HEADSPACE

December 24, 2024

Babylon & Investment Manager Annual Planning: 7 New Year's Resolutions for 2025 (& Beyond)

EXECUTIVE SUMMARY

- At this time of year, investment managers are often in the process of planning for the upcoming year, and potentially even multiple years ahead. As we reflect on 2024, several compliance and risk topics emerge as potentially beneficial focal points for 2025 and beyond.
- As investment managers contemplate areas of focus, resource needs, and potential opportunities, the following seven key compliance and risk topics should be kept in mind:
  1) The impact of making alternative products available to more mainstream investors;
  2) AI, robotics, and the "Compliance Officer of the Future;"
  3) Intensified and broadened global geopolitical conflict and warfare;
  4) Outsourcing;
  5) Form ADV Part 2A (Brochure) maintenance and validation;
  6) Substantiation of claims and representations; and
  7) Reducing the volume of written communications.
- At a minimum, investment managers should be intentional around how they decide to navigate each of the foregoing, the vast majority of which will be relevant for not only 2025, but for the foreseeable future.

INTRODUCTION

It seemed appropriate to make this month's essay a little more festive given the time of year it is – and how long and trying of a year it's been. So, I thought creating a list of "New Year's Resolutions" for investment managers to consider for 2025 would be a fun yet useful exercise. But as so often happens when drafting these, I found myself taking a brief research detour when I ended up asking a very basic question: "Where did New Year's resolutions come from?" The answer, as I found: the ancient Babylonians, 4,000 years ago. Without veering off course too much, the Babylonians made promises to the gods to pay their debts and return any objects they had borrowed during a 12-day festival known as Akitu. If they kept their word, their pagan gods would bestow favor on them for the coming year. If not, they would, euphemistically, fall out of favor (and we think our banking system has shortcomings!).

While the somewhat malevolent roots of New Year's resolutions don't have a place in this essay, this essay does offer several that investment managers may want to consider adopting as we reflect on what 2024 has held and how 2025 may shape up given current geopolitical, economic, and market environments. Babylon fell of course. Whether that's because they broke promises to their gods or simply didn't engage in thoughtful planning, I don't know. But, I do believe the "resolutions" that follow – some of which are "shinier objects," others of which are more "meat and potatoes" – can position investment managers for success for the year ahead and what seems to be a "new normal" for us all.

"MAINSTREAMING" ALTS

Investment managers and Compliance professionals should develop/continue developing a deepened understanding of private credit, cryptocurrency, and other alternative products to adequately assess and advise clients regarding the appropriateness of their use (depending on the particular circumstances). Compliance professionals should also partner with investment and product personnel to adopt and implement suitability, risk mitigation, and disclosure frameworks to ensure more mainstream investors – such as individuals, pensions funds, and pooled investment vehicles designed for these and similar investors – are not assuming uninformed and/or undue alts risk.

From crypto to private credit, the topic of alts seems *en fuego*. As reported last week, there has been a significant uptick in advisor demand for alternatives, with that demand bubbling up from retail clients. Investment managers seem to be in a race to add or augment private credit capabilities in particular, and in the context of crypto, one study earlier this year indicated that of 1,000 retail investors surveyed, 64% already were invested in digital assets or related products, with another 69% planning to increase such investments in the next two to three years. As of the end of September, it was reported that even U.S. pensions have increased their holdings (e.g. at that time, the State of Wisconsin Investment Board and State of Michigan Retirement System combined held more than $107 million in Bitcoin ETFs). The alts momentum seemed to continue, with the price of Bitcoin hitting $100,000 for the first time earlier this month. President-Elect Trump has also vowed to ease the regulatory burden on crypto, with his first steps toward this, it would appear, being his choice of Paul Atkins as the next SEC chair – a crypto company adviser and "consigliere." Yes, there may have been mainstream investor wariness toward investing in alternative products over the past several years, and certain investment professionals remain skeptical. However, data showing their increased adoption by and interest from investors, coupled with burgeoning governmental legitimization and destigmatization in certain respects, should command investment managers' attention. Investment managers should be prepared to field questions and interest from more mainstream investors on the use of alts in their portfolios and offer informed advice and recommendations (particularly given the potential risk such products some believe pose). This advice should be supported by a Compliance program framework that reasonably ensures robust suitability assessments, risk disclosures, and other appropriate risk mitigation are occurring.

THE COMPLIANCE OFFICER OF THE FUTURE

Investment managers should be designing overall AI strategic plans, and such plans should include formally researching robotic and AI tools available in the marketplace to enable Compliance professionals to transform from knowledge and mechanic/process-based workers to strategic/thought partners. Investment managers should also be exploring formal training and "reskilling" programs to make available to employees (or even mandate for them), whether such programs are internal or external.

