ACA Foreside™

Distribution Digest

Volume 4

Contents

Industry Perspective 4

In The Know 4

Crypto's Wild Ride 5

Wealth Management M&A Update 6

Why the Great Resignation Poses a New Level of Compliance Risk 7

Platform Intelligence 10

Mutual Fund Update 11

ACA Foreside Statistics 11

Intermediary Relationships - Omnibus vs. Networked - Determining the Best Platform Setup for Your Fund 11

ETF Update 11

ACA Foreside Statistics 14

Active vs. Passive 14

Russian ETFs 15

Industry Perspective

The U.S. exchange traded fund (ETF) market ended 2Q22 at $6.2 trillion, down 14.6% from their year-end 2021 high. U.S. long-term mutual fund assets also retreated to end 2Q22 at $16.6 trillion, a 20% decrease from year-end 2021. After experiencing record net flows of over $900 billion in 2021, U.S. ETFs net flows cooled in the second quarter of 2022, but remained positive at $291 billion. U.S. mutual funds in turn saw net outflows of $400 billion in 2Q22 after ending 2021 with net inflows of $309 billion. Although growth of ETFs has been strong over the past 10 years and flows remain positive, ETFs represent less than half of the assets in the vast U.S. long-term mutual fund market, which totaled $16.6 trillion at the end of 2Q22.[1]

Closed-end interval fund assets ended 2Q22 at $59.4 billion across 75 funds, while tender funds reached $50.2 billion across 82 funds for the same period. After a strong year in 2021, the marketplace continued to see new entrants into the space with 11 new interval fund registrations filed and eight new funds launched as of 2Q22. Half of the eight funds that came to market were credit strategies, with the balance split between real estate and private equity strategies. In turn across tender offer funds, registrations totaled eight, with six new funds launched over the same period. The make-up of the six new funds was mixed across strategies with three private equity, two credit, and one real estate.[2]

Expected lower returns in traditional asset classes, inflation concerns, as well as diversification benefits prompted increased institutional investor interest in alternatives over the last few years. Assets under management ("AUM") for alternative assets exceeded $13 trillion at the end of 2021 and are expected to reach $23.2 trillion by 2026 according to **Preqin's 2022 Global Alternatives Reports**. Fundraising, investments, and performance expanded in 2021, led by private equity, venture capital, private debt, infrastructure, and natural resources. After a strong 2021, fundraising has softened and slowed in 2022 as the market looks to understand the macro-economic backdrop of a higher interest rate environment and inflation concerns. Also weighing on investor confidence is the war in Ukraine.

According to **Preqin's Q2 2022 Private Equity Report**, fundraising, deal value, and exit values ($119 billion, $131.2 billion, and $150.7 billion respectively) all declined over the period and may continue to slow as institutional investors look to understand the impact of the market sell-off. Although private equity remains protected in the immediate term from the public market turmoil, longer term higher financing costs and sustained high inflation may erode some of the comparative advantages that private equity has over public equity markets.

Private Debt funds are tracking another strong year, according to **Preqin's Q2 2022 Private Debt Quarterly Report**. Fundraising for the quarter reached $40 billion, bringing the year-to-date total to $93 billion. Investor appetite for safer investments, such as direct lending, is expected to increase as market volatility continues to dominate headlines. Over half (56%) of investors surveyed are focused on direct lending strategies over the next 12 months, followed by 48% mezzanine, and 43% distressed debt.

[1] Morningstar Direct Asset Flows and Net Assets. Data as of 6/30/2022

[2] Interval Fund Tracker

Early signs of recovery for the real estate market are fading as rising interest rates begin to dampen short-lived progress leading to reduced activity. Global fundraising has fallen by almost a third (32%) quarter-on-quarter, and 11% year-on-year. Real estate debt strategies saw the greatest interest with quarterly inflows of $7.7 billion in Q2 2022. Office and retail assets saw additional pressure with continued low occupancy in offices and inflation pressuring consumers purchasing powers. Multiple market pressures across valuations, costs, and returns may drive managers and investors to assume a "wait and see approach" further hindering progress this year.

On the heels of sustained tightness in the commodities markets and strong 2021 returns, natural resources fundraising maintained near-record levels of $51 billion raised across 25 fund closures in Q2 2022. Energy focused funds made up the majority, or $50.5 billion, while the balance was allocated to agriculture and farmland funds.

