

AIMA JOURNAL



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Looking ahead: A review of FCA and SEC priorities,
and what to focus on in 2022 - *ACA Group*

ESG trends that could impact fund managers in 2022 - *Clifford Chance*

Trustless, but verified: Identity compliance in Web3 - *Parallel Markets*

The war in Ukraine: Seeking redress through
investment treaty claims - *Simmons & Simmons*

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“ Message from AIMA’s CEO



Jack Inglis
CEO, AIMA

In the previous edition of the AIMA Journal, I had the occasion to describe how the environment of the moment was centred on the outbreak of war in Ukraine, increasing headwinds in both the public markets and digital assets, along with the lingering effects of COVID-19 on global financial markets.

Plus ça change, plus c’est la même chose!

This edition goes to press in the wake of another sharp downturn in crypto markets, with the S&P 500 down 25% year-to-date, and concerns of runaway inflation levels not seen in over 40 years! Meanwhile, Russia’s invasion of Ukraine has passed its 100th day with no end in sight.

One topic that is largely absent from the Journal for the first time in a long time is the pandemic, which appears to have receded or at least been superseded by more urgent issues.

With so much going on, readers will be forgiven for not being focussed across the extremely busy pipeline of regulatory proposals emanating from the US’ SEC and the UK’s FCA. For this reason, we have chosen to open this edition by examining the myriad challenges posed by the potentially disruptive proposals that have been keeping [AIMA’s Government and Regulatory Affairs so busy](#) in recent months. Several articles in this edition address this broad topic from various angles.

Elsewhere, ESG and responsible investing continue to dominate industry headspace, including debates around what ESG means to various alternative investments – including private credit – and whether it offers a source for generating alpha, or how it might affect manager-investor relations in the long-term still live topics examined by contributors.

Although COVID-19 may be off the front page, the lessons learned during the pandemic are still being integrated across the industry. Firms have been exploring new ways of operating their business with a greater reliance on outsourcing, and increased demand for cybersecurity driven by remote working and greater use of digitisation. The practical applications of these changes to some firms' operating models are still top of mind for many and are presented prominently in this edition.

Finally, regional updates are offered for several major jurisdictions for alternative investment, alongside an updated analysis of the impact of the sanctions on Russia on managers with exposure to affected markets or who may have Russian investors.

My thanks to all the contributors who continue to make the AIMA Journal a highly valuable resource for so many.

Jack Inglis
CEO, AIMA



Upcoming AIMA conferences

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8 September

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Looking ahead: A review of FCA and SEC priorities, and what to focus on in 2022



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Governance, risk, and compliance professionals at financial services firms are preparing for a bumpy ride in 2022, as tectonic regulatory plates shift within a rapidly evolving operating environment. As regulators and firms emerge from the COVID-19 pandemic, which dominated the agenda for the past two years, there is catching up to do and new list of priorities. We outline what FCA and SEC registered firms need to prioritise in the months ahead.

Gensler, Brexit and Boris

It is unlikely that the UK will be offered EU equivalence soon, as long as the disagreement over the Northern Ireland protocol continues. The UK FCA is moving ahead with adjusting the EU regulations it onshored post-Brexit to better suit the UK market, with a substantial focus on ensuring the regulatory requirements are proportional to the risks. Meanwhile, the EU is moving forward with its legislative agenda, such as AIFMD II, which was published as a legislative proposal in November and is working its way through the European Parliament now. In the UK, firms can expect more tinkering with elements of EU rules, but probably not any major divergences – such as a rewriting of GDPR – in the near future.

In the US, the appointment of Gary Gensler as chairman of the SEC has led to the most ambitious regulatory change agenda that had been seen for some time. Firms are concerned about this, and more than 60% in the survey said that US rule changes were their biggest concern in terms of their compliance programme. For example, the SEC has proposed sweeping rule changes for private fund sponsors that will have an impact on non-US advisors as well. The SEC has also issued proposals for additional data to be captured on Form PF from private fund sponsors. There are other new rules or rule changes that are expected from the SEC, too, some of which are discussed later in this article.

The marketing maze – SEC Marketing Rules and the ESMA guidelines on marketing communications

Recently the US, UK, and EU have all been introducing new rules that may make it harder for firms to market funds across borders. For example, the US SEC adopted new marketing rules in November 2021, and there are some significant areas where fund sponsors will need to make changes before November 2022, such as around hypothetical performance, and the use of track records when a sponsor is spun off. Firms need to not only be aware of these rule changes and ensure they are fully compliant by the deadline, but also to make sure that relevant staff members are aligned around these changes because they impact the solicitation of investors in general.

Firms should also ensure they are compliant with ESMA's Guidelines on Marketing Communications, which in some ways are quite similar to the SEC's rules – it would be worth setting up a single project to tackle compliance with both. The new rules entail many changes – for example, they require firms to adopt a more retail style of communication for engagement with professional or institutional investors, particularly around performance information. ACA is finding that many firms were previously unaware of these changes, and so it's not a surprise that in the event survey, nearly 24% of respondents said that marketing and navigating access to EU markets will be their primary compliance focus in 2022.

Boarding the ESG train

The EU is the furthest along in developing its ESG regulatory regime, but the UK is catching up fast. For example, in December 2021, the FCA published a policy statement that requires firms to disclose how they consider climate-related risks in their investments and funds.

Now, the US is coming along too. Across the board, the focus seems to be on disclosure-based regimes, and so in the US it's likely that public company disclosure rules are likely to be issued first, followed by rules for advisors. US SEC examiners are very much focused on ESG today – they have conducted ESG exam sweeps and issued risk alerts about issues they have identified in those exam sweeps. So, firms based in the US or marketing into the US should make sure that any ESG disclosures to investors are consistent with and align with their practices. They should also make sure that an actual policy is in place if they discuss a sponsor's ESG policy or ESG considerations in deal-making activity. In summary, firms should make sure that any ESG marketing claims are backed up.

In general, firms need to make sure that their ESG marketing messages align with what is happening in reality in a particular investment or fund. They also need to be sure that the marketing messages are in compliance with the policies of a particular jurisdiction.

The first few months of the IFPR and the MiFIDPRU remuneration code

The Investment Firms Prudential Regime has been in place for just a few months now, so firms are still getting to grips with some aspects of it. Many firms had to work hard to meet the deadline, and so now is the time for those firms to go back over their Internal capital adequacy and risk assessment (ICARA) to ensure that all the inputs are true and accurate. Firms should also make sure their wind-down plan has been approved by the board. The FCA is expecting to see well-considered risk mitigation in the wind-down plan.

For the MiFID remuneration requirements, there are elements that firms will need to be careful of. For example, remuneration disclosure rules may mean that most firms won't have to publish these details until well into 2023, but firms should consider what is disclosed in other regulatory documents, and the possibility that with triangulation it may be feasible to figure out what specific individuals have been paid. Firms will want to consider carefully how they organise themselves, for example, who gets caught up within the material risk taker category.

Electronic communications – Don't shoot the messenger

As a result of the pandemic, at many firms home working is becoming the rule rather than the exception. The UK FCA has made it clear that it still expects both individuals and firms to be compliant with requirements to store and monitor electronic communications. It's important to remind staff that work devices should only be used for work purposes, and that communications on those devices are not private. Firms should also make sure that their e-comms surveillance is up to speed – that the right terms are in the lexicon, and that trade surveillance models are structured for the kind of business the firm does. Lastly, make sure that policies have been updated to reflect the work from home trend, so that remote working is no longer considered an exceptional circumstance.

Other issues ACA encounters regularly include the use of encrypted messaging platforms to chat with clients, such as WhatsApp. Sometimes employees believe that because a messaging platform is encrypted, their messages within that app are not disclosable during a regulatory investigation – this is something they need to be disabused of. Firms should also think about whether they are recording investment committee meetings taking place on Teams or Zoom. For in-person meetings, firms usually produce minutes that document what they want to record from that meeting. Now, regulators may be asking why meetings that take place on a Teams or Zoom platform are not being recorded in full.

To meet all these demands, compliance teams will need to think strategically about how they approach them. For example, are there places where technology could automate processes, reducing workloads, lowering costs, and making those processes more efficient? Or are there compliance activities that could be outsourced, such as marketing approvals? By thinking outside the box in terms of meeting these challenges, compliance teams can achieve their goals and ensure the firm continues to meet its regulatory obligations.

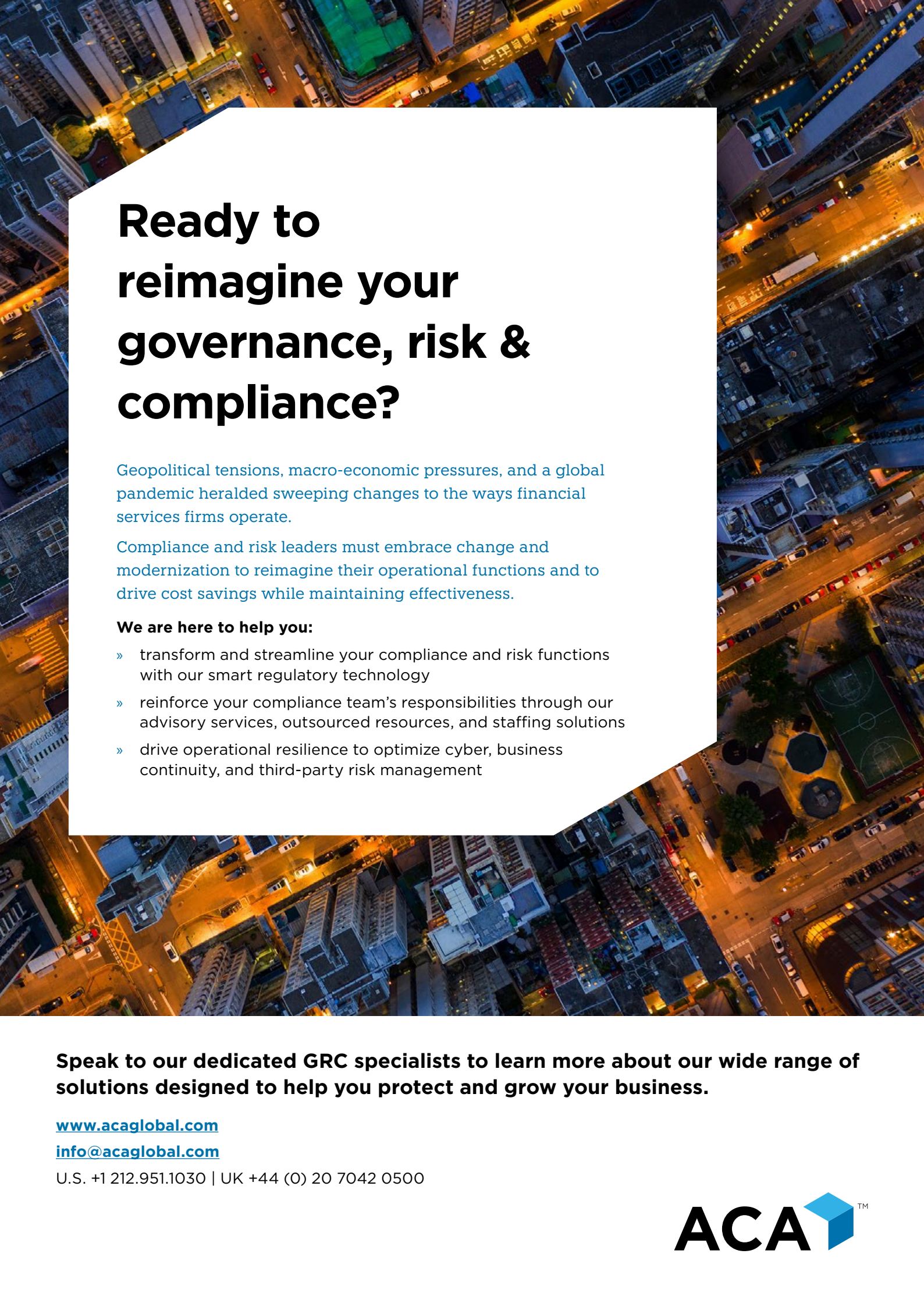
An inspector calls – SEC and FCA visits

In the US, the pace of SEC examinations has remained consistent at around 12-15% of advisers within the SEC's jurisdiction, and that rate should continue into the immediate future. Key issues in these examinations include:

- Conflicts of interest, and specifically in private markets, conflicts related to allocation of investment opportunities; multiple clients or multiple companies investing in the same portfolio company; financial relationships between investors and limited partners; and adviser or sponsor conflicts.
- Valuation practices and consideration around whether valuation practices are consistent with valuation policies.
- The monitoring of board deal fees or fee offsets.
- The use of complex codes of ethics or policies around the prevention of the use of material non-public information.
- Generally, disclosures that are inconsistent with the underlying facts, particularly around ESG products and about the track record of a product.
- The use of hedge clauses that purport to limit an adviser's liability.

It's clear that firms can no longer manage the governance, risk and compliance (GRC) burden on a project-to-project basis, throwing bodies and spreadsheets at a deadline and then moving on. Rather, GRC teams need to think about these changes strategically, and encourage their organisations to do so as well. By taking a more holistic view of the demands that they are being placed under, and employing technology, not only can costs be reduced but the resultant enhanced efficiency will provide the opportunity to allow the expertise of real people to focus on their expertise the high value matters, staff development, retention, and risk mitigation.

The content and survey findings in this article are based on a recent panel discussion and polls that took place during ACA Group's annual conference for firms with a European presence, [Regulatory Horizon 2022: Preparing for the Challenges of Tomorrow](#) conference. Here Ruth and Roxy from ACA Group were joined by Marian Grace Fowler, Partner, Investment Funds Regulatory Solutions Group, Kirkland & Ellis, and Phil Bartram, Partner, Financial Services & Markets Department, Travers Smith. All write-ups from the event can be found in a [complimentary whitepaper](#).



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The two pillars of AEOI compliance: What you need to know to be in scope

Nadia Maharaj

Director, Tax Reporting, Regulatory, Analytics, and Data
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Today, more than 100 jurisdictions have signed intergovernmental agreements (IGAs) with the US government, obligating foreign financial institutions (FFIs) in those jurisdictions to comply with FATCA reporting requirements. AEOI is not a statute, but it refers to the mechanisms for compliance reporting under both FATCA and CRS. Interpreting the reporting requirements adds more complexity, as they vary widely among different jurisdictions.

Fundamentally, the AEOI compliance process entails two main components:

1. **Due diligence** – The first pillar comprises the collection and quality assurance of account holder data. Financial institutions need to be aware of the documentation required. FATCA due diligence requires the collection of IRS W forms, specifically form W9, Request for Taxpayer Identification Number (TIN) and Certification, or the appropriate W8 series form for account holder classification. CRS due diligence analysis includes reviewing a self-certification form. If a tax form and self-certification form are on file, both should be reviewed together to cross-check for any inconsistencies in the information provided by account holders.
2. **Reporting** – After due diligence has been completed and the respective classifications have been assigned, a financial institution must prepare reporting files for AEOI in formats specified by the applicable government or tax authority. How and where the files are submitted depends on the domicile of the financial institution preparing the report. FATCA IGAs allow for one of two reporting models: Reporting Model 1, in which the FFI reports to the FATCA “partner” government; and Reporting Model 2, in which the FFI reports directly to the US IRS. For CRS, the submissions are made on the jurisdiction’s reporting platform based on the domicile of the fund.

