained by using an example of a current Cayman Island–based fund investing into the United States. Investors in that scenario, regardless of their residence, now may be subject to a 30 percent withholding tax from the United States with respect to dividends.

However, if TRACE goes into effect, which would facilitate transparency down to the investor level, investors residing in countries with tax rates lower than that of the United States would pay the tax rate of their resident country. It is not a stretch to suggest that some investors could see their dividend tax rate cut in half.

With that information, funds could aggressively market those benefits to investors, potentially resulting in an increase in capital inflows and an improvement of the fund's profit margin.

"The ability to marry investor and investment data could benefit investors and funds. We are suggesting fund managers study the TRACE program very closely, in anticipation that there could very well be a push in the short term to implement the program," according to John Crager, a managing director in KPMG's Financial Services practice who specializes in alternative investment tax issues. "If these benefits materialize — and we expect that TRACE could be up for discussion shortly — we believe fund performance could improve. And, that would be very beneficial in an environment where margins on investment profits are shrinking."

Technology for insights and compliance

Alternative investment managers seeking to rely more heavily on the power of state-of-the-art technology for purposes of CRS compliance will also need to keep the possibility in mind that the TRACE program may be the next major issue to manage. Technological solutions for that program will be essential.

Think of the ramifications facing a fund organization attempting to understand and deliver reports to 100 countries or more that have signed tax treaties that stipulate sharing of tax data.

However, even if TRACE implementation lingers, compliance with CRS and overall organizational efficiency dictates that managers focus the use of powerful technologies for several critical purposes:

— Establish an integrated approach to the management of new-client onboarding for CRS and FATCA

— Customize the data into formats so that the information can be quickly and precisely delivered to a myriad of jurisdictions

— Build a process with templates, controls, and transparency to manage documents and cases for clients.

Preparing for TRACE

Under the assumption that the TRACE agreement could be implemented within several years, we take the view that:

— Now is the time for fund managers to form an internal group to gather past and current information on the intentions of TRACE.

— All potentially affected fund organizations may find it useful to create tests that could help the organization understand the potential impact of the TRACE standardized system for claiming withholding tax relief at source on portfolio investments.

— It could be necessary to identify administrative barriers that currently affect the ability of portfolio investors to effectively claim the reduced rates of withholding tax to which they are entitled pursuant to tax treaties or to domestic law of the country of investment.

— It would be prudent for fund managers to learn how the OECD's TRACE Group plans to work with specific countries to eventually establish adoption plans for its Authorized Intermediary system. Also, fund managers will want to understand how the potential reporting requirements under TRACE would be aligned to those of other emerging reporting regimes (including FATCA) in order to reduce implementation costs for all stakeholders.

Technology, though, is little more than a collection of gadgets and jumbled strings of code unless it is used intelligently to provide managers with actionable insights about their business processes, client behaviors and demands, and emerging market opportunities.

In this era of disruption and tectonic shifts in virtually every aspect of the asset management business, fund managers are being asked to re-create business models and achieve alpha, all while having to understand and comply with regulation that is bombarding them from around the world. Add to those demands that these managers must deal with the fact that the amount of data in the world is doubling every several years, and their challenge of the job — aside from managing investment decisions — begins to take shape.

It's a job that people alone simply cannot accomplish. They need the power of machines and software that can ingest enormous amounts of information, calculate the implication of that information at the speed of light, and deliver on increasingly difficult expectations from investors, management, and regulators.

Fund organizations, for the most part, do not yet have the required talent to build out these systems and thus may need to co-source or outsource technology solutions. In many ways, fund managers are in a game of catch-up.

Three technology steps to help with CRS and TRACE

1 Manage new client onboarding

- Set a process to leverage efficiencies to gather information from funds and their investors. Information can be consumed in two aspects:
  - Processing account opening and tax documents by leveraging optical character recognition tools
  - Using Natural Language Processing engines to gather data from structured and unstructured documents into a database format.
- Obtain or leverage a rule-based validation check list or system to confirm the review of tax forms — along with comparison to other documents collected from investors for distinguishing and contrary evidence. Big-data databases can be leveraged to store data along with documents in the same record (e.g., Hadoop, NoSQL, CAT, or other tools).
- Establish a monitoring system to review internal and external databases for new information that may change the status of investors under FATCA and CRS regimes.
- Begin working on processes to gather information that could be leveraged for obtaining treaty rates (and "what-if analysis") in the event of TRACE being instituted.