Private infrastructure also experienced a fundraising frenzy in Q2 2022 as the global energy markets dealt with rising oil prices, and Europe's efforts to be less reliant on Russian hydrocarbons. **Prequin's Q2 2022 Infrastructure Report** revealed $50bn in aggregate capital was raised by just 15 funds in the quarter. Investors flocking to this attractive asset class resulted in the first six months of 2022 securing as much capital as expected over a whole record year.

In the Know

Crypto's Wild Ride

It's been a long and winding road for a spot crypto ETF this year. Bitcoin, the most mature member of the asset class, has yet to turn fifteen but still wants to drive. The U.S. Securities and Exchange Commission (SEC) and Commodities Futures Trade Commission (CFTC) are in conflict about who should be regulating this asset class. Welcome to the never-ending wild crypto ride.

Check Your Brakes

We have seen many times that bitcoin reaches a new high, quickly sheds its gains, then drops back to lows it has not seen in over a year. In its nearly-fifteen years, bitcoin has grown at a rate that makes it the envy of the investment world, as has its younger relative, ether. And yet, the term "crypto winter" has worked its way into common parlance. What drives these stops and starts? While there rarely are perfect roadmaps, nobody likes uncertainty and that is where we find ourselves today, particularly from a regulatory perspective.

Regulatory Traffic Jam

There are few in the industry, regulators included, who would argue that the crypto-asset world has clear guideposts. Naturally, there's agreement that fraud is a bridge too far, but, the rest needs work.

Looming large over recent events is who should be at the steering wheel. After a **recent SEC enforcement action**, CFTC Commissioner Caroline Pham called it "a striking example of 'regulation by enforcement.'" She also noted that the SEC's complaint could have broad implications given the SEC's argument that "dozens of digital assets, including those that could be described as utility tokens and/or certain tokens relating to decentralized autonomous organizations (DAOs), are securities." This comes on the heels of previous comparisons between the two regulators, such as a **June interview** where SEC Chair Gensler noted that the SEC does "full and fair disclosure" really well, but less so in the "oil markets or the wheat markets that the CFTC has." This back-and-forth will likely continue.

Even within the SEC, some see mixed signals. For example, the SEC has previously argued in its support of Bitcoin Futures ETFs that these afford investors the protection of the Investment Company Act of 1940. This seemed, to some, like a reasonable point until the approval of a **1933 Act Bitcoin Futures ETP** earlier this year. One consistent theme within the still-pending approvals of spot-crypto exchange traded products (ETPs) is the SEC's lack of comfort with crypto exchanges. Perhaps all roads lead to regulation of crypto-asset exchanges, but this still seems in the distance.

Watch Out For Potholes

A great deal of the 2022 crypto-asset news has been driven by multiple meltdowns, each with nuances, but all seemingly impacting what felt like a smooth ride the previous year. The Terra ecosystem and its now-infamous algorithmic stablecoin suffered a precipitous collapse, which many blamed on failures of the arbitrage mechanism meant to stabilize the stablecoin's peg. A number of crypto firms, including one of the largest crypto-hedge funds, filed for bankruptcy. Whether one can trace direct lines between these events or not, this year has already served as a harsh reminder that investors must look carefully under the hood.

What Is Around The Bend?

All that being said, where are we? Earlier this year, President Biden released an **executive order** delineating opportunities and concerns about crypto assets, urging cooperation and progress across regulatory agencies, acknowledging innovation while calling for development in "a responsible manner" that reduces "risks that digital assets could pose to consumers, investors, and business protections." Picking up this baton recently, Senators Cynthia Lummis, R-Wyo., and Kirsten Gillibrand, D-N.Y. introduced a bill that attempts to provide comprehensive guidance to the crypto-asset space and sets forth responsibilities among regulators. Overseas, as well, progress has been made, such as EU regulators reaching an early-stage agreement for the Markets in Crypto Assets (MiCA) framework.

In short, the ride remains bumpy, but progress has been made and there is hope for future direction.