The two pillars of AEOI compliance:

In Bermuda, a Reporting Model 2 IGA jurisdiction, a fund must enroll and submit the reporting files directly on the IRS International Data Exchange Service (IDES) Gateway portal for FATCA reporting.

However, in order to complete CRS reporting, the fund needs to register and submit the filing on the Bermuda Tax Information Reporting Portal. Reporting specifications will vary across different jurisdictions. Virtually all jurisdictions, however, require reporting by individual fund. They do not permit submission of all reportable accounts across all funds on a single return at one time. In the Cayman Islands, each fund must submit a single return for FATCA reporting. For CRS, each fund must submit a return by reportable jurisdiction in order to complete reporting. For instance, assume a Cayman-based fund has two investors to be reported, one to Germany and one to France. For a Cayman Island fund, a CRS Declaration is required once all the returns are submitted. The fund, therefore, must submit two CRS returns in total, one each for Germany and France, before the CRS Declaration can be performed to complete the filing. If there are no reportable accounts, a CRS "NIL" Declaration is still required.

FATCA reporting applies to US and non-US financial institutions, and specifically targets US taxpayers. The IRS does not require a NIL filing for FATCA reporting by US institutions. If there are no reportable accounts, then no further action is needed for a given reporting period. CRS reporting currently applies only to non-US financial institutions. The US is not a participating jurisdiction in CRS. A US taxpayer (entity or individual) investing in a non-US financial institution will not be reportable under CRS.

However, the US taxpayer must comply with CRS due diligence requirements. Each participating jurisdiction determines whether a FATCA or CRS NIL filing is required. Cayman Islands does not require a FATCA NIL if no reportable accounts are in scope, but does require a CRS NIL declaration to be performed directly on the Cayman DITC portal. In contrast, in Luxembourg, financial institutions are required as of 2021 to submit a FATCA NIL and CRS NIL filing if there are no reportable accounts in scope.

Reportable vs. non-reportable: requirements vary among different domiciles

The due diligence and reporting rules for FATCA and CRS will apply to any participating jurisdictions that have entered into exchange agreements with the US for FATCA and the OECD for CRS. FATCA requirements, which focus on US taxpayers, are fairly straightforward. All financial institutions domiciled in a jurisdiction with a FATCA IGA must comply with FATCA due diligence and reporting requirements. CRS is a bit more complicated. Any financial institution which is a legal resident in a CRS-participating jurisdiction must comply with CRS due diligence requirements. AEOI compliance appears to be trending toward requiring some kind of reporting on non-reportable accounts. This requirement is in addition to the FATCA and CRS reporting on reportable account holder information.



Common misconceptions: FATCA and US financial institutions

FATCA is certainly not as demanding for US financial institutions as it is for FFIs, but the due diligence and reporting requirements still apply. US financial institutions should have some sort of FATCA due diligence process in place to ensure compliance. FATCA reporting is only required only if US FDAP income was distributed during the tax year. US financial institutions do not have to submit a FATCA NIL return if there are no reportable accounts.

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Is *operational resilience* the regulatory buzzword of 2022? Definitely maybe.

Or should it be *corporate bouncebackability*? What's the story and why can it deliver value?



Ranjeet Sahni

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Operational resilience has been on the forefront of regulators' minds globally, with a plethora of announcements from the likes of the [SEC](#) and [NFA](#) in the US, the [FCA](#) in the UK, through to the [SFC](#) in Hong Kong and the MAS ([here](#) and [here](#)) in Singapore. In [Edition 126 of the AIMA Journal](#), there were two excellently-written pieces ([here](#) and [here](#)) that describe what operational resilience means in the eyes of (UK-focused) regulators and how firms should react. A year on, those themes remain applicable globally, so I shall not go into much further depth on those. What I will say is that there are various definitions of what operational resilience means, as there is no single definition but, to me, a better replacement for operational resilience is *corporate bouncebackability*.¹ This is because operational resilience can imply that resilience is solely an operational or technological issue, which is not true – having corporate bouncebackability can be a value-driver too, helping firms to create another avenue of competitive advantage.

Corporate bouncebackability versus risk management

All individuals and firms have had to develop some form of resilience in recent years. A key reason so many global regulators are focusing on this is because they want us, the financial industry, to be better prepared for what will happen in future, to prevent undue consumer harm, maintain market integrity and the ongoing viability of the firms, such as those of you reading this piece work for. I have used the word *will* deliberately because exogenous shocks will take place. This is an important nuance to recognise vis-à-vis the long-established world of stress and scenario testing in the world of risk management. Stress and scenario testing contain probabilistic elements (if), which bring with them potentially significant uncertainty. However, when thinking about corporate bouncebackability, future disruptive events must be treated as unavoidable (when).

¹ *Bouncebackability* was allegedly first coined in a sporting context in the world of football (soccer) by Iain Dowie, who was then the football manager of Crystal Palace, when describing the comeback his team had made from contesting a relegation dogfight to getting promoted to the Premier League at the end of that same season (2003-04). For full disclosure and the avoidance of bias, I am a life-long West Bromwich Albion fan (**Baggie**)!

As a simple illustration, there are several overlapping themes in the articles I have already referenced and what global regulators have published:


- **IT/cybersecurity** – cyberattacks will happen in future, given the ever-increasing sophistication of malicious actors
- **Fraud/misconduct** – breaches of policy/law/regulations will happen in future, as these are behavioural traits that cannot be eradicated. There is no real-life equivalent of “Ludovico’s Technique” (from “A Clockwork Orange”) that can apply to these kinds of misconduct!
- **Financial stability** – firms will go out of business in future
- **Outsourcing/third-party dependency** – some of those firms will be subject to the three bullets listed above. Financial firms are becoming increasingly more reliant on third parties and outsourcing of (critical) functions

So how can corporate bouncebackability provide value?

Initially, it is about firms being prepared for change across all businesses/departments. Being prepared means adopting a more heterogenous approach. Examples include:

- **Having enough and a mixture of sources of financial capital** – this is ever more important given the pace and scale of innovation within this industry, which may lead to increases in risk appetite;
- **Greater (neuro)diversity amongst leadership to attack different problems in different ways** – I have [previously discussed](#) that leaders are the pioneers of developing and enhancing a firm’s culture because of their disproportionate impact on the firm. Having leaders with different skills and diverse backgrounds will stand such firms in better stead to problem-solving and devising a suitable strategy for corporate bouncebackability. This is both for the firm itself and for the associated behaviours expected of the firm’s staff; and
- **A broader range of businesses/products** – e.g., launching a multi-manager, multi-strategy fund (instead of a single manager, single-strategy fund) to reduce that dependency on a single strategy/business initiative.

By adopting such a diversified approach, firms will become more agile and therefore react more positively to change. Also, it means that firms are less likely to be subject to correlated deficiencies across the firm, which, when aggregated, can lead to systemic failure. Having that level of preparation can bring short-term and longer-term benefits to firms.



In the short-term, the value of having corporate bouncebackability allows firms to:

- Dampen and manage the immediate impact of an external shock on their performance better than their peers; and
- Recover their performance quicker than their peers
- Demonstrate the greater extent of their recovery better than their peers – i.e., recover quicker and sustain higher performance for longer.

In the longer-term, having corporate bouncebackability allows firms to:

- Continue to differentiate their offering by demonstrating greater reliability;
- Capitalise on transient opportunities – e.g., winning the “war for talent,” entering new markets/jurisdictions; and
- Increase AUM by appealing to investors who are impressed with their ability to adapt to new circumstances

That last bullet point is arguably the most crucial, as this is where the evidence may be most easily seen. By demonstrating consistently strong corporate bouncebackability (especially during times of exogenous shock), investors may be more willing to redeploy their capital to such firms because of their faith in such firms to not only recover quicker from the initial shock, but also outline a clear long-term plan for continued success built on the firm’s corporate bouncebackability plans.



Conclusion

We cannot expect a let-up on the regulatory front in this area, so firms need to be thinking about this if they have not already. Having a concrete understanding of how to minimize the impact of a disruption to your external stakeholders and the broader economy, knowing where your firm's weaknesses lie, and developing your foundational elements (such as the four themes I mentioned earlier) will help your firm recover more quickly and provide a platform to emerge from any crisis in a stronger position.

As the world begins to open again, it may become easy to forget how we have adapted or to treat this adaptation as temporary in the pursuit of returning to normal but adopting these plans can provide value even after crises have ended.

Sailing in uncharted waters: The regulatory tide turns for hedge funds



Michael Cummins
Portfolio Management Lead
FINBOURNE Technology

2021 marked a strong and eventful year for global hedge funds, with total invested capital rising from US\$3.58 trillion in 2020, to an unprecedented US\$4.04 trillion by December 2021.¹ With the pandemic-induced volatility playing well to actively-managed strategies, including those of long/short equity shops, hedge funds have piqued interest from institutional investors - as they reallocate and diversify away from low-interest bonds and balance passive investments, such as ETFs and indexing strategies.

However, the scale of global assets under management has not gone unnoticed and we now see regulation is set to play an equally major role in the hedge fund industry this year. In the EU, there are reviews expected across the Alternative Investment Fund Managers Directive (AIFMD), the European Market Infrastructure Regulations (MiFIR) frameworks, and the EU Short Selling Regulation. While, more prominently, the US Securities & Exchange Commission (SEC) has created ripples across the hedge fund industry, with ambitious proposals set to improve market transparency.

In their press release earlier this year,² the SEC stated the proposed disclosure rules will 'enhance the Financial Stability Oversight Council's (FSOC) ability to assess systemic risk, as well as, bolster the Commission's regulatory oversight of private fund advisers and its investor protection efforts.' The view is that reporting will provide greater visibility of hedge fund activity, which could in turn offer timely market stress signals.

According to AIMA, 'these far-reaching proposals represent a major overhaul of existing market practices.' But as the industry unpicks the proposals and forms its response, the question remains, how will these regulations impact hedge funds across the globe operationally, and *how will managers continue to secure capital allocations and respond to market opportunities, while sailing in these uncharted waters?*

Systemic risk prevention or red tape?

While hedge funds have enjoyed a lighter touch approach, compared to their asset management counterparts, the new wave of SEC disclosure rules and indeed the AIFMD and MiFIR revisions expected in Europe, will see them bracing themselves against a changing tide. Having 'identified significant information gaps' over a decade's worth of data, the SEC, under the charge of Chairperson, Gary Gensler, is effectively intensifying its focus, starting with larger funds of US\$2+ billion AuM, before dropping to include funds of US\$1.5 billion AuM.

Pushing the envelope further than ever, the commission requires hedge funds to report in several instances; from when a fund is terminated, to events where it experiences a 20% drop in net asset

¹ [Hedge Fund Research](#), Nov 2021

² [SEC Proposes Amendments to Enhance Private Fund Reporting](#), Jan 2022

value over 10 days, a 20% increase in margin requirements over 10 days, an inability to meet collateral calls, and any redemption calls that exceed 50% of the funds value. To meet this, funds will need to have their investment data readily available and at little to no notice, while firefighting one or more of these events.

The thinking is that these events may correlate across a number of funds, which would then pose a secondary threat in other parts of the capital markets. If we look back, there is some evidence to suggest hedge fund blowbacks playing a role in past capital market events. This includes the now famous Archegos case and the recent 2020 US treasury market crash, where the hedging of treasury bonds and futures, contributed to a US\$90bn loss in the market and caused a sticky moment in US history.

Considering the new disclosure rules are the strongest since the Dodd Frank act, it is unsurprising that they have gone down like a lead balloon among fund managers. Many hedge funds and industry groups including the American Investment Council and [AIMA](#) are hitting back at the proposals. While, according to the [Financial Times](#), several US firms are pursuing a legal challenge, questioning whether the SEC has properly assessed the cost benefit analysis. There is also an argument of whether further transparency would really limit systemic risk - arguing that they only serve to add 'unnecessary paperwork' and according to some, more 'red tape'.³

The trouble isn't just with the scope of the reporting, it is the T+1 timeframe that the SEC is demanding, that is causing the primary concern. Perhaps this is why SEC Commissioner Hester Peirce, delivered the only vote against the new rules. In her statement, Peirce questioned whether it was 'appropriate or even wise' for the SEC to be demanding information within one business day when a 'hedge fund is suffering losses equal to or greater than 20% of its net asset value over the course of 10 days'.

To meet this demand, funds will need to arm themselves with a wealth of data available at the push of a button - requiring not only a well-oiled data infrastructure but a comprehensive Portfolio Management System (PMS) that can monitor the fund in real-time and generate reproducible numbers for reporting. For the majority of small-medium hedge funds, meeting this regulatory mandate with the current host of systems and processes is going to be a challenge at best, and impossible at worst. Considering these rules form part of the SEC's aspiring policy reforms, spanning issues from ESG, to cybersecurity – the current proposals may well be the tip of the iceberg.

The impact on hedge fund operations

The new rules may accelerate the urgency some hedge funds are already noting when it comes to addressing operations and will act as a litmus test for the many issues that lie beneath the surface. To steer the ship, funds will need to address not only core data processes, but cost optimisation and efficiency gains, if they are to succeed in meeting the regulatory wave headed their way and keep a sharp focus on the horizon.

Technology investment forms a critical tool in achieving this, enabling a timely regulatory response and delivering against AuM growth. While, running a hedge fund efficiently requires an initial investment in technology, maintaining that investment is just as important if not more significant, to the prosperity of the fund. Data management plays a vital role here, because data itself is a vital asset to mission-critical workflows, including stakeholder reporting.

3 [Private equity and hedge funds pan SEC's push for more data disclosure](#), Pitchbook, Jan 2022

With a relatively relaxed regulatory backdrop, larger hedge funds have channelled most of their efforts on alpha generation and strategy implementation. But as they have matured, their technology investment has lagged over time, leaving funds with an accumulation of 'technical debt'. This means more systems to rip out or integrate to, and more data to migrate and feed into. Combined with increased regulatory scrutiny, this tangle of outdated systems has created a number of operational barriers, making it difficult to meet regulatory change management within the required timeframe.