2 Transform data to reporting

- Information required for reporting generally comprises a combination of investor information (see step 1) along with the required financial information from fund managers that is delivered in an XML format. These reports are typically required for specific jurisdictions in which a manager has a domiciled fund.
- Each country has specific rules on data that must be reported. It is important to create a matrix of information required per jurisdiction, and that the matrix be tracked year after year.

3 Manage documentation and case management

- Documentation and case management programs allow users to contact clients in a controlled and consistent manner. Such a program should establish a process for tracking client progress in order to reach a conclusion on whether a client is, or is not, reportable. It also creates a process for storing relevant documentation and for easy retrieval.
- These programs should include templates for client letters and call "scripts" that can be customized for an organization's communications policies.
- Be sure to create a management dashboard, which gives the responsible executive visibility into the volume of cases being created, managed, and resolved.

CLOs - Regulation creates opportunities

Making the best of required rules

When given lemons, make lemonade.

Presented with demands to raise millions of dollars to meet tougher risk-retention regulations, asset managers packaging corporate loans into bonds are seeking to attract more investors by creating new collateralized loan obligation (CLO) vehicles using structures that may benefit not only fund managers but also investors.

CLOs, backed by diversified, syndicated bank loans, typically hold up to 200 loans from more than two dozen industries and carry a credit rating from Triple A to Double B.[4] The new CLOs now in the marketplace as a result of a December 2016 rule are complicated instruments, even for asset managers offering them to investors, most of which are private equity, hedge fund, and other institutional investors such as pension funds and insurers.

The new rule requiring asset managers with CLO portfolios to develop a risk-retention strategy necessitates fund sponsors find creative avenues to raise additional capital in order to meet risk-retention requirements.

Some will view this regulatory demand, created as part of the Wall Street Reform and Consumer Protection Act (aka the Dodd-Frank Act), as onerous, resulting in time away from the business of creating new business. And, while the rule is complex and time-consuming it, in our view, carries the positive potential for sponsors to demonstrate to regulators and investors that they support the "concept of shared investor risk," as a manager recently described it.[5]

What's more, astute investors seeking to realize alpha in an increasingly uncertain market may find the proverbial silver lining in this new CLO rule.

Strategic options to comply and invest

The risk-retention rules under Dodd-Frank enacted October 2014 require that a sponsor or an affiliate of the sponsor of a securitized financial asset retain a minimum of 5 percent interest of the credit risk in the transaction.

Accomplishing that goal requires that managers — and investors — understand available options for risk-retention structures in order to be able to choose the arrangements that fit their needs.

Options include one where the sponsor purchases the required 5 percent interest directly, although such an option could mean an investment of millions of dollars.

For many (perhaps most) sponsors, investing such a sum would be difficult. Since the face value of a typical CLO can range from $400 to $500 million, and, given that most asset managers — unlike banks — are not heavily capitalized, the prospect of a single asset manager having to pony up at least $20 million to purchase 5 percent of the face value would be quite a feat.

Because most CLOs are not public companies and cannot raise funds through public debt or equity issuance,[6] private CLOs typically use a capitalized management vehicle (CMV) where a separate stand-alone entity — apart from the asset manager — would be created.

The CMV would be capitalized with equity investors. The capital of the outside debt and/or equity investments would be used to fund the expenses and the acquisition of the required retained interest. In return, management fees and returns in the retention interest would be distributed to the debt and/or equity investors.

On the other hand, a majority-owned affiliate (MOA) — set up as an affiliate of the sponsoring asset management firm

[4] "Opportunities in CLOs Offer a Reality More Compelling Than Big-screen Fiction," pionline.com, May 9, 2016; "CLO Risk Retention Rules May Lead to Hefty Bill," Reuters, April 19, 2016.

[5] "In Support of CLO Risk Retention, If Not the Rule Itself," asreport.com, December 6, 2016.