Wealth Management M&A Update

With the market uncertainty YTD, many believed there would be a slowdown in wealth management M&A activity following a record breaking 2021, according to **Fidelity's Quarterly M&A Review** for the Second Quarter 2022. Instead, momentum continued with a record-setting 119 transactions across Registered Investment Advisors ("RIAs") totaling $160.5 billion in assets under management, and a 47% and 21% increase in transactions and assets respectively for RIAs over YTD June 2021. Activity favored the RIA space, with the generally quiet and already consolidated Independent Broker Dealer ("IBDs") space only seeing two transactions across $58 billion in client assets, a 60% and 11% decrease in transactions and assets respectively over YTD June 2021. Noteworthy, the RIA marketplace saw $1B+ transactions continue at the same pace with 34 transactions in both 1H 2022 and 1H 2021, while the growth in smaller transactions Sub-$500 million nearly doubled to 59 in the 1H 2022 compared to 30 in 1H 2021. Overall, there is a very competitive market environment that continues to lean towards a seller's market. A strong 1H 2022, amid market volatility and rising interest rates, suggests activity may continue at a rapid pace in the coming months as attentive buyers align with sellers looking to leverage stronger platforms and execute succession plans.

Why the Great Resignation Poses a New Level of Compliance Risk

As regulations constantly evolve, the departure of key personnel is a growing threat. Here's why third-party experts can mitigate increasing legal risk and improve performance.

When it comes to "key-man" risks in asset management, many assume these threats reside exclusively in the front office, or within a firm's investment operations. Amid the Great Resignation, however, fund managers are quickly discovering that turnover in other areas can be just as debilitating to the business, especially to those business operations not perceived as core to the firm's success.

The compliance function, in particular, is generally taken for granted, and often not appreciated for its role in back-office distribution to advance new growth initiatives with regulatory confidence. Yet, when key compliance personnel retire or pursue greener pastures, or when it becomes obvious these functions are understaffed, that confidence can quickly fade.

At a time when the available workforce feels as if it's shrinking, and experienced talent is more elusive than ever, demands on compliance teams and for compliance professionals seems to be growing faster. As the **FCPA Blog** recently observed, the proportion of risk, regulatory, and compliance staff at Citibank, to cite just one example, has ballooned from under 5% of the bank's total employees in 2008 to approximately 15% of its total workforce in 2019. Moreover, the pressure in certain circles is intensifying. The SEC fired a shot across the bow of the private equity industry in the last week of January through **a risk alert** that called attention to inconsistent disclosures, misleading performance information, and other failures in marketing observed across the asset class.

While the world's largest banking institutions can afford to throw money at the talent problem, either by adding staff or enticing the best candidates into back-office distribution roles, most traditional fund managers will struggle to cope when faced with sudden departures. Within the back-office distribution function, in particular, turnover doesn't just create bottlenecks that can slow near-term AUM growth, it creates legal risks that grow more acute each day. Asset managers that, among other things, maintain a Financial Industry Regulatory Authority (FINRA) member broker-dealer primarily for the purpose of providing back-office distribution services, are increasingly turning to dedicated third-party specialists. They don't just fill the void, but bring deep expertise, elastic bandwidth, and innovation to a critical function.

Understanding the Role of Compliance in Back-Office Distribution

Part of the challenge to recruit and retain compliance professionals is that asset managers rarely appreciate all that goes into the roles within back-office distribution. Top candidates don't merely bring legal acumen, they must also have a mix of soft and technical skills. Most of all, professionals are expected to stay on top of ever-evolving regulatory regimes, understanding not just the letter of the law, but more importantly, ongoing precedent and how regulators are interpreting new rules.

New waves of regulation keep coming: Effective last May (and with a pending compliance date of November 4, 2022), the SEC rolled out 430 pages for the new **Marketing Rule** for investment advisors. Among the changes, the SEC redefined what constitutes an "Advertisement," outlined new conditions applicable to testimonials or third-party ratings, and prescribed how exactly advisors can document investment performance in advertising.

The Specialist Advantage: Addressing the Compliance Risks

It only takes one bad FINRA or SEC exam to create expensive complications and reputational damage for firms and individuals. (If professionals are licensed with a broker-dealer, they can be held personally liable for violations.) Meanwhile, other emerging asset categories, including crypto currencies and environmental, social, and governance (ESG), are creating new opportunities for fund managers, and new compliance risks in the absence of clear direction from regulators.

ESG compliance has been a moving target for both fund managers and investors for several years. Five years ago, the U.S. Department of Labor (DOL) **issued interpretive guidance** in favor of incorporating ESG considerations into the fiduciary duties of plan sponsors. In 2020, it **amended** its "investment duties" regulations to reverse previous guidance. This past October, they then **proposed a new rule**, that yet again, opens the doors for fiduciaries to consider ESG as part of manager selection.