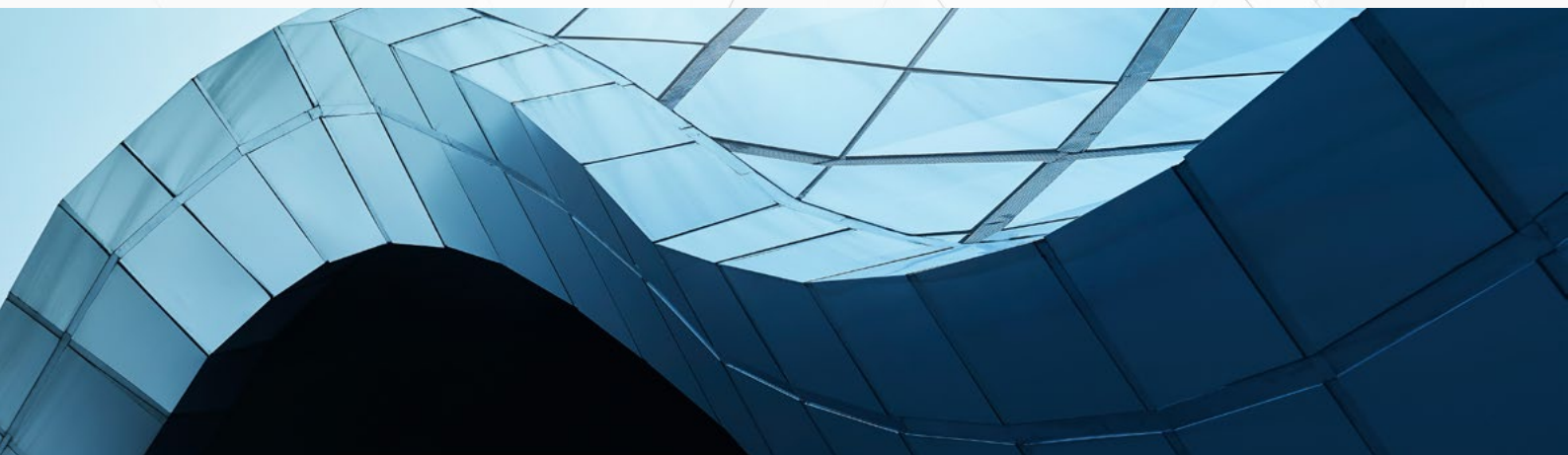
In our recent [hedge fund market report](#), we identified that many of the operational challenges and market opportunities funds are facing, including those around regulatory requirements and investor due diligence, can be addressed by cloud-native data management tools, which tackle the root cause.

For smaller, leaner funds, the inevitable future provides a timely opportunity to secure a scalable data foundation sooner rather than later, to support and future-proof PMS capabilities, while providing the ability to adapt to incoming regulatory and market changes. The trick for these funds will be doing this at lower cost, with greater operational ease and without taking their eye off the ball.

Emerging technologies, such as cloud-native, SaaS solutions can reduce operational effort and increase agility. When combined with PMS capabilities, SaaS data management solutions enable both greener and more established funds with a cost-effective and responsive foundation to support data-intensive workflows; from portfolio management through to investor reporting and accounting.

With one source of real-time data serving operational, investor and regulatory needs, funds can holistically benefit from transparent oversight, enhanced control, and innate financial sense. These technologies also make it easier to operate in a proliferated data environment and excel at translating large volumes of complex, multi-asset data, including ESG, alternative and newer asset classes, such as cryptocurrencies.

Importantly, the benefits of a modern data stack also extend beyond the fund itself. The use of open APIs simplifies connectivity and unlocks data from other systems, providing a complete audit trail for data interrogation. Using a secure cloud infrastructure, this data can be permissioned into the extended ecosystem, automating the delivery of stakeholder-specific information to regulators and investors, within a T+1 timeframe.



Future-proofing growth in a regulatory climate

By adopting an interoperable approach to hedge fund operations, funds can de-risk operational change and ensure business continuity in an increasingly regulated market, all while achieving scalable and resilient operations. Without it, navigating through an evolving regulatory storm will prove testing. More than anything, improving operational infrastructure and data processes, mitigates regulatory cost and operational risk, so funds can confidently meet regulatory and investor demands, while securing the allocations that will fuel their growth.

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ESMA guidelines on marketing communications

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The recent cross border distribution of funds package of rules (Regulation EU 2019/1156 and Directive (EU) 2019/1160) (the **CBDF Rules**) attracted a lot of attention in respect of its changes to the approach to pre-marketing and reverse solicitation when raising capital from EEA investors. We now see attention turning to the accompanying ESMA Guidelines on Marketing Communications (ESMA 34-45-1272) (the **Guidelines**), in force from 2 February 2022, which have introduced additional content requirements for marketing materials being shared with EEA investors.

What are marketing communications?

One particular area of debate has been exactly which materials are in scope of the Guidelines. The Guidelines do not define marketing communications, but give some non-exhaustive lists of examples of documents that should be considered as marketing communications:

- Marketing material addressed individually to investors or potential investors on the fund manager's website or elsewhere (e.g., made available at the fund manager's office)
- Communications advertising a fund addressed to EEA investors
- Communications by a third party used by a fund manager for marketing purposes

These categories of documents would all be naturally what would be regarded as marketing materials. However, interestingly, the Guidelines also give examples on what should not be treated as marketing communications under the Guidelines:

- Legal and regulatory documents of the fund, including a prospectus and the Article 23 disclosures (the specific information required to be disclosed to EEA investors under AIFMD)
- Information issued in the context of *pre-marketing* as defined in the CBDF Rules (so documents like teasers or presentations, that are often debated as to whether they are permitted *AIFMD pre-marketing* in the EEA - see under "*Pitch-books/presentation decks*").

PPMs

PPMs, which some might regard as the main marketing document for a fund, are not mentioned in the Guidelines, and prospectuses are explicitly excluded from scope. What is not clear is whether the word prospectus is restricted to meaning a prospectus required under the EU's Prospectus Regulation (which would be reviewed thoroughly by regulators in addition to being subject to detailed content requirements). Alternatively, was the word prospectus meant to include PPMs too, especially given that in some countries the two words are used interchangeably? National regulators may not all follow the same approach on this particular scope question.

Some in the market are considering that PPMs are out of scope as they could be regarded as a legal or regulatory document of the fund. While a PPM serves as a vehicle for the Article 23 disclosures to EEA investors as required under AIFMD (and therefore is a legal requirement), the commercial sections of a PPM will cover much more ground than regulatory disclosure strictly requires, and are fundamentally promotional, with the aim of attracting investors. Therefore the prudent approach would be to review the commercial section of a PPM for compliance with the Guidelines.

Pitch-books/presentation decks

Pre-marketing, (as codified under the CBDF Rules), include documents like a teaser, presentation or pitch-book, and is excluded from scope. However, the Guidelines represent the first time EEA regulators have set down their expectations in relation to content requirements, and a wise approach includes compliance with at least some parts of the Guidelines (particularly the fair, clear and not misleading ones) in respect of pre-marketing materials as well.

Detailed requirements under the Guidelines

Some of the requirements of the Guidelines are quite granular and will necessitate a more careful review of marketing communications addressed to EEA investors.

1. *Identification of marketing communications*

The Guidelines note that marketing communications should include sufficient information to make it clear that the communication

- i. has a marketing purpose
- ii. is not a contractually binding document
- iii. is not an information document required by any legislative provision, and
- iv. is not sufficient to take an investment decision.

Where a *marketing communication* includes prominent disclosure of the term 'marketing communication', it will be deemed to be compliant with the requirement of being identifiable as such. There is also prescribed disclosure language that materials will need to incorporate.

2. *Equal prominence to risks and rewards*

The Guidelines also include detailed requirements on presentation of risks and rewards information. This includes that the font and size used to describe the risks should be at least equal to the predominant font size used throughout the marketing communication, and that risks should be displayed in a prominent position.

Risks can no longer be disclosed in footnotes, which might present a challenge in the context of marketing decks and pitch-books. The size requirements might mean that more thought would need to be put into what risks are included in such documents.

3. *Fair clear and not misleading*

There are some granular requirements on the content of marketing communications being fair, clear and not misleading.

Over-optimistic wording

The marketing communication should not make use of over-optimistic wording such as best fund or best manager and should refrain from diminishing the risks of the investment such as *safe investment* or *effortless returns* without clearly explaining that such rewards may not be obtained and that there is a risk of losing all or part of the investment.

Comparison with other funds

The fund being promoted may only be compared with other funds characterised by a similar investment policy and a similar risks and rewards profile, unless an explanation on the difference of the funds is also included.

Past performance

There are detailed requirements on disclosing past performance and simulated past performance of a particular fund. Where there is no past performance (e.g. for new funds), simulated past performance can only be disclosed in limited circumstances, such as a new share class simulating performance based on the performance of an existing share class, or in case of a feeder simulating based on the performance of the master fund. Where a new fund uses a benchmark or objective return, the reward profile may only refer to such benchmark or return.

As there are specific requirements mentioned for new funds, the general market view has been that track record information of the manager on performance in previous funds is not subject to the requirements on past performance.

There are also requirements on expected future performance, including being based on reasonable assumptions supported by objective data, and on a time horizon that matches the time horizon of the fund. Future performance must be accompanied by some disclaimer language.

There are not yet settled market views or practices on the questions around the Guidelines. For now, fundraising preparations should include a more detailed review of marketing materials when they will be directed at EEA investors.



Non-EEA sponsors

While it is clear that the CBDF Rules and the Guidelines apply to EEA sponsors, they are both silent on whether they apply to non-EEA sponsors looking to market their funds to EEA investors under national private placement regimes.

There is some variance in approach between EEA countries on whether the CBDF Rules apply to non-EEA sponsors. From a practical perspective, this variance means that non-EEA sponsors seeking to market into multiple EEA jurisdictions will need to ensure compliance with the CBDF Rules and the Guidelines. It is likely that the Guidelines were intended to apply to non-EEA sponsors marketing in the EEA as well, given that one of the objectives of the package of rules is investor protection.

ESG trends that could impact fund managers in 2022

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ESG investment is booming – according to research from Bloomberg, ESG assets are forecast to hit US\$53 trillion by 2025 (a third of global assets under management) and the US\$2.2 trillion ESG debt market is forecast to hit US\$11 trillion in the same year.

This presents huge opportunities for financial investors including dedicated asset managers, fund management arms of diversified banking groups and institutional investors, including sovereign wealth funds and insurance companies. This article explores some of the ESG trends and challenges that may be relevant to financial investors in 2022.

- **Supply chains:** As financial investors sign up to net zero emissions targets, they will need to put pressure on their suppliers to do the same in order to achieve those targets. This may result in short term disruption as a result of the recalibration of supply chains (for example some suppliers may be cheaper but may not meet the ESG standards imposed upon them). However, it also presents opportunities for M&A activity in businesses that provide supply chain management and transparency solutions.
- **Decarbonisation:** Decarbonisation will continue to gather pace, but the big question in the run up to COP27 in Egypt, is how to decarbonise developing and emerging economies and the role the developed world has to play. This presents opportunities for financial investors in facilitating M&A investments in emissions reduction, energy efficiency technologies, carbon offsetting and trading markets (accelerated by the agreement on a global carbon market mechanism largely completing the 'Paris Agreement Article 6 Rulebook' coming out of COP26). They could also potentially rethink their strategies around carbon- intensive fossil fuel assets (for example, instead of divesting those assets, they could consider investing or holding onto those investments in order to drive change from within, including by winding down the operations of these assets earlier than the expiry of their design life and incorporating cleaner energy solutions in parallel). This also presents opportunities for the private sector to partner with the public sector in developing and implementing decarbonisation solutions.

- **Infratech:** The resilience of critical infrastructure is a priority for governments across the world as they look to 'build back better' from the global pandemic and prepare strategies to achieve their climate targets. The integration of technologies like blockchain, distributed ledger technologies (DLTs) and the metaverse, is likely to be key to facilitating these outcomes. This presents opportunities for financial investors to invest in businesses related to asset tokenisation and smart infrastructure as well as data centres and technologies including 5G and the Cloud which have become integral to IT systems worldwide. In parallel we expect there will be increased focus on the associated ESG implications including:

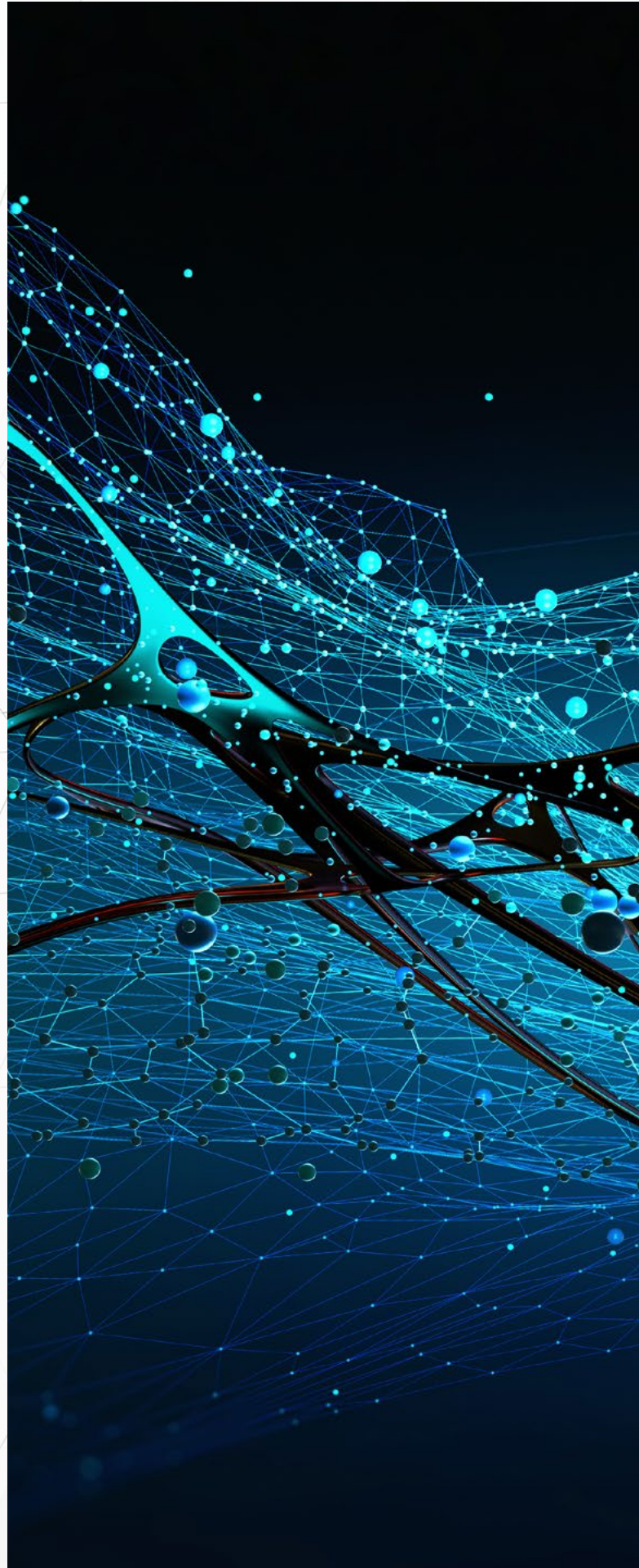
- "E" – a focus on the environmental implications of blockchain validation processes due to excessive energy consumption and electronic hazardous waste.
- "S" – a focus on the use of sensitive data and personal information that can be a target for repression, espionage, sabotage and foreign interference activity, leading to increased scrutiny by governments of foreign investments in relation to these transactions.
- "G" – a focus on the governance arrangements associated with the decentralisation of infrastructure systems as a result of the integration of these technologies. The collective responsibility of participants in a decentralised system aligns with the increasing awareness of sustainability and social inclusion – both culturally and politically.