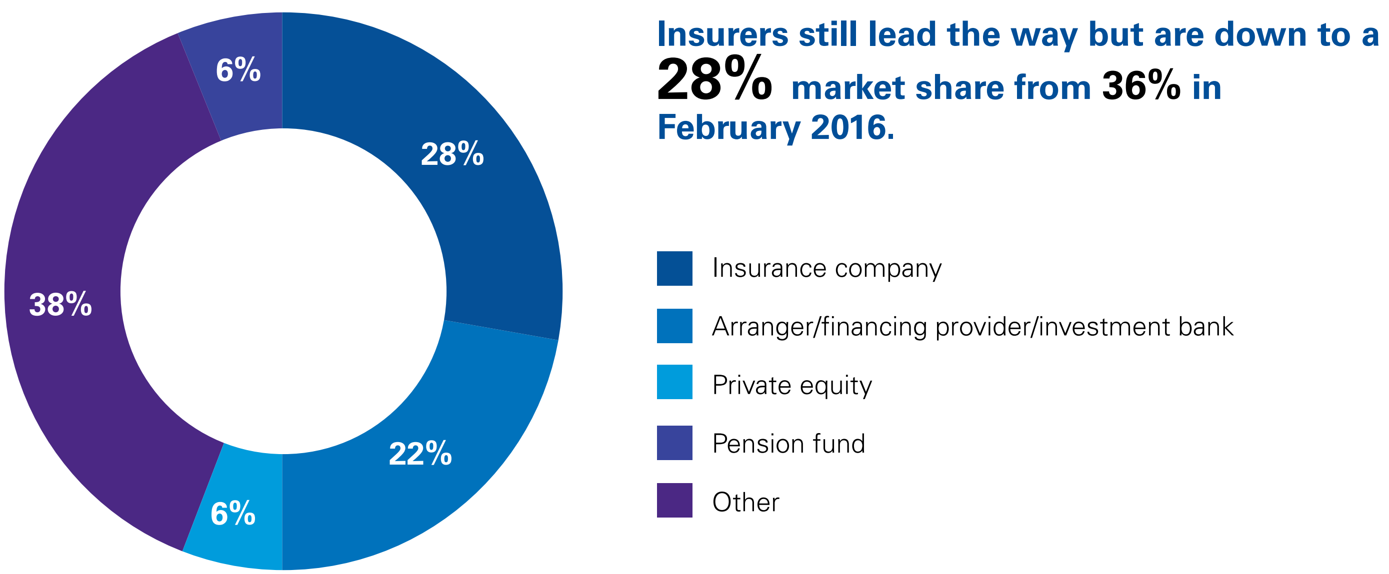
[6] "Managers Untangle New Risk Retention Regulations for CLOs," *Institutional Investor*, July 9, 2015.

that retains the credit risk — allows the asset management sponsoring firm to be the CLO asset manager. The CLO asset manager must, however, own more than 50 percent of the equity in the MOA or hold a controlling financial interest under Generally Accepted Accounting Principles. Ownership in the credit risk of the securitized asset can be in a vertical form, meaning owning a 5 percent piece of each tranche of the multi-tier CLO's notional value, or 5 percent of the fair market value on the equity on the CLO's horizontal position.

A third option, a capitalized majority-owned affiliate (C-MOA), is a hybrid, which allows a collateral manager to raise the amount of money needed to meet the risk-retention requirements for a variety of CLO transactions.[7]

Alternative investors, such as insurance companies or pension funds, are becoming interested in investing directly in the risk-retention structure rather than the securitized bonds offered by the CLO.

Figure 1: According to a Maples and Calder December 2016 survey report; "Risk Retention Survey of US CLO Managers," insurance companies are leading the way in terms of industry types providing financing for CLO financing to meet risk-retention requirements.



Source: http://www.maplesandcalder.com/fileadmin/uploads/maples/Documents/PDFs/Maples_Fiduciary_-_Risk_Retention_Survey_-_Part_II_-_December_2016.pdf

[7] "Capital Manager Vehicles Demystified," Dechert LLP, July 2015.

Investors either in the entities or the securities must understand how the structures fit their overall investment strategy. The investors may need specialized advice in order to gain clear understanding of the implications of the investments and the structures.

Institutions that are investigating investments into the managers seeking to raise funds to meet the risk-retention requirements are attracted to how CLO funds match assets to liabilities over time. CLO funds have term-lives of six or more years, which match up well with insurance company needs. Additionally, CLO funds are currently producing spreads of about 400 basis points, which is attractive in the current low-interest-rate environment. Further, as a partial owner of the fund as an affiliate, the institutional investor can pick up additional returns in management fees.