Staying on top of these regulations doesn't just inform how investment advisors can market ESG products, but also to whom they should be marketing these strategies to in the first place. The SEC, for its part, spent much of 2021 **soliciting** and **compiling** public comments for an upcoming release of **new** rules related to climate change and other environmental disclosures.

The Specialist Advantage: Finding Cost-Savings and Fresh Innovation

Beyond hedging against the Great Resignation, third-party specialists also yield considerable cost savings. It stands to reason that as fee compression puts pressure on profit margins, and as the costs of compliance and compliance technology steadily increase, the incentive grows for asset managers to look hard at any area that can be efficiently outsourced. For example, one recent trend has seen asset managers shutter their limited purpose broker-dealer and outsource their non-core operations — savings can start at $150K a year in overhead, fixed fees, and net capital requirements alone.

And yet job cuts are not necessarily involved with transferring distribution compliance to a third-party. Asset management staff frequently wear many hats, and the ability to have employees focus on the manager's core business and not be distracted by managing a regulated broker-dealer is a benefit. Moreover, a "lift-out" in which certain in-house personnel transition to the specialist vendor, can also facilitate cohesion and limit severance costs for outgoing employees. The point is that managers have options.

From the perspective of in-house compliance teams, the biggest advantage is in working with experts who know, precisely where the regulatory boundaries lie and through their client base, have seen nearly every scenario across every asset class. It's often the case that in-house compliance teams live on one end of a very wide risk spectrum: they either overlook material risks that will attract regulatory scrutiny or adopt an overly conservative posture that prevents firms from fully articulating their edge or promoting new strategies effectively. Specialists who work across hundreds of clients, and are in regular contact with regulators, bring an innate understanding around how different regimes interpret law that by design is principle-based and broad in scope.

The expanding reach of ETFs illustrates the benefit of third-party expertise. For traditional mutual fund managers that are looking to roll out ETF products for the first time, or **convert a mutual fund into an ETF**, in-house staff, unless they've navigated these waters at previous employers, rarely understand the regulatory nuances involved. These may include compliance program policies and ETF-specific operating procedures, developing Authorized Participant contracts and approaches to AP contract negotiation, as well as other overlooked requirements to create a dedicated ETF-servicing capability. An outsourced specialist can implement these protocols quickly and efficiently, generally in as little as one month's time.

The Great Resignation is not a fleeting phenomenon. Outsourcing back-office distribution compliance can certainly mitigate the recruiting and retention challenges that are only becoming more acute for highly skilled positions in narrow niches. But the benefits extend well beyond risk mitigation and cost savings: It's also about turning regulation from an obstacle into a catalyst for innovation.

"This article originally appeared in ***ETF Express*** *on March 14, 2022."*

Platform Intelligence

ETF Secondary Market Does Not Need Selling Agreements

The question around selling agreements comes up quite frequently as asset managers who have been previously focused on mutual funds look to enter the market with an ETF. Uniquely, ETFs operate in two markets that involve different types of market participants – the primary market and secondary market. In the ***primary market***, focus will be on building relationships with Authorized Participants ("APs") and Lead Market Makers ("LMM"). APs are broker-dealers who are creating the market for your ETF. They will enter into a relationship with the fund through an AP agreement and will manage liquidity and pricing/bid/ask spreads through the creation and redemption process. ACA Foreside, as a legal underwriter, will work to enter into those agreements with APs, as well as verify and confirm AP orders. That said, most trading usually occurs in the "secondary" market, or on an exchange, where investors buy and sell existing ETF shares. In the ***secondary market***, agreements to make an ETF available are not generally necessary.

Since an ETF is traded like a stock, some intermediaries will make it available once it is listed on an exchange, while others have requirements that need to be met or a robust due diligence process which must be followed to vet the product prior to making it available to its advisor base. Although the requirements vary, they tend to include AUM levels, track record lengths, performance, fee alignment with peers, tracking-error guidelines, and demand from the field. It is important to keep in mind that even if the stated requirements of a platform are met, it does not mean the product will automatically be reviewed or made available. Initial access for an ETF will be through the multi-channel supermarkets or custodial platforms, which generally allow for an ETF to be available upon listing. That said, although open architecture in nature, there can still be restrictions or additional hurdles for some ETF product types or structures.[3] The landscape is continually evolving, and intermediaries are constantly modifying or establishing formal processes and programs in support of the product. Determining access to the ETF upon listing is a key factor that will drive your distribution strategy and success.