- **Greenwashing:** We expect that stakeholders will continue to ramp up pressure on government and companies to 'walk the talk' when it comes to ESG. This risk will get personal in 2022 with an increasing focus on directors' duties to consider the ESG implications of their decisions (in addition to the fiduciary duties of funds to do the same). It will be important that financial investors roll out regular training for their staff and develop crisis management plans to mitigate the risks associated with climate-



related litigation and stakeholder activism. In addition, as the green financing landscape continues to evolve from its early stage and voluntary requirements, financial investors will need to balance the opportunities associated with promoting sustainable finance to their stakeholders – including access to additional capital and pricing advantages – with potential added verification and reporting costs, and the reputational risks associated with greenwashing.

- **Increased regulation:** We are unlikely to see a global convergence of ESG regulation in 2022. Rather, we expect to see increased regulatory change particularly in APAC and the US, as governments seek to align themselves with market trends coming out of Europe. Financial investors will need to keep track of these developments (including reporting and disclosure) in order to develop strategies to navigate the increasingly complex regulatory landscape on the entry to investments, during their lifecycles and upon exit. Playing to the highest or lowest common denominator with respect to compliance may not be the right strategy and so finding the right balance will be essential.
- **Whole of life approach:** Whilst ESG is increasingly being embedded along the value chain for financial investors, we expect that in 2022 the focus will be on adopting a more 'whole of life' approach – from fund formation through to the investment process (i.e., due diligence, acquisition, ownership and exit). Having a strong ESG commitment from the top, and clear ESG objectives established from the outset which are focused on value creation, may assist with implementing ESG initiatives in portfolio companies – particularly in regions where companies are still getting to grips with understanding ESG and its impacts (for example, Asia Pacific and Africa as compared with Europe, North America and Oceania).
- **People and wellbeing:** A portfolio company's ability to secure a sustainable talent pipeline (and therefore maintain value/share) will be interlinked with employee wellbeing initiatives, upskilling the existing workforce (including for green jobs or to be environmentally compliant), and diverse recruitment. Firms or funds with a strong narrative in these areas may present a





positive opportunity, and a failure to navigate social requirements may undermine value or market share due to reputational (and financial) impact and talent flight risk. This will see investors needing to carry out social due diligence (including human rights due diligence) on their own business and those in which they invest (in addition to their supply chains), to avoid allegations of social washing. Stock exchange and regulator developments plus employee expectations will increasingly impose requirements for a breadth of diversity credentials, at board level, and below, and investors will want appropriate access to metrics on diversity performance (to display a positive picture on this on exits or disposals).

This will also see an increased need to update data privacy governance frameworks to manage access to broader DE&I data. Firms will also increasingly explore AI for recruitment and need to navigate ethical and bias issues and seek to put in place appropriate frameworks to manage this. Board and workplace culture and ethics (as well as composition) will be subject to greater scrutiny, with pressure to ensure that the voice of the employee is increasingly present and appropriate actions are taken: whether through enhanced whistleblowing channels, increased unionisation, ESG-outcome based remuneration and employment practices, or the undertaking of ESG investigations. Employee action is likely not just to be about employees' own social rights (for example, freedom from harassment), but on their employer's position and actions on climate and sustainability.

Is there alpha in ESG data for sovereign debt?

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Introduction

Incorporating environmental, social and governance (ESG) analysis has been the natural habitat for sovereign bond investors for decades – especially as it pertains to governance. What is new is that ESG data have matured over the last decade, and we are entering a phase where the data have both a long-enough history and broad-enough coverage to make it interesting to quantitative investment firms.

At Man Group, we have been able to demonstrate [alpha from ESG factors](#) in systematic security selection for equities. Can the same be said for sovereign bond selection? After all, ESG analysis – particularly the ‘E’ & ‘S’ components – have become increasingly important in forming long-term growth, inflation and monetary policy outlooks, all of which are important factors investors look at for sovereign bond selection.

For the reader in a hurry: we have not been able to find systematic alpha in ESG data for sovereigns so far. However, for a discretionary fund manager, we believe ESG data analysis is a potential rich area for idiosyncratic alpha.

The link between ESG data and discretionary analysis for sovereigns

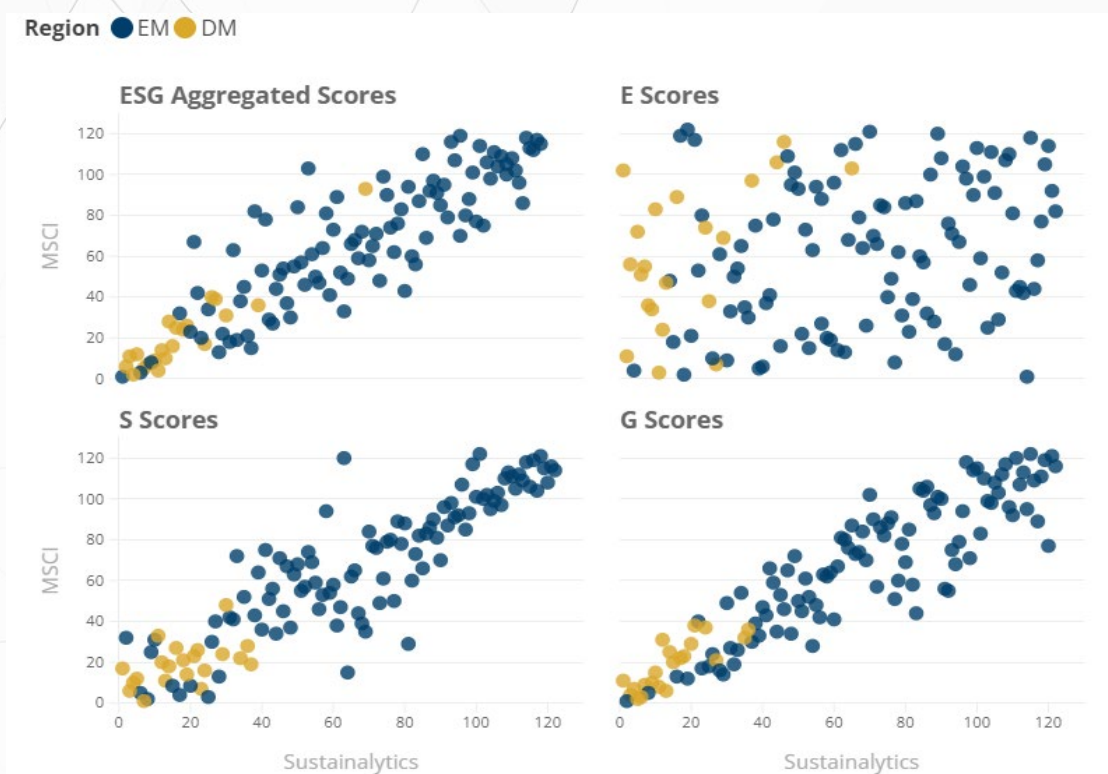
The alignment of investment returns and long-term sustainability objectives has been the subject of many finance researchers for several years, not least at Man Group.¹

Naturally, good – or improving – ESG factors can help the investment process, and gauge the solidity of the tax base for a sovereign issuer, and the sustainability of government finances as it relates to E, S and G. The reverse also applies: taken to the extreme, it is unprofitable to invest in a security issued by an organisation that goes bankrupt due to bad management and/or running the business or country in an unsustainable way.

We believe it is worth looking at the correlations of the E, S and G scores across vendors to determine if there are any areas of data confusion that can provide idiosyncratic alpha.

As Figure 1 below illustrates, there exists a very high level of agreement across two well-known ESG data vendors in both governance and social data for sovereign bonds. This suggests to us that the data is well known, not subject to much debate, and thus potentially lacking alpha. What is interesting, though, is that there is very little agreement at the 'E' level.

Figure 1: MSCI, Sustainalytics Agree on 'S' and 'G' Data for Sovereign Bonds; Less So for 'E'



Source: MSCI, Sustainalytics; as of 21 March 2022

The pronounced disagreement on 'E' scores is worth analysing. At a headline level, differences are already obvious, with MSCI defining 'E' simply as environment, whereas Sustainalytics uses a broader 'natural and produced capital' category. Under this heading, Sustainalytics considers 'corruption' and 'rule of law' as 'E' – rather than the more traditional classification under 'G'.

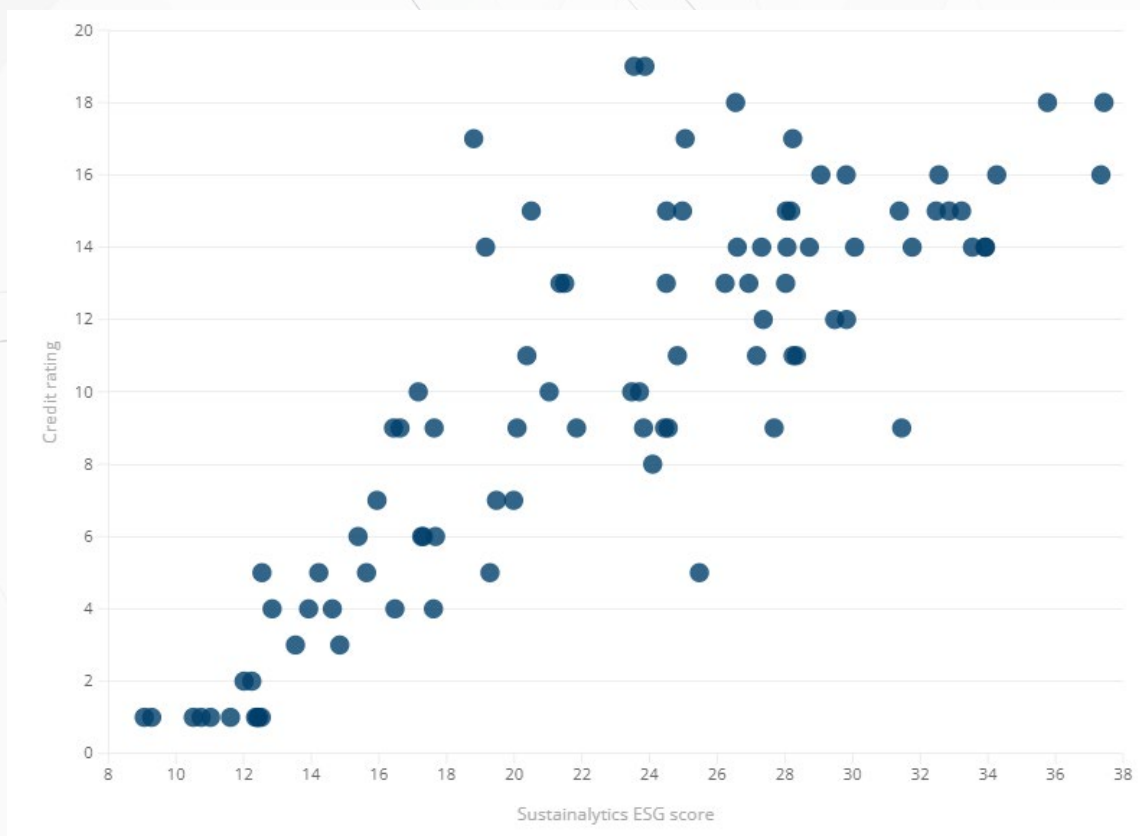
¹ See, for instance: "ESG and Man Group's Multi-Asset Offering", 1 Oct 2019; <https://www.man.com/maninstitute/covid19-interrupt-esg-trend>; and Man DNA Quarterly Commentary, "Applying our ESG Principles in Multi-Asset funds", 1 October 2020.

More detailed analysis reveals more subtle differences in the construction of the 'E' scores, whereas the frameworks surrounding 'S' and 'G' are strikingly similar. For example, MSCI focuses on environmental externalities, whereas Sustainalytics more directly considers factors like carbon intensity. This direct versus indirect approach appears throughout the analysis framework, with another example of Sustainalytics using 'land below 5 metres' to represent sensitivity to a changing climate, whereas MSCI less prominently adds 'vulnerability to environmental events' as a general category.

So, using aggregate scores could point to limited alpha potential if only using aggregate ESG scores. However, there is more scope for alpha when considering 'E', 'S' and 'G' scores and the various components separately.

Overall, though, there is a positive correlation between credit ratings and ESG scores ² (Figure 2 below), which implies that: (1) ESG data has analytical value for sovereign default probability; and that (2) this value is already priced in, to some degree.

Figure 2: Credit Ratings Are Positively Correlated to ESG Scores



Source: Bloomberg, Sustainalytics; as of 21 March 2022

Note: Credit ratings range from 1 for AAA to 19 for CCC3; the lower the Sustainalytics ESG score, the better.

That is not the same as saying that ESG data are not additive – it is quite possible that ESG data are additive after a quantitative transformation that removes the fundamental data content that is captured in price data. This could, for instance, be done through regressions.

² As determined by Sustainalytics

Researchers at Barclays³ have done such an exercise and found no evidence of alpha in systematic selection of sovereign bonds using ESG data, even after regressing out fundamental factors such as credit ratings. However, they did conclude that the ESG score of a portfolio of sovereign bonds could be optimised without sacrificing return beta, or generating negative alpha, which may imply the ability to improve risk-adjusted returns by lowering the likelihood of experiencing future negative shocks through ESG data.

Overall, we believe ESG analysis for a discretionary fund manager can be additive to sovereign debt selection in at least three ways:

1. A discretionary fund manager can disaggregate, dissect and analyse the data in order to reach a conclusion that disagrees with the consensus;
2. While aggregate ESG scores agree across data providers, there is more debate and disagreement at more granular levels of data – especially for the E pillar – hence potentially more scope for alpha;
3. Importantly, increased investor engagement, net fund inflows and regulatory changes may benefit investments with better ESG scores in the future.

Systematic alpha in ESG data for sovereigns

In our article '[ESG Data: Building a Solid Foundation](#)', we demonstrated that there was alpha to be found from ESG factors in systematic security selection for equities. Is there an alpha signal in ESG data for systematic selection of sovereign debt issuers too?

Before embarking on a quantitative quest, we have some thoughts on this from the outset.

First, positive ESG scores can be an indication of a corporate or country's ability to grow in a stable and sustainable way. While an equity investor can benefit from profitable growth, this may be less relevant for debt securities. A large part of successful debt investing is more about accurately identifying the probability of default than the market, i.e., selecting between sovereigns that pay their coupons and return the principal at maturity versus those that are likely to become distressed.

Second, we would posit that historically, there has not been alpha in ESG data as it pertains to developed market sovereigns with strong ESG characteristics, especially if the data confirm common knowledge. Recently, however, this pattern may have changed as environmental data is increasingly being used to drive fiscal⁴ and monetary policies.⁵ There could, of course, be alpha in weak ESG data for sovereigns, to the extent that ESG factors could lead to negative shocks such as natural disaster incidents that a country is ill-prepared for, necessitating large fiscal outlays that could undermine the ability to pay coupons or principal.

Third, a backtest of historical ESG data may well be a poor guide to the future, as environmental and social considerations were not perceived to be as acute or important as they are now in the eyes of citizens, governments and investors.

