KPMG — Asset Resiliency Digital Trading Podcast Transcript

July 2023

Presenter

Hello, and welcome to "Global AM Perspectives", a new KPMG podcast series for asset managers, fund managers and investors around the world. Through discussions with leaders from KPMG and major market players, this series will include short episodes that look at some of the most pressing issues, emerging trends and market opportunities within the asset management, real estate and private equity industries.

In this episode we discuss how the leading asset managers are engaging with this increasingly important asset class, key areas where asset managers and investors should focus to help manage their risks and enhance their opportunities going forward and the main reasons that asset managers are keen on crypto.

We are delighted to be joined by Tony Tuths, Digital Asset Practice Leader at KPMG in the US, Gautam Ganeshan Director, Asset Management at KPMG in the Cayman Islands and Kunal Bhasin, Co-Lead and Director of Cryptoassets and Blockchain CoE at KPMG in Canada, to discuss some further findings and steps asset managers can take to succeed when considering digital assets.

With that Tony, Gautam and Kunal on behalf of our listeners I would like to welcome you to the podcast.

Tony if I can come to you first, tell us for asset managers who aren't already trading this asset class why should they be paying attention to it?

Tony Tuths

Yeah. Thanks. The primary reason people, all asset managers want to pay attention to this area is for really the underlying technology, distributed ledger technology or blockchain. That's the type of technology that has the potential to revolutionize finance as we know it by doing, creating things such as instantaneous settlement, real time collateral movements, decentralized finance, or defi, which is just basically software that will permit people to do traditional finance type activities.

Think borrowing, lending, market making peer to peer without a central intermediary. And of course, something like that has a potential to create a greater, you know, greater liquidity pools and also things like fractionalization become possible with blockchain, with meaning. I can take large scale assets, think infrastructure, real estate, or even private fund interests. I can take those and I can fractionalize them so I don't have to sell things in such big denominations.

So things like that have the potential to change finance as we know and so people do want to pay attention to that. And then of course, the other reason you want to pay attention is because of the investment opportunity that's there when these things happen. We know crypto in and of itself tends to be an asset class currently that has high volatility and relatively lower liquidity if you're comparing it to traditional asset classes.

And so if that's an area where your investment teams can thrive, well, that's probably something you want to pay attention to. Probably the other reason that every asset manager wants to pay attention to this area is, even if you don't believe in crypto and you have no interest in going down this road you still want to pay attention because of what is starting to happen in the market, which is tokenization, meaning traditional assets, the ones that you currently trade, whether it's commodities, equities, whatever it may be, they will all trade in tokenized form relatively soon.

And so you want to be familiar with what that is, how it works and what that can do to your portfolio.

Presenter

Thank you for those great insights, Kunal coming to you, what are the key trends that asset managers are seeing in digital assets?

Kunal Bhasin

Thanks, for having me. And we talk about one of the key trends that asset managers need to keep an eye out for. I would say the first one and the most primary one would be the regulatory updates. So in especially in the US, we've seen where Coinbase and Binance, the biggest, largest crypto exchanges in the world, were sued by the FCC for different reasons, even though, you know, the lawsuits were just a day apart from each other.

They were quite different in nature. So I can go into a little bit of details of what that was before diving into some of the other trends that asset managers need to keep in mind. So when we talk about the Binance lawsuits, SEC alleged Binance or several charges, including running an unregistered securities exchange, you know, flouting their KYC rules, mishandling the customer response and misleading investors and regulators.

Out of this, I feel like the mishandling of customer front and the presence of any market making affiliates that are owned by the co-founder of, by the founder of Binance are the most demanding charges at this point. Whereas in case of Coinbase, the charges are really for being an unregistered securities exchange broker and a clearing agency. So one thing to note is that for Coinbase there were no charges around mishandling of any customer funds or illegally trading against their customers.

So, you know, it would be interesting to see how these two organizations respond to the lawsuit by a Coinbase has openly said that they will be taking the SEC to court. So it will be it may be years before we get some regulatory clarity. But on on a little bit of a positive front from a regulatory angle, we do have a digital asset market structure bill that was unveiled by the chairs of the House Agriculture and Financial Services Committee in the US on the same day as the lawsuit against Coinbase.