[3] At Schwab, semi-transparent active ETFs require an agreement in place prior to making them available.

Mutual Fund Update

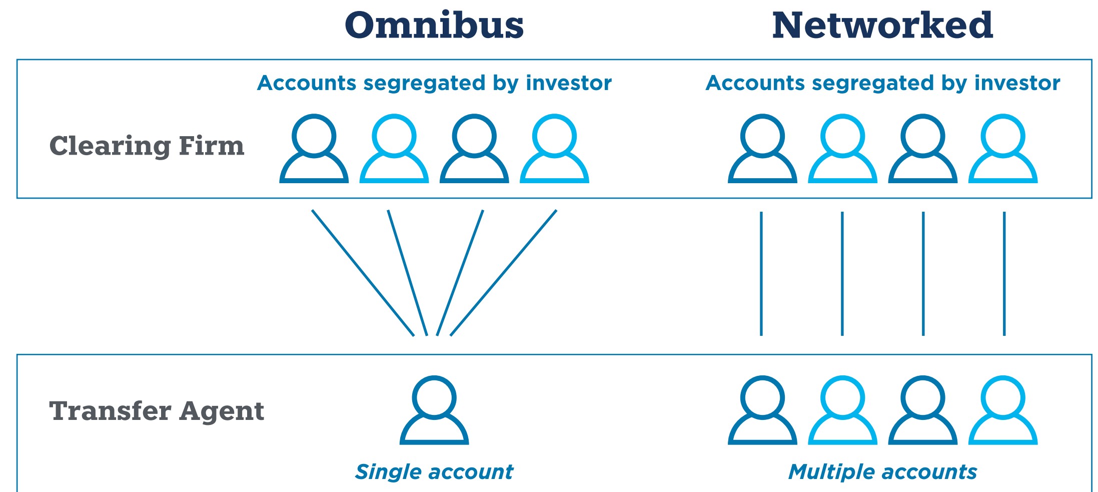
ACA Foreside Metrics

(Statistics as of 06/30/2022)

Intermediary Relationships – Omnibus vs. Networked - Determining the Best Platform

Setup for your fund

Omnibus accounts allow for managed trades of more than one investor held in the name of the associated intermediary in a single account at the transfer agent. A networked relationship involves an intermediary placing separate purchases and redemptions across separate individual accounts. There are several factors to consider as Funds weigh the pros and cons of each potential setup option: cost, feasibility, and data visibility.



Cost

Platforms typically charge a per account "networking," "administrative," or "recordkeeping" fee in the range of $12 - $20 per account. In addition to this platform fee, a fund will also typically pay a per account fee to their selected Transfer Agent in a similar cost range to maintain shareholder accounts. In contrast, omnibus accounts are most commonly billed by the Platform on assets under management at a rate in the 10 – 15 basis point range, while funds typically enjoy a cost savings on their Transfer Agency bill as the number of accounts are reduced to a single omnibus account. The consideration then becomes a mathematical problem on average account size. For example, a fund's breakeven account threshold on hypothetical fees of $28 in a networked account (to factor in Transfer Agent cost) or 10 bps (.001) on an asset balance of $10,000,000 could be calculated as (10,000,000 x .001 = $10,000 = $28 x 357 accounts). If a fund were to add a 358th account in this example under this Intermediary, it would then become more cost effective to roll-up to an omnibus relationship.

It is also important to note that omnibus capability may come with additional ancillary costs, primarily through the Omni/SERV service offered by the National Securities Clearing Corporation ("NSCC") at a monthly cost of $1,500. The service streamlines the transmission of activity and position files for participating platforms, improving transparency for omnibus relationships.

Feasibility

Many large platforms either prefer or now require funds to onboard products in an omnibus fashion. This is a forward-thinking strategy by an intermediary as they seek to avoid the task of converting a fund's networked relationship to an omnibus relationship at a future date. These manual, time intensive conversions are often referred to as "roll-ups" because many networked accounts are combined into a single account for trading purposes. Conversely, some funds prefer to start a platform relationship on a networked basis for perceived advantages on initial platform fees. Naturally a fund does not have many accounts at a platform on day one of availability. Once a fund determines it would like to request an intermediary to roll-up its networked relationship to omnibus, the intermediary may have a waiting period based on similar fund requests, typically creating a platform fund roll-up queue in the range of 3-24 months, or outright rejection of the fund request to roll-up. This could cause a fund to be subject to higher invoice payments for an extended amount of time.