³ Source: Barclays; Performance of ESG-Tilted Portfolios of Sovereign Bonds; 26 January 2022

⁴ Lai, Olivia; "What Countries Have a Carbon Tax"; Earth Org; 10 September 2019, <https://earth.org/what-countries-have-a-carbon-tax>

⁵ Brunetti, Celso., et al; "Climate Change and Financial Stability"; Federal Reserve; 19 March 2021; <https://www.federalreserve.gov/econres/notes/feds-notes/climate-change-and-financial-stability-20210319.htm>

In our analysis, we were not able to find systematic alpha in ESG data for sovereigns – at least not yet. This could be due to the following reasons:

- First, contrary to ESG data for equities, where there is much disagreement between data providers, ESG data for sovereigns agree with each other at the aggregate level – as well as for S and G factors. This suggests there is little controversy and debate, especially for developed-market ('DM') sovereign issuers. Low controversy implies low alpha content;
- Second, we find there is a high correlation between ESG data and fundamental factors such as credit ratings. This is possibly a function of the large influence of the 'G' component in ESG scores, which has long been part of sovereign bond analysis;
- Third, environmental and social constraints on global production have been less significant in the past, when they were non-binding and less dominant, while macro factors dominated. Thus, a test of historical ESG data is not likely to show as much relevance as one might expect going forward. Increases in pollution, population and climate events have resulted in more economic sensitivity to environmental and social factors.

Conclusion

We have not yet found strong evidence that there is alpha in using headline ESG data for sovereign security selection in a systematic way.

However, an ESG approach to sovereign debt selection can be additive in at least three ways: first, a discretionary fund manager can disagree with the data and the consensus, due to the edge the fund manager and their process provide; second, while aggregate ESG scores are in agreement across data providers, there is more debate and disagreement at more granular levels of data, hence potentially more scope for alpha; and third, flows and regulatory developments are likely to benefit investments with better ESG scores in the future.

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The ongoing evolution of ESG in private credit



Anuj A. Shah
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Introduction

The integration of environmental, social, and governance (ESG) factors into private credit investing has gained widespread global adoption across the asset class over the past few years. Amongst both asset allocators and asset managers there has been an increased recognition that embedding an ESG analysis into the investment process helps identify and ultimately reduce downside risk.

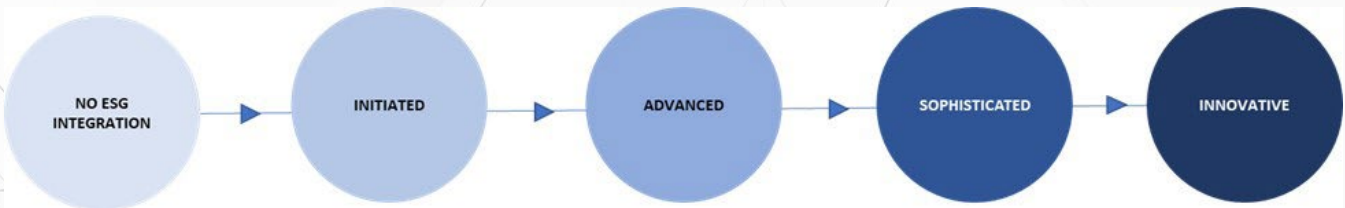
At the same time, new issues are beginning to emerge within ESG. Biodiversity and natural capital apply to any investment that has significant exposure to physical assets. Human rights in supply chains are now being viewed as a systemic issue. And asset owners are starting to ask their managers about the impact, or outcomes, of their investment activities.

As the ESG landscape continues to evolve, and as more precise ESG information becomes available through broader and more standardised corporate disclosures, the expectations of what it means to be 'ESG integrated' also continues to expand and advance.

This paper (1) defines the current state of what it means to be ESG integrated, (2) examines the early stages of ESG integrated practices in private credit, (3) presents trends driving the adoption of more sophisticated and holistic ESG integration, and (4) highlights the more advanced ESG integration practices now taking root at mature state private credit asset managers.

ESG integration

Identifying ESG factors relevant to a business and integrating them into investment strategy, analysis, and decision making is what is now widely considered 'ESG investing'. The assessment of ESG factors is supplemental to 'traditional' investment analysis and may be undertaken by a distinct ESG team or embedded into an investment team's processes. Yet, the house view at [Close Group Consulting](#) (CGC) is that ESG integration is not binary – it's not something you simply do or don't do – and should be measured on a maturity scale since asset managers are at different stages in their ESG integration journeys.



Maturity level	Description	Score
No Integration	Non-existent to negligible ESG integration. Asset managers at this stage have usually not started integrating ESG in a meaningful way.	1
Initiated	Lower level of ESG integration. Asset managers at this stage tend to be at an early stage of ESG integration.	2
Advanced	Moderate level of ESG integration. Asset managers at this stage tend to be relatively well advanced in ESG integration practices and are in line with industry best practices.	3
Sophisticated	High level of ESG integration. Asset managers at this stage tend to be very advanced in their ESG integration practices and are ahead of the industry.	4
Innovative	Very significant level of ESG integration. Asset managers at this stage tend to be innovators and are leading the industry in creating ESG integration best practices.	5

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It's important to note that the above maturity levels have been defined by CGC against industry best practices. In addition, given the dynamic nature of ESG, the expectations for the practices that underlie each stage do evolve over time.

ESG in private credit (early stages)

In the private credit asset class, there inherently is a focus on an assessment of downside risk that may affect performance because of the limited potential for upside. Within ESG, this means gaining a better understanding of the material factors that may arise during the lending period. The level of sophistication when it comes to identifying material ESG factors and the processes in place that support the ongoing monitoring of those ESG factors create a systematic ESG framework; the distinct characteristics of this framework has typically revealed a private credit manager's overall risk management capabilities and approach when it comes to ESG. With the goal of incorporating a clearly defined and consistent systematic framework for ESG risk management, a top-down approach to ESG emerged during the early stages of ESG integration in private credit.

This top-down approach is best exemplified by an early-stage process that has been widely adopted to identify material ESG issues. The [Sustainability Accounting Standards Board](#) or SASB has issued standards that identify a subset of ESG issues deemed most relevant to financial performance in each of 77 industries. SASB recognises that "not all sustainability issues matter equally to each industry,

and the same sustainability issue can manifest differently across industries”, which is why the [SASB Standards](#) were created to be industry specific. The Standards are readily [available](#), based on evidence-based research, have included input from companies, investors, and subject matter experts, and are overseen by an independent Standards board. In short, integrating the use of the Standards is defensible and additive, and it’s therefore easy to understand why many asset managers began their ESG investing journeys by implementing the use of the Standards to identify material ESG factors.

Demonstrating a stable process across portfolio company lending opportunities has also been key to developing a systematic framework for ESG risk management. Many private credit firms have created and published a firm-wide ESG policy, deployed a governance process for the implementation of the policy, and became [signatories](#) to the Principles for Responsible Investment. The firms participate in industry initiatives related to sustainable investing and now have resources with specific ESG training and skills. In addition to identifying material ESG issues, many managers also use ESG factors to help define their investment universe, track some ESG metrics/KPIs, and provide ad-hoc ESG reporting. Taken in sum, the implementation and consistent execution of these ESG-focused initiatives comprise the framework for ESG risk management at private credit managers.

Private credit managers do, however, face several limitations when it comes to the further advancement of ESG integration within their organisations. Many of CGC’s private credit clients have remarked on the high volume of deals they need to review and how the integration of ESG factors into investment analysis cannot slow down the overall process in what remains a highly competitive market. In addition, clients have emphasised that they have limited influence when it comes to actively managing ESG factors due to the constraints presented by a) the asset class (i.e., debt vs. equity) and b) their lending period. Clients have also noted the lack of ESG disclosures by private companies.

Trends driving increasing maturity

There are a confluence of factors currently driving private credit managers to further evaluate and enhance their ESG integration practices. A primary driver is an increase in the awareness and knowledge of ESG integration best practices by asset owners/LPs, and their subsequent raised expectations, vis-à-vis ESG integration, for their asset managers. This is oftentimes reflected in the increased sophistication of ESG due diligence questionnaires sent to managers (e.g., asset class specific ESG questions).

Developments in the regulatory environment have accelerated the focus on ESG practices with investors seeking to define and document their ESG credentials more formally. In the US, the SEC issued an [ESG Risk Alert](#) in April 2021 that highlighted the variance of ESG integration practices amongst financial firms. The Risk Alert was intended to assist firms in developing and enhancing their compliance areas. At CGC, our clients have focused on ensuring that ESG workflows have been embedded into their regular governance & oversight cadence. Earlier this year, the SEC [announced](#) that ESG is one of its 2022 examination priorities, stating that it will look at whether investment firms “are accurately disclosing their ESG investing approaches and have adopted and implemented policies, procedures, and practices designed to prevent violations of the federal securities laws in connection with their ESG-related disclosures”.¹

¹ <https://www.sec.gov/news/press-release/2022-57>

Other trends driving further ESG integration include:

- increasing internal capacity of investment teams on ESG and climate
- more attention given to the impact of ESG issues on the volatility of cash flows
- the centralisation of ESG initiatives within an asset manager through the hiring of a Head of ESG and/or dedicated ESG resources to support and oversee ESG due diligence
- the availability of ESG technology tools to assist with data measurement, management, and reporting
- a desire to provide proactive proof against greenwashing
- competitive differentiation

Advanced ESG integration practices

More advanced private credit managers have integrated ESG considerations across the full investment life cycle, transitioned from a simple qualitative to a more quantitative assessment approach, defined ESG risk tolerances and parameters, and implemented ESG data management programs.

More specifically, advanced managers have moved beyond an industry-level evaluation of material ESG issues to a more precise portfolio company and business model specific assessment of distinct E, S, and G risks. This type of assessment typically includes a quantitative scoring framework (with separate E, S, and G scores as well as an overall ESG score), with the output being incorporated into the investment committee memo. This quantification and formalisation into the investment decision making process allows for comparison between investments, benchmarking, tracking, regular reporting, and an audit trail.

Distinct E, S, and G scores serve additional purposes. Advanced private credit managers use them to identify material, higher risk ESG issues to incorporate into sustainability linked loans, with interest rate ratchets based on improved performance on the material ESG issue. This aligns incentives between the portfolio company (interest rate reduction), private lender (reduced risk), and GP sponsor (value creation from improved performance on the material ESG issue). The granular view also feeds a more regular reporting of top exposures across a portfolio against risk tolerances. LPs are increasingly looking for this level of sophistication of identifying and managing ESG risks as a proxy for a manager's overall risk management capabilities. And lastly, climate risk assessments of portfolio companies across physical, transition, and liability risk are an emerging best practice at the more advanced ESG integrated private credit managers.

Navigating ESG: How insurance can respond to increased risk



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There has undoubtedly been greater scrutiny on how companies deal with environmental, social and governance (ESG) issues in recent times. Indeed, in many jurisdictions it is now a leading issue for shareholders, regulators, investors and the wider public. The heightened focus on ESG poses challenges for the asset management industry. Like all companies, asset managers need to respond to the ESG concerns of their shareholders and regulators. In addition, asset managers also need to consider the ESG priorities of their investors, including the marketing of investments within an ESG framework.

From a financial lines insurance¹ point of view, we see the greater scrutiny on ESG resulting in two areas of insurable claims for asset managers and the funds they manage. First, directors and officers may face claims from shareholders and regulators for actual or perceived ESG failures, including greenwashing, i.e., unjustified claims about environmental practices. Second, it seems asset managers are now more vulnerable to claims by investors and regulators for alleged misrepresentations in respect of investing within an ESG framework (including greenwashing).

Directors and officers insurance

There have been several recent ESG related claims against directors and officers. For example, in the USA a major suit has been brought by the shareholders of Cisco Systems against its directors in relation to the absence of any African-Americans on the company's board.² In the United Kingdom, recent reports suggest the board of directors of Royal Dutch Shell could face a derivative shareholder claim in respect of allegations that they failed to prepare properly for the net zero transition.³

An increase in claims has been coupled with greater regulatory oversight around ESG. From April, thousands of large UK-registered companies and financial institutions are required to disclose climate-related financial information on a mandatory basis, in accordance with The Companies (Strategic Report) (Climate related Financial Disclosure) Regulations 2021.⁴ It is likely that within the next few years that requirement will be extended to apply to the majority of UK registered companies. Similarly, in March, the Securities & Exchange Commission proposed rule amendments that would require US public companies to include certain climate-related information in their registration statements and periodic reports.⁵

¹ Professional Indemnity, Crime and Directors' & Officers Liability insurance.

² Filed in California in September 2020. Ultimately, the claim failed – the Californian court granted the defendants' motion to dismiss in March 2022: <https://www.dandodiary.com/?s=ESG>

³ <https://www.rpc.co.uk/perspectives/professional-and-financial-risks/shell-directors-facing-potential-uk-esg-shareholder-derivative-lawsuit/>

⁴ <https://beale-law.com/article/directors-and-officers-accountability-for-esg-compliance-and-performance/>

⁵ <https://www.kirkland.com/publications/kirkland-alert/2022/03/sec-proposes-new-climate-disclosure-requirements>

How can D&O insurance assist?

When faced with ESG related claims and regulatory investigations, directors and officers will naturally look to their D&O policy for coverage.

Claims

Core D&O coverage typically applies to claims against the directors or officers for actual or alleged acts, errors or omissions committed in their directorial or official capacity. A claim against a director or officer alleging ESG related failures is likely to fall within that category.

Regulatory investigations

D&O coverage for regulatory investigations typically applies for costs incurred by the directors and officers in responding to non-routine regulatory investigations into the company's affairs or the conduct of the director or officers. Again, a regulatory investigation in respect of ESG issues is likely to fall within one of those categories.

Other considerations

Modern D&O policies tend to have a small number of exclusions. However, most policies will have some form of pollution exclusion. Consideration should therefore be given to such exclusions in the context of potential claims and regulatory investigations involving environmental issues.

Given that the incidence of ESG related claims and regulatory investigations are on the rise, the increased risk should be considered in the context of determining the correct limit of liability under a D&O policy. In some cases, it may be appropriate to purchase increased limits, particularly for publicly listed entities, and dedicated 'Side A' coverage (which only applies where the company is unable to indemnify its directors and officers).

Many D&O insurers now ask specific questions around ESG at renewal as it is now viewed by many as a major risk area. If companies are able to demonstrate robust ESG policies, implementation and reporting, it will undoubtedly assist in making the risk more attractive to insurers. Unfortunately many companies struggle to understand and manage the evolving ESG landscape, and fall-short in being able to demonstrate well-structured and transparent corporate sustainability practices. Here is where having the right consultative partner is key to helping mitigate against greenwashing risks and regulatory pitfalls.

Professional indemnity insurance

To date we are not aware of many significant claims against asset management companies relating to alleged ESG failures. However, last year saw two notable developments. First, investigations by regulators in Germany and USA began into German asset manager DWS in respect of its ESG investing. It has been reported that the investigations were triggered by allegations made by DWS's former global head of sustainability that it made misleading statements in its 2020 annual report, where it claimed more than half of its US\$900bn in assets were invested using ESG criteria.⁶ DWS's offices were recently raided by German federal police and BaFin in connection with the investigation. Second, in July 2021 the UK Financial Conduct Authority wrote to asset managers to highlight concerns about applications to launch new funds with an ESG or sustainability focus, warning that these "often contain claims that do not bear scrutiny".⁷

⁶ The Financial Times, 31 August 2021

⁷ Ibid.