At this bill really provides a functional framework that would provide digital asset firms with any sort of regulatory authority that they're looking for and fill the gap that exists between the authorities of the CFTC, which is like the Commodities Futures Trading Commission and the SEC. So, you know, there is some positive news happening on the regulatory front and hopefully we don't the enforcement or regulation wide enforcement, but more clarity through some of these bills that are currently being discussed in Congress.

The other key trends I would mention that asset managers should keep in mind is really that there has been an emergence of crypto asset management software for IRIAs are the registered investment advisor and these softwares enable, you know, the advisors to manage dated exposure to their client crypto asset portfolios. So keep an eye out for those and any asset manager that is looking to get into crypto this might be a way for them to provide exposure to their customers or on crypto asset market, as well as making sure that their customers are not going elsewhere or making any risky moves with their asset when it comes to crypto.

The other areas I would talk about is the crypto ETF. There's the ETPs and the closed ended trust. So these are all regulated investment products that the market participants are more familiar with in Canada and in Europe we have the ETF and ETP respectively. However, in the US, we still don't have a crypto based ETF.

There have been a few applications, but none have been approved so far. What we do have is a closed antitrust, such as the GBTC, which may or may not be traded at a discount to NAV. The other area to keep an eye out for the derivatives are like, you know, there's options, there's futures, there is perpetual swaps.

And interestingly, CFTC actually recently approved CBOE Digital to clear any margin Digital Asset Futures and CBOE is now the first exchange/clearinghouse to be able to offer margin to its clients as well. Other high level trends I would keep an eye out for if I were an asset manager was this tokenization of credible assets, especially when we talk about bonds that commercial real estate that like the tokenization and secondary marketplaces are are unlocking liquidity on secondary markets in an inherently illiquid market.

Lastly, I would say there are some protocol upgrades and asset managers are thinking about responsible investment and keeping their investment ESG compliant and Ethereum's move to proof of stake now allows it to be part of a responsible investment that is ESG compliant as well, because its energy consumption went down by almost 99 percent. So, you know, keeping abreast of the various updates in the crypto space is quite, quite important for the asset managers that are looking to engage in the space and offer products and services to their customers.

Presenter

That's great insight. Thank you Kunal. Gautam what are the areas asset managers should want to focus on?

Gautam Ganeshan

Thanks for having me,. given the nature of the asset class as compared to the traditional asset class, there are some unique considerations for asset managers to be aware of. Amongst others, these include custody, valuation and liquidity and technology. From the custody perspective, with digital assets, asset managers are responsible for custodying their assets to a greater degree as compared to in the traditional asset market.

So they need to be aware of the different methods of custody. This includes self-custody external custody or hybrid custody. A self-custody solution is where the manager develops a custody solution themselves and process themselves and safeguards the assets in wallets using policies they've developed internally or with consultants. External custody is similar to the mechanism in where traditional funds engages a third party, either a custodian or an exchange from a digital asset perspective for them to custody the digital assets on their behalf and a hybrid method is where a number of companies are now offering custody as a solution, where there's an element of control by the manager, but it's built upon the infrastructure and technology, which is externally developed. Some things to consider as managers evaluate their options with respect to custody are their ability to design and manage a self-custody operation. Do they have the technical knowledge to do so? And how does it scale as their investment portfolio changes? Secondly, the evaluation of counterparty risk, both in the external custodian and hybrid model is such an important consideration and is often even more important with digital assets as compared to the traditional asset market.

Managers should keep in mind and should consider the controls and processes, their counterparties have relevant to the financial stability as well as do they have industry audits and certifications such as SOC reports in place. The second area of consideration, which an asset manager should be aware of, is with respect to valuation. Digital assets trade in a market which trades 24 hours a day, seven days a week, there isn't a closing time for the digital asset market as there is in traditional markets.