Data Visibility

One benefit funds often take for granted on networked accounts is the general visibility of account and rep level information without the need for an additional sales data vendor. This information can be extremely valuable to firms from a marketing perspective and all of the potential costs associated with a fund's marketing strategy. Under an omnibus account, there is more anonymity as this data is not readily available. Sub-accounting data that does exist can be extremely difficult to unpack from data files that are produced. Disparate forms of this and other sales data often lead funds to hire a sales data vendor to achieve their sales and marketing goals. This can affect commissionable products as they look to accurately compensate their wholesaling teams. Some platforms have even made it difficult to receive any omnibus sub-accounting data at all.

In summary, the best decision for your fund will depend on the variables discussed: average account size, ease of compensating wholesalers, estimated pace of account growth at platforms, platform fee rates, and the number of omnibus platforms involved to justify support of other omnibus service infrastructure costs. Feel free to **contact the Dealer Services** team at ACA Foreside for further details.

Omnibus	Networked
Subaccounts of multiple investors	Single investor account
Account appears in name of financial intermediary	Accounts appear in names of individual investors
Limited transparency into account and rep level data without enhanced sales reporting	Visibility into account and rep level data through transfer agent
Intermediary performs sub-accounting	Transfer agent performs sub-accounting
Higher fees charged by intermediary to maintain shareholder accounts	Intermediary fees in addition to transfer agent fees charged to maintain shareholder accounts

ETF Update

ACA Foreside Metrics

789	$184 BN	66	167
number of funds	assets	trusts	issuers

(Statistics as of 07/31/2022)

Active vs. Passive

The ETF wrapper was originally designed to offer investors a stock-like experience (single security that trades intraday) that passively tracks a diversified index, such as the S&P 500 or Nasdaq-100. Over time, index providers and issuers began adding tilts, sector focuses and weightings, and overlay structures, to name a few, to enhance alpha.

Fifteen years after the first ETF debuted, the first actively managed product hit the shelves. This paved the way for active issuers to put their strategy in an accessible and efficient wrapper, allowing complete control over security selection for the portfolio. Despite this, active ETFs were slow to take off, with full transparency often cited as the reason for hesitancy.

Another 15 years after the debut of active ETFs, active launches are now outpacing passive with 64%[4] of the overall ETFs launched last year being active. Although assets in active ETFs make up a small portion of the overall ETF market, **about 5%**, the growth of active ETFs is outpacing that of passive ETFs.

The active space has allowed managers outside the top-5 issuers by assets to create a niche for themselves. Although the top five generally have actively-managed ETFs, smaller shops have been able to flourish with active ETF suites.

In 2019 the SEC approved a new type of ETF wrapper, allowing semi-transparent ETFs to shield their holdings. This gives active issuers further options to bring their strategy to market. While there are a number of different models of the semi-transparent wrapper, generally these structures allow issuers to reduce the level of transparency on the portfolio's holdings, whether by obfuscating weights, substituting securities, or reducing the frequency with which they disclose holdings.

[4] Morningstar Direct

Russian ETFs

Recently there have been serious **geopolitical issues in Europe** that have caused extreme volatility in the markets and even lead to some securities being halted and delisted. Many emerging markets ETFs have marked portions of their portfolio securities to $0, and some Russia-specific ETFs have closed to creations or have liquidated.

For firms that have already issued, ACA Foreside suggests working with counsel to understand what the fund is allowed to do in certain situations such as volatility or delisting securities and communicating the decision to your various service providers to ensure all are aware of any changes. This will ensure the smooth operation of the ETF regardless of the underlying market conditions.

About ACA Group

ACA Group ("ACA") is a leading governance, risk, and compliance (GRC) advisor in financial services. We empower clients to reimagine GRC and protect and grow their business. Our innovative approach integrates advisory, managed services, and distribution solutions with our ComplianceAlpha® regulatory technology platform with the specialized expertise of former regulators and practitioners and a deep understanding of the global regulatory landscape.

About ACA Foreside Distribution Solutions

We work with asset management firms throughout the world to facilitate compliance and product distribution through legal underwriting, registered representative licensing, and DTCC/NSCC fund sponsorship. We have experience working with all types of pooled investment vehicles such as mutual funds, exchange traded funds (ETFs), alternative products, closed-end interval funds, business development companies (BDCs) and private placements.

For more information, please email **busdev@foreside.com** or **visit our website here.**