How can professional indemnity insurance assist?

When faced with ESG related claims and regulatory investigations, asset management companies will naturally look to their professional indemnity policy for coverage.

Claims

Core professional indemnity insurance typically applies to claims against the insured asset management company for actual or alleged acts, errors or omissions committed in its provision of professional services. If claims allege misrepresentation around ESG investments, it seems to us that there is a good prospect that professional indemnity insurance will respond, although much will hinge on how certain policy terms are defined – particularly the definition of ‘professional services’.

Regulatory investigations

Professional indemnity coverage for regulatory investigations typically applies for costs incurred by the insured asset management company in responding to non-routine regulatory investigations into its provision of professional services. Therefore, if a regulatory investigation focuses on alleged misrepresentations around investing within an ESG framework, it seems that there is a good prospect that professional indemnity insurance will respond, although as per the above, much will hinge on how certain policy terms are defined.

Other considerations

Coverage for regulatory investigations described above is by no means a standard feature of professional indemnity insurance for asset managers. Indeed, in the last few years many insurers in the London market have attempted to remove such coverage (where it exists) or to amend it so that it only applies to costs incurred by employees, as opposed to the insured asset management company itself. Accordingly, this is an area of coverage that should be reviewed.

The comments above in the D&O section in respect of pollution exclusions apply equally to professional indemnity policies as most policies include such exclusions. The issue of increased limits of liability and increased insurer scrutiny are also relevant to professional indemnity insurance, although perhaps to a lesser degree than for D&O insurance.



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Trustless, but verified: Identity compliance in Web3



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Decentralised finance (DeFi) is continuing to gain ground, with more than 4.7 million unique wallet addresses in use. As the industry grows, so does the urgency to develop a decentralised identity solution that adheres to the DeFi ethos while protecting sensitive user and investor identity information.

DeFi is attractive to users and investors alike because it enables a 'trustless' system by using cryptocurrency and blockchain technology to manage financial transactions. The traditional Web2 financial system relies on a structure of trusted intermediaries, such as banks, broker dealers and transfer agents. By contrast, DeFi participants can rely on the blockchain's public and immutable ledger of activity. All financial transactions are recorded on a blockchain and governed by on-chain smart contracts that are programmed to effectuate transactions under certain defined conditions. Parties need not trust, or even know, each other or recruit an intermediary in order to transact with confidence. Advocates of DeFi assert that the decentralised blockchain makes financial transactions more secure, more transparent and reduces costs.

However, decentralised transactions pose many concerns - two of which we focus on in this article. First, without an intermediary bound to protect transaction participants, how vulnerable is an anonymous, trustless system to fraud?

In recent months, crypto “rug pull” scams have soared in frequency; nefarious actors lure investors into trustless systems, then pull all their liquidity —disappearing with the investors’ money and leaving them with worthless currency. These schemes are achievable largely because the identity of the offering sponsor is unknown, and in some instances, unknowable.

Second, how do participants avoid unwittingly becoming accomplices to money laundering and/or violating sanctions prohibitions? The Russian invasion of Ukraine has underscored how critical it is to ‘Know Your Customer’ — not just to satisfy heightened regulatory scrutiny, but also to ensure that those who are subject to sanctions are truly blocked from participation in financial markets.

So how do we preserve the decentralised nature of Web3 while bringing trust and compliance to Web3 financial transactions?

There have been several proposals for decentralised identity verification and compliance in Web3, all of which maintain that Personal Identifying Information (PII) such as social security numbers and dates of birth should never be put on the blockchain, where it would be publicly viewable and vulnerable to fraud and identity theft.

Any solution must operate as a proxy for identity that confirms a participant’s eligibility to transact without displaying any PII. On-chain identity tokens, Verifiable Credentials and wallet monitoring protocols all supply these sorts of proxy-based identity verification, although each comes with unique limitations.

On-chain identity tokens

An on-chain identity token could provide a comprehensive solution to confirming critical aspects of a wallet owner’s identity and can be leveraged in a decentralised transaction. Identity tokens are native to a blockchain and can interact directly with smart contracts. In turn, smart contracts can require all parties to hold a valid identity token as a condition of participation. In this model, DeFi participants provide identifying information (e.g., passports, addresses) to an outside third party (such as Parallel) who performs robust KYC checks that conform to industry standards for regulated financial institutions. That third party verifies and validates the identifying information, screens the identity against sanctions lists, and issues a non-transferable token to the natural person or business entity. Token holders can then participate in any Web3 native application such as a decentralised exchange (DEX) or decentralised autonomous organisation (DAO).

In keeping with Web3 principles of decentralised anonymity, identity tokens do not contain any PII, but they do contain the necessary information to assure market participants that their counterparties do not have a history of fraud and are not subject to sanctions. For example, a token would indicate: i) whether the owner is a natural person or business entity; ii) that the owner has submitted information to a KYC/AML review and iii) that the owner is not currently sanctioned and is being monitored for new sanctions. Tokens can even assert the owner’s investor accreditation status. An on-chain identity token provides seamless KYC in every transaction without the need for bespoke identity checks.

It should also be noted that as regulated financial institutions (such as fund managers) move toward participation in DeFi, they could fulfill their BSA compliance obligations by requesting that the relevant token holders release the identification data provided to the token issuer, which would be done off chain.

DIDs & Verifiable Credentials

Decentralised Identifiers (DIDs) are a type of unique identifier directly (and provably) owned by the identity holder — not unlike an email address or username — that enables decentralised, reusable identity. DIDs are entirely controlled by the identity owner and are independent of centralised registries, government authorities and identity providers.

DIDs provide a framework to receive and share Verifiable Credentials (VCs)—cryptographic certificates that convey information about the DID holder. DID holders seeking a Verifiable Credential can present physical forms of identification (such as a driver's license, passport or utility bill) to a VC Issuer. The issuer authenticates the documentation before issuing the VC (which may, but need not, house the original documentation provided for authentication). The VC then acts as an immutable, cryptographic piece of evidence tying attributes to the DID holder.

For example, a DAO could require as a condition of admittance that any applicant seeking membership must hold a VC proving that they are not sanctioned. An investor who wishes to join that DAO could provide a physical form of identification, such as a passport, to a VC issuer. The VC issuer would confirm that the identification is valid and that the holder of that identification is not subject to sanctions. Then the issuer would issue a VC to the investor's digital wallet indicating that the holder of the passport is not subject to sanctions. The investor can then present the VC to the DAO (the verifier in this example), and, if the DAO accepts the VC, the investor would be permitted to join.

Web3 users can choose to transact only with counterparties that have been issued a particular VC. VCs can offer transaction parties assurance that a particular attribute has been verified for all counterparties without requiring transfer of PII.

However, because the use of VCs is an off-chain process, separate from a transaction, it adds a significant impediment to activity in a blockchain-native environment.

Wallet monitoring

Wallet monitoring is another common approach to add security to Web3 applications. Firms survey the activity of digital wallets in order to identify and track wallet addresses linked to criminal behavior (like rug-pulling scams). Users can research any wallets that are parties to an upcoming transaction and ensure that none have previously engaged in known fraudulent or suspicious activity.

However, wallet monitoring is limited by its scope, since these protocols provide no mechanism to identify a wallet's owner. Criminal actors can simply create new wallets for each fraudulent transaction and evade detection. Additionally, wallet monitoring does not perform any KYC that would indicate, for example, if a wallet owner is subject to sanctions. While it certainly provides a layer of security for DeFi transactions, wallet monitoring is an inadequate replacement for a robust KYC process.



The DeFi market is growing. But that growth is limited by a lack of regulation and vulnerability to fraud. Building compliance infrastructure will meaningfully accelerate adoption and attract both risk-averse investors and regulated financial institutions. Identity solutions that preserve the decentralised elements of Web3 while infusing a level of transparency, security and integrity to the market are the way forward.

We at Parallel will continue to be at the forefront of these technologies. If any of these topics are of interest to you, please feel free to reach out directly.

Deep dive on automation: What approaches are asset servicers taking to future-proof their businesses?



Tim Mietus

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Citco Technology Management, Inc.

The growing popularity of alternative asset classes has created both challenges and opportunities for the asset servicing industry.

The growth in assets under administration has created a clear path to organic growth thanks to the potential to win new and expanded client mandates.

However, accommodating that growth means asset servicers need the ability to scale up their operations to meet demand.

As witnessed across many other industries, technology is being used more and more for the heavy lifting behind the scenes – especially when it comes to managing all the data that needs to be processed, and ensuring workflows are optimised.

Below, we take a look at some of the leading options for asset servicers who are trying to build the business of tomorrow to meet client needs.

Streamlining processes with robotic process automation

One area where automation is having a big impact is processes and workflows.

Many asset servicers have multiple teams implementing manual tasks, which can lead to human error and delays, particularly at times of increased volumes.

In order to adapt processes to meet the rising demands of a growing industry, the Citco group of companies (Citco) has been looking to Robotic Process Automation (RPA), which as a tool automates tasks that are carried out by humans, often pertaining to multiple teams or departments.

RPA, which Citco has in production for a number of use cases, can improve back-office processing by reducing the number of manual touchpoints within asset servicers' businesses, leading to less risk of errors, improvement in STP rates, and overall improvement in client service.

Natural language processing

One technology making waves in the industry is Natural Language Processing (NLP), which concerns the interactions between computers and human language, with a focus on how computers can be used to analyze natural language to extract information.

This idea itself is not new. Citco has been using an earlier version of NLP called Enhanced Optical Character Recognition for a number of years to extract key data points from text-based documents. However, such technology would traditionally struggle with non-standard formats and interpreting the nuances of human language.

With the advent of artificial intelligence, the complexity of NLP is progressing at pace, with the ultimate aim of being able to use computers to review non-standardised documents and extract key information without the need for human intervention.

The benefits of such technology to asset servicers are clear, whether in reading PDF statements from third parties to extract Net Asset Values (NAV) and speed up NAV finalization or by automating data extraction for processes such as capital call notices, corporate actions, and account statements.

Such uses would serve to speed up delivery and improve the client experience, while freeing up human resources to focus on oversight and higher value-adding operations.



Machine learning

One other approach is to instigate a series of rules for computers to follow. Known as machine learning, this works by implementing algorithms to teach computers a task they need to achieve, using both good and bad examples to 'train' them.

The algorithm then finds relationships between the data and 'learns' how to predict the target or answer the question from the training dataset.

Like the other models, it means computers can take the strain on a number of tasks, delivering a consistent, efficient - and crucially a scalable - process.

However, as with its processes above, these take time and investment from operations teams to initially implement in order to build a rigorous enough process.

Where do we go from here?

RPA, NLP and machine learning are already radically changing the way we do business. As well as enhancing how asset servicers work and giving them greater breadth to expand their workloads, they can be upgraded with new solutions as needed.

They are not the only solutions out there, with distributed ledger technologies such as Blockchain also presenting multiple potential use cases across the industry. These could include things like client onboarding, regulatory compliance, and the use of smart contracts.

The key with much of this is time. All of the above, if implemented effectively, should reduce turnaround times. This could range from NAV processing that may switch to more regular cycles as more steps get automated, to its use in collateral management where clients may expect faster responses to their emails as the industry automates the process of “inferring” client emails thanks to NLP.

In such a world, those asset servicers that don’t have cutting edge solutions may well see an impact on their ability to maintain and grow their market share.

The case for greater industry standardisation

When we see such examples of automation, it is easy to see the value that disruptive technology can bring to asset servicing and how it will enable the industry to scale in line with growing demand.

However, while Citco welcomes this progress, the real end game that we should all strive for is a better ecosystem for all participants in the industry.

By standardising the documents that we use, for example, and by enhancing communication between managers and investors when it comes to the various tasks that we carry out every day across the industry, not only will we create more streamlined processes, but also establish a consistent foundation for technological solutions to build from

Of course, due to the way the industry has grown these changes will not happen overnight, and that is why technologies like those detailed here will be critical in managing the capacity constraints on the industry in the short term. However, it is the aspiration of many market participants, ourselves included, to push for the elimination of non-standard data and paper to truly digitise the sector.

This will mean a concerted effort to get competitors to cooperate by adopting the same technologies. While this has historically been a challenge, Citco firmly believes there is growing momentum for this to happen, with the end result being a sector which benefits from a more streamlined alternative investment universe.



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Going modular: Why outsourced trading is no longer an all-or-nothing option



Damian Hoult

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Damian Hoult, Outsourced Trading Distribution and Product Development Executive at State Street, explains how outsourced trading solutions are gaining traction among fund managers across all asset classes.

Outsourcing trading execution used to be a binary decision. Fund managers either concentrated entirely on asset allocation and strategy and handed over all trading to a third-party, or they built an in-house trading desk to handle all their liquidity requirements and potentially create an extra avenue for alpha.

However, asset owners and managers are becoming more receptive to a modular approach as technology advances expand execution capability and regulatory burdens increase execution costs. In Bloomberg's 2022 US Institutional Equity Trading Study, 20 percent of participants said they have plans to implement some form of outsource trading in the next two years.¹

What are the main benefits of an outsourced trading solution over in-house execution?

Outsourced trading should not be seen as an alternative, but as a partner offering a broad spectrum of products and services for fund managers to choose from. A fund manager considering outsourcing should first assess the needs of their portfolio and whether they can perform cost-effective execution.

If they are unable to, outsourcing to a global third-party platform can fill those gaps and create the optimal trading model. The Bloomberg survey showed, for instance, that traders are more willing to outsource specific markets, asset classes and account types — rather than the whole trading desk. It also indicated that quantitative asset managers and hedge funds are more open to this than traditional fundamental funds.

¹ <https://www.bloomberg.com/professional/blog/webinar/bi-analyst-briefing-us-equity-trading-2022-can-retail-and-institutions-share-a-market/>

In practice, we're seeing different parts of the industry embrace outsourcing for multiple reasons. There are the funds that are just launching and may not have the scale to justify building an internal trading desk; managers who are expanding into new areas and lack the necessary expertise; smaller-sized firms with one-off events such as managing an unusually large cash flow; and hedge fund managers who want to take advantage of a short-term opportunity in a new market, where setting up internally would take too long.

These scenarios often involve complying with constantly changing regulatory environments across the globe, and this requires a significant investment in both people and technology, which in practice is only financially viable for the largest asset management firms. In some markets, the risk of breaching regulations can be catastrophic, so being able to outsource this risk alone can be invaluable. Using an outsourced trading desk provides the benefit of instant access to global teams that have local regulatory and compliance expertise.

Fund managers always need to be on top of costs that can eat into their performance. How does outsourcing help?

For many hedge fund managers, the cost of building desks to access global markets from a single hub or moving into other asset classes can be prohibitive. Some of the bigger outsourced trading desks can offer multi-asset class trading, which enables fund managers to tap into trading expertise within a specific asset class without building their own trading capability.

For the more opportunistic hedge funds, outsourcing also provides the economy of a variable — rather than fixed — cost structure. Effectively, you rent rather than own, and only pay to play. A trading solution is available whenever you need it, but unlike building an internal capability there is no cost when you don't use it.