Asset managers should speak with their service providers, including fund administrators, lawyers and auditors, to ensure that their valuation methodologies are in line with best practices and the appropriate standards. And thirdly, from a liquidity and technology perspective, there are various options that managers have to access the market to trade digital assets. KPMG, in conjunction with AIMA, recently released a Digital Asset Trading Guide, which go over some of these considerations and options that managers have include centralized exchanges, decentralized exchanges and OTC platforms, centralized exchanges and OTC platforms are going to use many institutional space will be familiar with, but the concept of a decentralized, exchange, or DEX, is unique to the digital asset environment. And this is where traders can trade peer to peer without the need of an intermediary. One variation on a DEX is a liquidity pool where there is a pool of tokens locked in a smart contract, and that's used for trading between the tokens and a pool. Now, along with these different mechanisms of trading are also technology risks, which are important to consider.

And amongst others, they include making sure that the asset manager interacts for contracts where there have been audits performed, limiting and monitoring of the transfer limits and reviewing the smart contract code. Other measures, which asset managers should also consider when interacting with digital assets are wallet address whitelisting particularly important when using exchanges. IP address whitelisting can minimize the impact.

API keys are compromised and the use of test transactions. That is before sending the assets to an address. When interacting with a third party such as an OTC or foundation to send a small amount to make sure that the details are correct. There are a number of other things to also consider, such as Kunal pointed out from a regulatory perspective, but conscious of the amount of time that we have here today.

Presenter

Thank you Gautam that's great. Tony tell us how this can potentially translate into stakeholders value?

Tony Tuths

Is it within the realm of asset management for investors on the one hand, it creates a more opportunity for alpha, more opportunity for outsized returns because there's a broader investment set that's available to them, both from whether it's the asset managers themselves bringing to their investors investment opportunities inside the fund or the investors going outside the traditional asset management venues and perhaps making investments on their own, using decentralized finance to create peer to peer transactions, what have you.

So for investors, there's definitely a broader, more diversified investment set available to them in that should result in better performance over time. Now, for the asset managers themselves, what they are able to achieve from this is, number one, a much broader and more diversified investor pool. Now in the United States, for example, everybody still has to be an accredited investor to invest in a private fund.

However, the investment minimums that managers often use are quite high and leaves out the massive affluent community with this technology if we tokenize the fund interest, for example, which some prominent fund managers have done recently, this creates the opportunity for smaller bite sized pieces. So rather than having $5 million minimums, we can have say a $100,000 minimum. And traditionally we might not have done this because of the frictions and the effort that's involved in subscriptions or redemptions and things of the like.

But doing it in tokenized forms make it faster, cheaper, easier, so we get a broader, more diversified investor pool. And that's a great way to bring different pools of liquidity to a fund. Also, speaking of liquidity, the other opportunity asset managers have is to offer different liquidity options to people. You know, in traditional funds, we might have, for example, in a closed end fund, there might be absolutely no liquidity.

But being able to allow investors to trade amongst themselves on a tokenized fund might create some limited liquidity where there once was none. And then in open ended funds, you often see quarterly, maybe monthly liquidity options for investors. And there's various reasons one might do that. But if you knew that you had a tokenized a fund vehicle and you were able to do daily subscriptions and redemptions, how would that change your philosophy style is something that's available.

The other thing I would mention is for asset managers is also the opportunity on funding and derivatives, things of that nature. Once they, they and their counterparties and traditional finance firms or defi, as the case may be, are on chain transactions. This creates things that are funding that can be cheaper because we can have real time collateral. We can also obviously have diminished counterparty risk and all asset managers should really be thinking of their current portfolio and asking themselves when this comes to be, which is not that far off in the future, or if I can actually make a lot of this happen today, how would that change my asset mix?

How would that change my portfolio? What are the things that are going to be disrupted? What are the things that are going to be opportunities? So I think for there's a lot of value that can come to the stakeholders from diving into the blockchain world.

Presenter

Great. Thank you Tony. Gautam, coming to you, what are some of the reasons you see as to why firms would be hesitant?

Gautam Ganeshan

Yeah, I think it's something which has already been touched on briefly from Tony and Kunal's comments, but namely one of the things which is raising quite a bit of concern now are the regulatory considerations. And there are a number of countries around the world which are introducing legislation and guidance which has been welcomed by the wider market. But there's still we're still awaiting guidance, as Kunal pointed out, from the United States in terms of how they view digital assets.