In 1950, British mathematician Alan Turing published a famous vital step toward machine intelligence in his paper "Computer Machinery and Intelligence." In this paper, Turing proved that any solvable mathematical problem could be solved by a machine; in the same stroke, he also pointed the way toward how computers could be programmed to become all-purpose machines solving logic-based problems and conducting logical analyses far beyond the field of mathematics. Fast forward to 2019, where the Organisation for Economic Cooperation and Development forecast that within 15-20 years, new automation technologies were likely to eliminate 14% of the world's jobs and radically transform another 32%. With information – and large amounts of it – able to be retrieved and processed by robotics and AI, sunsetting are the days where a Compliance Officer will be needed to evaluate whether a trade by an individual constitute front-running, or whether brokers obtained satisfactory execution based on transaction cost analysis. The SEC has already been employing technology and methodologies to do just this. Rather, Compliance professionals will be increasingly relied upon to do two fundamental things. First, instead of serving as information processors based on what's fundamentally a mechanical exercise of "decision-treeing" information, a greater proportion of a Compliance professional's day will and should consist of rendering advice, counsel, and decisioning based on analysis already conducted by AI. By way of a simple example, in the instance of front-running, Compliance professionals should be focusing more on things such as appropriate discipline and remediation for the circumstances, and thinking more about mitigation strategies in the future. Second, Compliance professionals will need to and should begin to think more like data scientists. For example, in the instance of best execution, rather than simply analyzing TCA reports, Compliance professionals should be thinking about different types of data, other points of inquiry, and different technological needs to more deeply assess best execution. Of course, this will require not just a shift in mindset, but also training and reskilling. The role of "Compliance Officer" will and should still exist, but what that means will and should look notably different than what it does today. With respect to reskilling, investment managers can determine whether to pursue such an effort internally (as organizations like Amazon, Vodafone, Wipro, and even McDonald's have done), or consider leveraging a number of AI training and reskilling programs offered through academic institutions such as MIT, the University of Texas, and myriad other more regionally and locally based colleges and universities. Ultimately, investment managers should be asking themselves, "What type of work do we see our Compliance Officers truly adding value to, and how do we evolve toward that?"

WORLD WAR III

Investment managers should ensure they are being thoughtful and intentional when evaluating and reacting to rapidly evolving geopolitical risk. Measures to consider can include reevaluating the sufficiency of their and their vendors' cybersecurity programs; reevaluating their and their key vendor dependencies and operational resilience based on geographic locations; reexamining risk disclosures in prospectuses, Form ADV's, and other investor materials; and reexamining whether existing investment risk & analytics practices are sufficiently designed to continually assess the investment risk the current and future geopolitical climate may present.

"Has World War III Already Begun?," was an essay featured in *The Wall Street Journal* the week before last. The question of what constitutes a "war," along with its official "start date," is not meant to be the focus here. But, as I'm sure many of you may have thought as well, with North Korean troops being ferried into Ukraine via train through Russian territory, Israel continuing to improve its position in the Israeli-Palestinian conflict, and numerous countries staking out territories and positions in and around Syria, the numerosity of full-scale open conflict in multiple locations across the globe has many "world war" attributes. And this doesn't even include the publicly disclosed cyberattacks Russia and China have been making on the U.S. (or vice versa for that matter). My point is that geopolitical risk seems to be more prevalent and intense than it has been in recent years, raising questions about market stability, cybersecurity vulnerabilities of nation states and private companies alike, operational risks for vendors based in certain locations, the potential for increased and more complex sanctions, and a host of other topics. With the deeply interconnected nature of the modern world, these global geopolitical conflicts have the potential to be felt by investors more acutely. It would seem prudent to account for this potential risk on a number of fronts, including: investor disclosures, cybersecurity assessments, business continuity assessments, vendor risk assessments, and investment risk analytics practices.

OUTSOURCING

Notwithstanding a nebulous future of the SEC's proposed Outsourcing Rule, investment managers should not "put pencils down" on designing and enhancing their third-party risk management programs and methodologies.

In a larger meeting I was in shortly after the POTUS election, a colleague remarked to the group, "The [Advisers' Act] Outsourcing Rule is dead for all intents and purposes." The group nodded in agreement. Maybe, maybe not; but it doesn't necessarily mean that investment managers should deprioritize implementing sound third-party risk management programs and methodologies. Outsourcing is not going away, and the case for investment managers to outsource certain functions is becoming more and more compelling. Outside of any regulatory imperative, investment managers should have a business interest in understanding the types of risks their existing and prospective vendors present to their ability to deliver investment management services to clients and not create undue risk of client harm. Building and continuing to evolve third-party risk management frameworks will allow investment managers to adequately understand important risk areas relative to vendors, including cybersecurity, use of AI, business resiliency, and other areas more specific to particular vendor types. For foreign vendors in particular, given the protectionist nature of the incoming Trump administration and global geopolitical environment, it would not come as a shock if the SEC placed heightened scrutiny on investment managers using such vendors, especially if something goes awry.