On the regulatory side, where compliance costs are steadily rising, transaction cost analysis (TCA) has become an integral part of the investment process for asset managers and owners. Some outsourced trading businesses have invested heavily in market-leading bespoke analytics products to measure and identify trading costs and use as an input to identify execution cost savings and help improve fund performance. Outsourced trading desks will always direct flow where liquidity is available, which gives clients "best execution" outcomes.

What has COVID-19 taught fund managers about their trading set-up?

COVID-19's work-from-home requirement showed us that traders do not all need to work in the same location as their team members. Once you accept the idea of not needing all your asset managers and traders to be in one place, outsourcing some of your trading to a better-suited location is a much smaller step.

Another discovery was the shortfall in almost everyone's business contingency plans (BCPs). BCPs were based on the premise of providing a separate workspace if the primary location is not functional or available, but they never accounted for the possibility that personnel would not be able to move.

So in the same way that cloud technology has made computer access portable, outsourcing ensures trading continuity when access to internal capabilities is restricted.



How should fund managers be thinking about the optimal model for their business?

As with most issues, it usually comes down to money. Fund managers need to constantly invest substantial sums in technology to stay updated with the evolving market structure and global regulatory requirements and to optimise their trading outcomes.

Global outsourced trading firms invest significantly in technology to stay ahead of the curve, which is only possible thanks to their global footprints and scale. This is reflected in the Bloomberg survey, and explains why small- and medium-sized firms are more open to outsourcing: it gives them access to markets and resources that would not otherwise be available. Having already made that investment, large asset managers tend to prefer to stick with their in-house desks.

It is important to distinguish between different outsourced trading desks. Some are experienced in managing cross-asset class trades, derivatives, overlays and FX, while others may only offer a more vanilla service. Outsourced trading is not a binary offering or one-size-fits-all solution, and not all outsourced trading desks are created equal.

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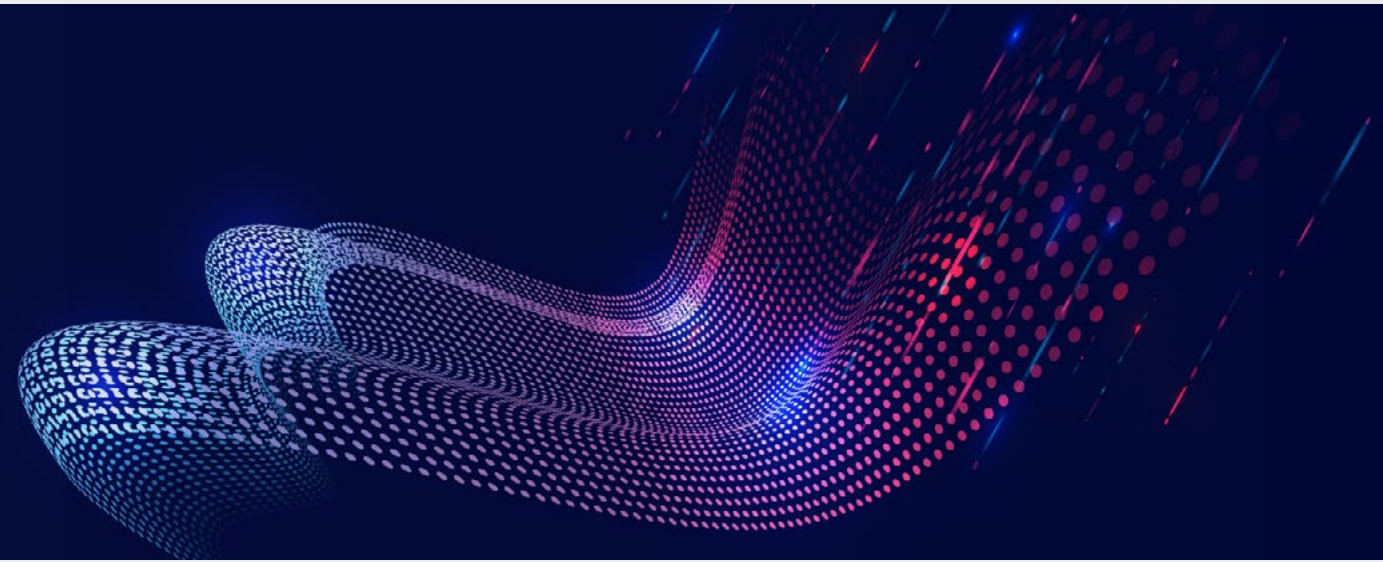


STATE STREET ALPHASM

As the threat of cyber attack continues globally, managers look to digital advancement for further protection



George Ralph
Global Managing Director and CRO
RFA



In January 2022, the World Economic Forum published their 'Global Cybersecurity Outlook' report. In this document, the organisation details how societies are increasingly reliant on technology to manage everything from business processes to public services. Governments and companies have been active participants in creating this future and as a consequence, have been shaping a new cyber landscape for the world. As such, a key focus in the Global Cybersecurity Outlook' report is to build cyber resilience.

Building cyber resilience has never been more important. Last year, the World Economic Forum worked alongside over 120 global cyber leaders to accumulate and organise a collection of highly detailed insights on emerging cyber threats.

A key driver for the focus for worldwide cybersecurity systems are digital trends and their rapid acceleration in proliferation due to COVID-19. The pandemic disrupted the societal landscape worldwide, pushing the population to embrace a new frontier of interconnectedness and digitisation of the workplace. Offices embraced working from remote locations overnight because there was little other choice, and this event has driven the adoption of digitisation at a far more rapid pace. With the developments of more sophisticated tools for working remotely, distance learning and digital entertainment, the trend for digital advancement will only continue to accelerate and we are seeing advancements both in our personal and professional lives to illustrate that.

Whilst the digital transition meant the finance world could continue to do business with relative ease thanks to technology, there is another side to this story which is much more troubling and ominous. This new digitised landscape and existence has led to a more frequent materialisation of cyber incidents. This is always costly and damaging to those involved. However, it is not only the digitalisation of the workplace that proposes a greater threat. Supply chains that rely on technology partners and who use third parties are also becoming digitised which in turn creates new exposure to vulnerabilities to cybercrime.

The civilised world is living and working within a context of widespread dependency on digitally complex systems. In this climate, there are greater cyberthreats and their growth is advancing beyond the speed in which society can manage and prevent them efficiently and effectively. The World Economic Forum reported at the end of last year that throughout the course of a week, following a discovery of a critical security flaw in Log4j, a widely used software library, there were over 100 attempts every minute to exploit the vulnerability that was exposed. That is over 1,008,000 attempts for just one exposure alone. This example illustrates the severity of risk that companies are facing and the crucial and essential reasoning for adequate monitoring and management software for all of our businesses.

With the looming threat of cyberattack, investing in digital advancement via cybersecurity is a priority for businesses within the financial sector. Human behaviour and work interactions are increasingly defined and shaped by ubiquitous technologies. By consequence, companies and businesses must seek to continue to adapt their competence and capacity to handle and minimise the risk of malicious cyber criminals who are exploiting the ever changing technological landscape. It is for this reason that cybersecurity should be a priority for all. By investing in cybersecurity, the world will truly be unleashing the potential of the digital economy.

In order to progress in this new frontier of work and living, firms should consider investing in a managed detection and response platform as part of their overarching IT strategy. Businesses within the financial services sector should seek access to an outsourced partner who can support cybersecurity via a SOC (Security Operation Centre). This is a centralised function that offers around the clock monitoring of the work of employees, services and



technology, whilst also seeking to improve the overall security posture of the business through the continuous prevention, detection, analysis and response to cybersecurity threats and incidents. Whilst technology and digital advancement has in some parts created the problem with regards to cyber safety, it is also a key part of the solution. Moving forward to the next iteration of technology and digital transformation, it is critical for businesses to have a 24/7/365 view of their overall business operations and data and this should derive from continuous machine learning that contextualises threat intelligence from markets and global geopolitical events.

In addition to implementing managed detection and response strategies, companies must gain assistance and advice from external experts. In their 'Global Cybersecurity Outlook 2022' report, the World Economic Forum shared that 84% of businesses now believe that cyber resilience is a business priority for their company and this should be achieved through support and direction within their leadership. However, contrasting this figure, 68% of businesses believe that cyber resilience plays a critical role in risk management for their company. This misalignment between understanding of how cybersecurity should be carried out within a business illustrates the need for companies to seek external expertise to ensure their business is secure. A gap between leadership teams can leave businesses exposed to even greater risk.



In conclusion, it is clear that society will continue along its path to migrate and adapt into an increasingly digitised world. Along this road, the threat of cybercrime will also be at the foreground of business decision making moving forward. Preparing for and mitigating risks and attacks will be costly to organisations, not just on a financial scale, but also in terms of infrastructure, mental wellbeing and societal cohesion. As the world looks ahead to the rest of 2022 and beyond, it is essential that businesses globally see cybersecurity as a strategic business issue that drives and influences decision-making. It is no longer a question of 'how' firms are protected in terms of cybersecurity, but rather 'how well' they are protected, with a key focus on sophistication, effectiveness and fortitude.



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The war in Ukraine: Seeking redress through investment treaty claims



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Introduction

The war in Ukraine has had a profound economic impact on asset managers with exposure to Russia. The Russian response to Western sanctions has been to threaten or impose its own counter sanctions, restrict the transfer of funds abroad, introduce discriminatory trading restrictions against foreign investors holding securities listed on the Russian stock exchange, and nationalise foreign-owned assets and businesses.

What can and should asset managers do about this? Many businesses are exiting Russia voluntarily, but many others are being forced out. Investors are having to write off very large sums from their balance sheets or, at the least, significantly mark down the value of their Russian investments. A number of commentators have written about the use of side pockets and other measures to deal with stranded Russian investments. However, asset managers should also consider whether there is anything that they can do to defend their positions and asset valuations, or even to seek legal redress. A potential avenue for remedy would be to bring a claim under an applicable investment treaty, which may offer asset managers, funds or their investors the ability to bring a claim against Russia in a neutral forum to seek potentially significant damages for the loss of their investments caused by the actions of the Russian State.

What is an investment treaty?

Investment treaties are designed to promote investment by the investors of one contracting State into the territory of the other contracting State. They contain a number of protections for investors, including guarantees of fair and equitable treatment, protections from unlawful expropriation without adequate compensation, and guarantees that investments and income can be repatriated by the investor to their home State.

Russia is a party to over 60 bilateral investment treaties. These include several jurisdictions in which major institutional investors and investment managers are based (for example the UK, Singapore, France, and Germany), and others that are commonly seen in investment fund structures, such as Luxembourg and the Netherlands. There are also numerous multilateral treaties containing investor-State protections.

If Russia infringes the protections afforded to qualifying investors under these treaties, an investor may be able to bring proceedings in international arbitration – a neutral forum – to seek redress.

Very broadly, assuming the offer to arbitrate is wide enough to cover the dispute, if someone qualifies as an **'investor'** with an **'investment'** under an applicable treaty, they may bring a claim. An investment manager, fund or a fund investor will therefore need to establish that they fall within the applicable definitions.

What is the definition of an 'investor'?

The starting point for the definition of an 'investor' is the definition used in the particular treaty. In general, this is very broad. There is also usually general wording to the effect that it includes both natural and legal persons.

There are different approaches to establishing whether a **legal person** is covered. Quite often it is by reference to where the entity is incorporated but may also be by reference to where it has its seat or management. This has potential implications in an investment fund context, where the fund vehicle may incorporate in one jurisdiction, but the management entity be located in another.

Some investment treaties state that the investor needs to have 'substantial economic activities' or 'substantial business activities' in the State in question. This may preclude a claim being made by a shell holding company. However, that is not always the case, and if this requirement is not stipulated in the treaty, then a claim may be permitted.

The definition of 'investor' can also often extend to indirect ownership, either explicitly or implicitly. This means that the fact there are intervening companies in a corporate structure will not prevent a company higher up the chain from bringing a claim. This can be the case even if the corporate structure includes intermediate holding companies located in a third-party State (i.e., without an investment treaty). Indeed, the corporate chain may provide access to more than one investment treaty claim. If the intervening companies are incorporated in other jurisdictions with investment treaties in place, there is nothing to stop each company in the chain bringing a claim. They would not be able to make double recovery, but they can run multiple proceedings in order to increase the overall chances of success.

What is the definition of an 'investment'?

As with the definition of an 'investor', the definition of an 'investment' in investment treaties is, again, typically very broad.

An investment will almost certainly include an ownership interest in physical assets involved in running a business, such as civil infrastructure or machinery, as well as shares in project companies in the host State. However, the definition of 'investment' is usually much wider than this, often encompassing **every kind of asset** including:

- (i) movable and immovable property, and other related property rights such as mortgages;
- (ii) shares and other forms of participation in a company or business enterprise;
- (iii) claims to money, and claims to performance under contract having a financial value;
- (iv) IP rights, technical processes and know-how attached to an investment; and
- (v) rights, conferred by law or under contract, to undertake the search for, or the cultivation, extraction or exploitation of natural resources.

Notwithstanding that these definitions are already very expansive, in many treaties the **categories are non-exhaustive**, allowing investors to argue for other forms of asset to be included. A possible issue arises with portfolio investments, that is, investors whose only interest in an asset is as an investment rather than holding a stake for management purposes (which may cover investments made by the majority of managers and funds).

Different tribunals have made different comments on this, which emphasises the need to consider the terms of the treaty carefully and to choose your tribunal with care.

Enforcement

A lack of optimism on enforcement is a common theme of commentators on this topic, particularly on whether Russia's creditors will be able to **enforce against sufficient assets to cover their claims**. It has been estimated that affected Ukrainian parties alone will need hundreds of billions of dollars and previous enforcement against Russia has been fraught with difficulties.

Nevertheless, it is reported that about 40-50% of the Central Bank of Russia's **foreign reserves** have been frozen as a result of recent sanctions – estimated at about US\$643 billion. Accessing these funds would be very difficult. In England – and in most countries – the reserves of foreign central banks are subject to sovereign immunity, but if the sanctions against Russia continue for many years, these assets may well become a target for determined and tenacious creditors willing to test the law in this area.

Some creditors may also seek to enforce against the assets of Russian State-owned companies – some of which have substantial assets located abroad. Whilst this would be challenging in the UK, the enforcement of arbitration awards is by nature international and cross-border. Arbitration awards can be enforced very widely across the world under the New York Convention. Executing an award against Russia against the assets of State-owned entities may be a viable option in some jurisdictions.

Practical considerations

Asset managers and funds with exposure to Russia should consider undertaking the following actions:

- **audit** investments and investment structures to establish which may qualify for investment treaty protections;
- **preserve documents**. These records will be the evidence needed to prove a legal claim for damages. This is particularly important for businesses or offices actually based in Russia. If those businesses or offices are expropriated, access to evidence may be lost, so it is important to preserve data off-shore where possible;
- when **divesting assets**, consider whether a right to bring a claim can be retained, or whether that right will be sold together with the asset and, if so, how that right may affect the value of the transaction;
- **conduct valuations now** with the benefit of control of the asset and access to documents. This should cover the value of the investment today – at any impaired value – and also the value prior to the imposition of Russia's measures; and
- **assess claim viability now**: enforcement is unlikely to be easy or swift. However, prospects of enforcement are maximised by taking decisive action early, to be at the front of the queue – with an enforceable award in hand – in the global enforcement race that will follow;
- **take legal advice on funding options**: you may be able to obtain third party funding for your claim in return for a share of recovered proceeds;
- consider sending any **notice of dispute** sooner rather than later, as most investment treaties contain a cooling off period requiring parties to negotiate before commencing a claim – timeframes vary but these are typically 3 or 6 months.