In recent days, the United Kingdom in light of the, the guidance that they're putting out there and the environment that they're having there, so we can see that that's one of the considerations which a lot of management, one of the sessions a lot of managers should be aware of before entering the space. Kunal also touch earlier on crypto ETPs, and while they're available elsewhere in the world, there's it's yet to be made available in the United States based upon the physical crypto. Then technology risk may also be something which is deterring some participants. there have been a number of high profile hacks and exploits in recent years which may have concerned some companies. However, recruiting the individuals with the knowledge and experience and putting in place the appropriate risk mitigation measures does reduce the risk.

And as Tony pointed out, digital assets offer another opportunity for managers to generate Alpha. a recent Coinbase and Preqin report, showed that over 2 to 3 and five year horizons, the aggregate crypto multi-strategy and hedge strategies had meaningfully better risk adjusted performance than certain strategies such as equity, long biased and traditional multi-strategy.

So while there may be some reasons to give some pause, considering and implementing measures to mitigate the risks, create a unique opportunity for growth for asset managers.

Presenter

Excellent, thank you Gautam. So Kunal how can KPMG professionals support clients with the transition to Digital Asset?

Kunal Bhasin

Thanks. I would even add to what Gautam was saying as you know, why some of the firms are actually hesitant. I think, you know, it all starts with education, right? And that's really the foundation of KPMG service offerings. So, you know, we can help clients that are looking to engage with crypto assets, we can help educate them, their leadership, we can help them in their, even feasibility analysis and, and a thesis development to get the buy in from the leadership to demonstrate that this is an asset class that they want to be a part of.

So really it all starts with education that we can help out with from there. It's really working with the clients to identify the opportunities that they want to engage in. So helping them narrow down the opportunities and prioritize them based on their, their risk appetite, even, you know, the financial feasibility at the time. So helping them design their business strategy and operational models are all we can help a lot with the vendor assessment I mentioned, you know, the RIAA softwares that are available. So before you engage with one or the other, it's really important to do appropriate due diligence on the vendors, making sure a lot of the risk considerations that cause them. And Tony had alluded to earlier have been taken into account and, you know, the ratings, the risk ratings for these vendors are considered prior to formally engaging with them.

So KPMG can certainly help out with a lot of that due diligence. And all of this really forms part of operationalizing the strategy that we help them with. So that operationalization also includes helping the organization update their, their risk framework or design new risk frameworks as applicable, as well as new policies and procedures, upskilling the teams within their organizations on designing a new compliance program or upgrading one in order to make sure that it embeds all of the requirements as it relates to crypto assets in their jurisdiction and really helping them with all of their policies and procedure upgrades from a Treasury custody suitability standpoint as well.

So, if I just take any eagle's eye view from what KPMG can do, like starting with education to strategy, to operationalization and then helping manage all the risk on their ongoing operations.

Gautam Ganeshan

And just add on to there, from an audit, perspective as well, we're working with a number of the larger companies in the digital asset space from an audit and Tony can talk from a tax compliance perspective, but as Kunal pointed out to helping the companies get educated, get introduced today to the space, and then also work with them on th, an ongoing basis under compliance requirements.

Tony Tuths

Yeah. And of course Gautam right, we all know that the tax system moves a little slower than the innovators in the in the financial system. So we don't have tax rules for all of the assets in the trade here. So we are trying to fit them as best as we can within the existing tax framework. And that's not only in the United States, but all across the globe.

So one thing that KPMG helps our asset managers with is surveying the various jurisdictions in which they're working and keeping up on top of whatever the tax developments are there and creating the safest framework we can for the current tax treatment of these assets.

Presenter

That's great. Thank you Tony, Gautam and Kunal, for taking the time to join us on the podcast today. It has provided great insight and key take aways for our listeners.

To let us know what you think about this episode, or if you have any ideas for future episodes, please email us at assetmanagement@kpmg.com. And remember, you can find our latest publications, articles and other material on kpmg.com/assetmanagement.

Join us again next time as we'll continue to explore other top of mind issues within the asset management, real estate and private equity industries so stay tuned. Thanks for listening.

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