FORM ADV PART 2A (BROCHURE) TICKING-&-TYING

When performing the annual Form ADV updating amendment, investment managers should also consider tying statements made in the Form ADV Part 2A (Brochure) to their Compliance program environment. Investment managers should consider creating a Form ADV control map that ties each statement or representation in the Brochure to a corresponding policy or procedure that ensures its accuracy and implementation, with a corresponding Compliance test that serves to validate.

One common finding in SEC enforcement actions, regardless of the topic covered (e.g. marketing, electronic communications, trade allocation, etc.) is that an investment manager's brochure may state the manager does or does not do X, but either: (a) the manager lacked written policies & procedures to ensure such statements could be true and/or adhered to, and/or (b) the investment manager failed to test to ensure such statements and/or policies & procedures were being adhered to. When performing the annual Form ADV update, investment managers should not just be thinking about making updates to figures, data, and changes in business and the like. Investment managers should also be examining their brochures and verifying each statement is supported by a corresponding policy or procedure, which is in turn mapped to a Compliance testing program and schedule.

SHOW ME (i.e. SUBSTANTIATE IT)

If an investment manager is going to make certain claims about its business or representations about its business practices, it needs to be sure it can prove it (or at least provide a reasonable basis for why it believes the claim, representation, or statement is true).

Hailing from Missouri – the Show Me State – this New Year's resolution is particularly dear to me. When looking at a number of the SEC's Marketing Rule enforcement actions, one common type of violation noted concerned investment managers' being unable to substantiate claims made in their marketing materials – be it performance-related or more qualitative statements (e.g. "deeply experienced," "expert," etc.). Similarly, in other types of documentation in other enforcement action types, investment managers may state they do or don't engage in certain practices, but when asked to provide evidence proving or a basis for such statements, they were unable to do so. The rule of thumb is simple: anything investment manager says or publishes, it must be in a position to substantiate it in some shape or form, be it through supporting data, documentation, or a sound explanation/justification.

HAVE A CONVERSATION

Rather than sending a Teams message or email, consider popping down to a colleague's office or giving them a buzz on the phone – and even challenge the entirety of the organization to adopt a similar practice. Reducing the amount of unneeded written communications has multiple benefits, including reduced litigation and regulatory risk, as well as improved employee relationships and organizational culture.

Written communications certainly have their place in an organization. They can provide evidence that certain regulatory required functions have been performed and can also serve as a reminder trail when personnel are trying to recall or retrieve facts relevant to a particular matter. However, not everything needs to be nor should it be put in writing. Unless a communication is a regulatorily required record or is needed to evidence the performance of a certain function, investment managers should consider being intentional about the types of things they counsel their personnel to communicate in writing versus via conversation. The SEC's electronic communications enforcement actions over the past several years show the recordkeeping headaches written electronic communications can create. Additionally, creating written records where no regulatory obligation to create them exists creates litigation risk as well, with more records being available to discovery than might otherwise be the case. Certain studies have also shown that relying on verbal rather than written communication actually strengthens bonds and relationships amongst employees, suggesting reducing the amount of written communication can have cultural benefits as well.

PARTING THOUGHTS

Some may say we are beginning to live in a "brave new world." While that is a philosophical conversation far beyond the scope of this essay, investment managers have always faced increased complexity and challenges since our industry began. While many of these are due to exogenous forces and factors, there are also many that are the result of the minds of our own industry looking for new ways to offer value to clients and obtain a competitive edge – which I think should be championed and embraced, provided such efforts are pursued responsibly and thoughtfully. I do believe we are at the beginning of a transformational epoch on many fronts in our industry and world at large, but I also don't know that such periods are unprecedented in the arc of human history. Nor do I think investment managers lack the tools and foundational principles they need to travel successfully over this continually extending arc. Will new tools and principles emerge along the way? Probably, but let us end on two quotes, the first by businessman, writer, and futurist Alvin Toffler, the other by Henry Ford:

> *The illiterate of the 21st century will not be those who cannot read and write, but those who cannot learn, unlearn, and relearn.*
>
> – Alvin Toffler

> *Anyone who stops learning is old, whether at twenty or eighty. Anyone who keeps learning is young.*
>
> – Henry Ford

With that, cheers to continually learning and growing, and building towers that won't fall.

Happy holidays and New Year, everyone. And as always, thanks for reading . . .

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