Challenges and opportunities with CLOs for sponsors and investors

Two developments in the CLO industry are noteworthy: The volume of CLOs available is off its achieved high in 2014, although it remains considerably higher than the high achieved in 2011 (see Figure 2: U.S. CLO yearly volume). Part of the reason for the lower volume in the past two years could be due to the impact of the risk-retention rule's demand for the 5 percent set-aside. Also, there has been a consolidation in the number of asset managers offering CLOs, and there is evidence that there could be more consolidations in the immediate future.[8]

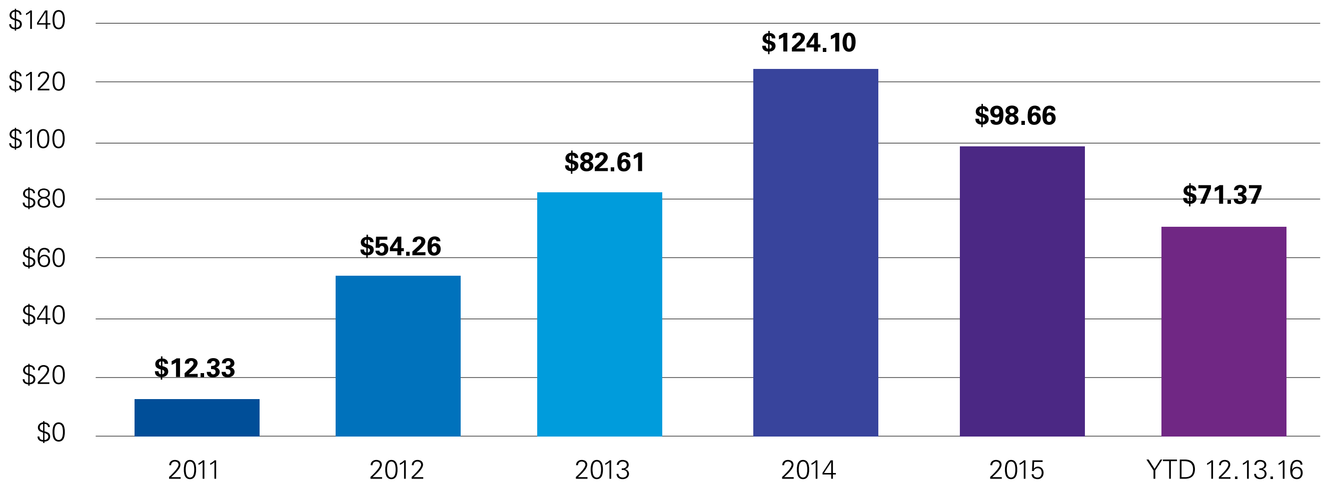
In a February 2014 statement before the U.S. House Subcommittee on Capital Markets and Government Sponsored Entities, Meredith Coffey, executive vice president of the Loan Syndications and Trading Association, suggested the risk-retention rule has "impacted the volume of CLOs being done and the types of managers that can issue CLOs." But it is important to recognize that CLOs are an important source of capital in the economy. A current estimate is that CLOs provide at least $400 billion in financing to U.S. businesses.[9]

We expect CLOs to remain a vital source of fuel for growth and source of opportunity for asset managers and investors alike. Coffey warned that among the "unintended consequences" of the risk-retention rule are "effectively picking winners and losers among CLO managers." Further curtailment could negatively affect the national economy at a time when concerns about credit availability are being voiced across industries.

[8]LCD, S&P Global Market Intelligence research, December 2016; "CLO Risk-Retention Rules May Lead to Hefty Bill," Reuters, April 19, 2016.

[9]LCD, S&P Global Market Intelligence.

Figure 2: U.S. CLO yearly volume



Source: LCD, an offering of S&P Global Market Intelligence

KPMG Observation

- While investing in CLOs is a complex undertaking, they will continue to serve a valuable purpose for all parties – Sponsors, investors, and businesses that seek a source to offer bonds for sale. Consequently, CLO specialists on the sell and the buy side will be in demand due to the rule changes and the resulting structures being created. Sellers and buyers may want to consider outsourcing options to help manage the risks and identify the opportunities associated with CLOs.
- Looking at it solely from the investor's perspective, it is essential for them to understand that, because CLO structures are multifaceted, they must appreciate the impacts of each CLO structure.
- Questions for investors and sponsors to consider:
  - Does the investing party have a review protocol for choosing the types of CLO?
  - How long has the asset manager been in the CLO business, and does it have affiliate investors with a track record with CLOs?
  - Are sponsors targeting long-term investors, and seeking to develop relationships that will bring back buyers for CLO offerings?

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