In short, claims under investment treaties may provide an enforceable avenue for the recovery of value for asset managers in light of Russian counter sanctions and other measures which discriminate against foreign investors in Russia. Practical steps to investigate any rights are available and should be considered sooner rather than later in case further measures are brought in.

If you would like to know more, please contact one of the authors of this article.

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Launching a hedge fund? Call the (right) prime broker



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Most managers taking the leap of faith to launch a new hedge fund don't think about appointing a prime broker first. Strategy, potential investors, and a compelling pitch probably occupy more of the new or emerging manager's attention in the decisive early days.

Yet an experienced prime broker can help with a whole raft of services that can make the arduous task of getting a new hedge fund off the ground a tad easier. In fact, the right prime broker may become a long-term partner, on hand for the launch and to help build future growth.

The hedge fund industry is emerging from the COVID pandemic with signs of rude health. In the first quarter of 2022, new capital allocated to hedge funds by institutional investors was reported to be the highest since mid-2015. In the same period, the [AIMA Hedge Fund Confidence Index](#) ticked up one point to +17.

Many in the industry say this, along with the challenges and opportunities created by the heightened market volatility brought on by macroeconomic concerns, is likely to fuel a spate of new fund launches. Here are some key decisions the aspiring fund manager needs to make.

Strategy and target investors

The first is deciding on the strategy and which investors to target. Is the aim to attract renowned allocators or will the fund start small, catering to family and friends? This is a key decision that will determine the structure of the fund and, potentially, where it is domiciled. But whatever the ambition, managers must be aligned with their target investors from the outset.

This requires early discussions on fee structures. Some investors may demand lower fees or other concessions to invest in a start-up hedge fund, relaxing their demands as the fund grows. Eagerness to win an early investment must not lead a new manager to commit to an arrangement that proves to be a bad deal over time.

Many new managers find themselves running a business for the first time. This makes choosing the right COO vital. Not only can the COO handle critical tasks such as due diligence and compliance, an experienced and respected officer can boost the appeal of the fund for potential investors.

Pitfalls

Numerous pitfalls await the new or emerging manager. But help is available from service providers, including prime brokers. Many PBs have been involved in numerous fund launches and are valuable sources of advice, including on how to avoid costly mistakes.

Nonetheless, it is important to choose the PB best suited to the scale and ambition of the emergent fund. The anticipated growth in fund launches has increased competition among prime brokerages, meaning the bulge-bracket titans of the industry are more willing to take on funds with fewer assets under management, say \$25 million. However, these large providers may demand a certain level of revenue from their hedge fund clients, who may find themselves dropped if that revenue is not forthcoming.

In reality, many funds have at least two prime brokers – often one large and one mid-sized. It's commonly accepted that the mid-sized PB are more responsive and have more time to engage with the client, while matching the large firms in asset coverage and capability.

Choosing a prime broker, then, is a critical early decision for the new fund manager. Other appointments include a fund administrator, a law firm and accountants. PBs can usually provide contacts for these and other service-providers.

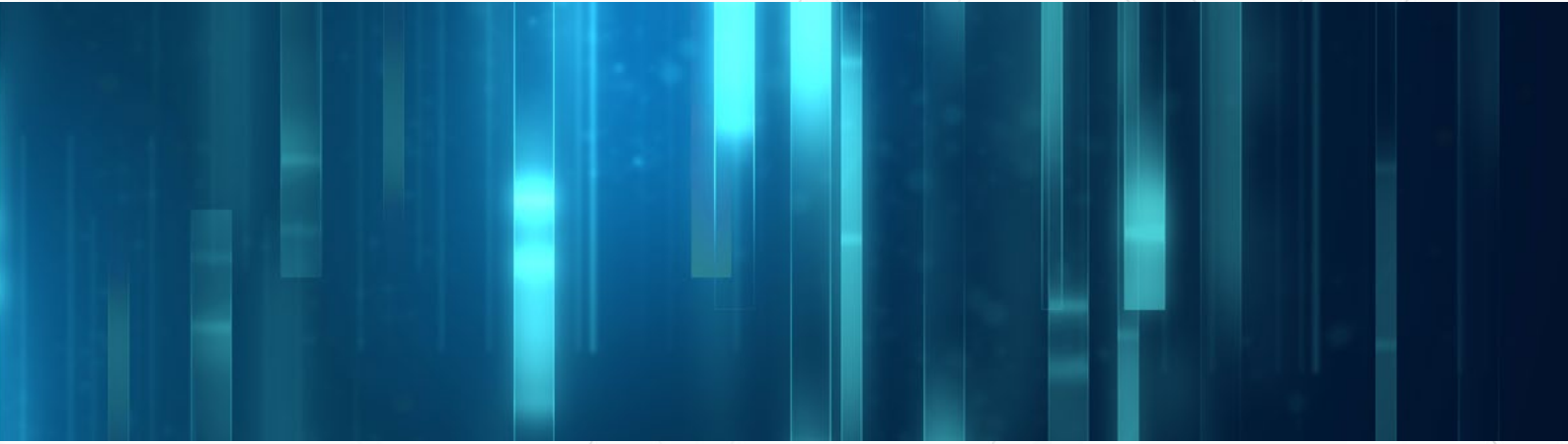
In-house or outsource?

Veterans of multiple fund launches caution CIOs to match spending on these essential services with the overall scope of the fund. These days, a key decision is whether to keep these services in-house or to outsource. Even the COO role can be outsourced.

A major growth area is outsourced trading, which saves funds the cost of infrastructure and in-house traders' salaries.

With these matters decided, the new manager can concentrate on raising money from investors. A clear strategy is essential, as is a compelling account of why the CIO's team will be able to implement it. This requires intense research into the potential investor base and the competition. Managers should be prepared to be compared to managers with competing offerings and be ready to articulate why their strategy is different. And better.

Allocators will look at the manager's investment track record, particularly in running a similar strategy. They will also look at the cohesiveness of the team. Chopping and changing within the senior management is likely to be frowned upon.



Raising capital is hard work, requiring persistence and patience. A potential investor needs to get to know and trust a new manager, who should be prepared for numerous meetings – many of them fruitless. Many new managers make the mistake of underestimating how long the process takes.

But, again, help is available from a prime broker. Capital introduction is a fundamental aspect of the relationship between a PB and a fund. While some PBs might chase money wherever it may be, a responsive high-touch firm will carefully select potential investors appropriate to the size, strategy, and track record of the fund.



Right money at the right time

It's a case of introducing the right money at the right time – and it helps both funds and allocators.

The right PB also finds time for the small stuff, even down to honing the pitch document and the slide deck.

It may seem premature, but new funds should be thinking how they can build for scale from the start. A lengthening track record running money for family and friends may open the door to investment from, for example, university endowments.

As a fund grows, outsourced services may be taken in-house. Once prohibitive fixed costs can become a worthwhile investment as assets under management increase. In any case, systems and service-providers should be scalable and able to grow with the business.

Prime brokerage is changing and PBs can expect to face questions about their responsiveness and their experience of the hedge fund industry and fund launches.

Of course, a new prime broker can be brought in at any time. But if the manager makes the right choice from the start, they may find they have a partner who will advise and work with them every step of the way from launch to growth.

Luxembourg: The new securitisation regime offers more flexibility and new opportunities

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On 9 February 2022, the Luxembourg Parliament voted to adopt a law that brings about long-awaited reform of the Luxembourg's securitisation regime.

The law of 25 February 2022 – which was published in the Luxembourg official gazette on 4 March 2022 and entered into force on 8 March 2022 (the **Amended Law**) – clarified certain aspects of the Luxembourg law dated 22 March 2004 on securitisation (the **2004 Law**) as well as adapted the 2004 Law to the requirements of the current securitisation market. The intention is that the updated securitisation regime will increase the appeal of Luxembourg securitisation vehicles and bring new opportunities for the Luxembourg financial services industry.

This article summarises the main changes that the Amended Law made to the 2004 Law.

Additional financing options

Before the Amended Law was enacted, a Luxembourg securitisation vehicle (**SV**) had to finance the acquisition of the risks that it intended to securitise by issuing securities (*valeurs mobilières*), and in principle¹ the SV could not make use of other sources of financing, such as entering into a traditional loan agreement that was not structured as a debt security.

The Amended Law has introduced changes that allow SVs to finance, partially or totally, their activities by entering into contractual types of borrowing (for example, borrowing by way of a loan agreement).

In addition, the Amended Law replaces the reference to 'securities' (a term that is not defined under Luxembourg law) in the 2004 Law with a reference to 'financial instruments' (*instruments financiers*), a term that is clearly defined in the Luxembourg law dated 5 August 2005 on financial collateral arrangements.² The reason for this amendment is to ensure uniform interpretation and more certainty for market participants, especially where the securities issued by the SV are not governed by Luxembourg law.

These changes clarify and extend the means by which SVs can finance their securitisation activities. They also align the Luxembourg securitisation regime with the European Securitisation Regulation³ by ensuring that any securitisation transaction subject to such EU Regulation can be performed by and through Luxembourg SVs (including securitisations resulting from entering into loan agreements).

¹ Except on an ancillary and/or limited basis.

² Article 1, point 8 of the Luxembourg law dated 5 August 2005 on financial collateral arrangements, with the exception of claims and rights under Article 1, point 8, f.

³ Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent, and standardised securitisation.

Active management of debt portfolios: opening the door to CLOs

While the 2004 Law was silent on this subject, in practice the CSSF's⁴ regulatory approach was very restrictive with regards to the SV's management of its securitised assets. The CSSF considered that the SV's *"action must be limited to a "prudent man" passive management"⁵ and that such management "can under no circumstances consist of either active management of the portfolio aiming to take advantage of short-term fluctuations of market prices and resulting in an ongoing activity of claim acquisition and assignment or (...) a professional credit activity performed by the securitisation undertaking on own account"*.⁶

In light of the current debt market practices and the opportunities that a more permissive approach would offer to the Luxembourg financial services industry, the Amended Law allows SVs to actively manage – directly, or through a third-party manager – a portfolio of assets consisting of debt financial instruments or claims, provided that their acquisition is not financed by the issuance of financial instruments to the public.⁷

Such a development will further increase the attractiveness of Luxembourg SVs as standalone investment vehicles as well as core parts of wider investment structures that manage debt portfolios. We anticipate that the Amended Law, that allows SVs to actively manage debt portfolios, will put Luxembourg higher on the list of jurisdictions that CLOs managers consider when establishing their European investment structures.

Clarification of the criteria for SVs to be approved by the CSSF

SVs issuing securities to the public on a continuous basis must be authorised by the CSSF.

While the concept of the *"issue of securities to the public on a continuous basis"* was not legally defined before the reform, the Amended Law now clarifies the conditions under which SVs must be authorized by the CSSF, by adding the following definitions, which reflect current regulatory practice:

- an SV issues financial instruments on a continuous basis when it offers financial instruments to the public more than three times during the course of one financial year, taking into consideration the total number of issuances by all compartments of the SV;
- an issue of financial instruments is *offered to the public* when:
 - it is not reserved to professional clients;⁸ and
 - the nominal value of the financial instruments is lower than EUR 100,000; and
 - it is not distributed by means of a private placement.

Increased flexibility to grant security interests

The Amended Law allows SVs to grant security interests over their assets in order to cover obligations *relating* to the securitisation transaction. This broadens the circumstances under which security interests can be granted,⁹ addressing direct commercial needs of the market while at the same time maintaining investors' protection. Specifically, the SVs can now grant security to secure obligations of third parties to the extent the security granted by the SV *relates* to the relevant securitised transaction.

⁴ The Commission de Surveillance du Secteur Financier, i.e. the Luxembourg financial supervisory authority.

⁵ *Frequently Asked Questions, Securitisation* from the CSSF dated 23 October 2013.

⁶ *Frequently Asked Questions, Securitisation* from the CSSF dated 23 October 2013.

⁷ See below on the concept of "issue of securities to the public".

⁸ Under the meaning of article 1 of the Luxembourg law dated 5 April 1993 on the financial sector.

⁹ Before the reform, SVs could grant security interests over their assets or transfer their assets for guaranteed purposes only in order *"to secure the obligations it has assumed for their securitisation or in favour of its investors, their fiduciary-representative or the issuing vehicle participating in the securitisation"*.

Subordination

The Amended Law includes a set of rules to clarify the ranking between the claims that holders of instruments issued by an SV may have against the SV. Although these rules apply by default, they may be overridden by specific contractual arrangements between the parties to the securitisation transaction.

More flexibility as to the legal form of the SV

Before the securitisation regime was reformed, there were limited legal forms that could be used to set up a Luxembourg securitisation company and, in practice, most securitisation companies have been set up as public companies limited by shares (*sociétés anonymes* or SA) or private limited liability companies (*sociétés à responsabilité limitée* or Sàrl).

The Amended Law offers more flexibility and securitisation companies can now be set up as common limited partnerships (*sociétés en commandite simples* or SCS), special limited partnerships (*sociétés en commandite spéciales* or SCSp), simplified limited liability companies (*sociétés par actions simplifiées* or SAS) or general partnerships (*sociétés en nom collectif* or SNC). The addition of the SCS and the SCSp, in particular, has been welcomed by investors and managers who are already familiar with these tax transparent partnerships.

Accounting requirements

To ensure the same level of accounting transparency to investors no matter the legal form of the SV, the Amended Law now provides that an SV that is set up as an SCS, SCSp or SNC (which are legal forms that are in principle subject to less strict accounting requirements) is subject to the same obligations in terms of accounting preparation and publication as an SV that is set up as an SA or a Sàrl.

Furthermore, to reinforce the effectiveness of the legal segregation between compartments of an SV, the Amended Law provides that when a compartment is financed by the issue of shares, it is possible to have the accounts prepared at the level of the compartment and such accounts only need to be approved by the shareholders of that compartment.

Conclusion

The changes made to Luxembourg's securitisation regime have been welcomed by the Luxembourg financial services industry, with the further opportunities and flexibility for Luxembourg SVs that they bring.

With the Amended Law permitting active management of debt portfolios, CLOs managers may now consider Luxembourg as a jurisdiction of choice and Luxembourg SVs as a serious option for setting up their European investment structures.

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An aerial night view of a city skyline, likely New York City, featuring prominent skyscrapers like the Empire State Building. The image is overlaid with a network of glowing white light trails and arcs that connect various points across the city, symbolizing global connectivity and cross-border cooperation.

Dechert
LLP

What a difference a year makes

An update on Ireland's Investment Limited Partnership



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Prior to the amendments to the Investment Limited Partnerships Act, 1994 taking effect in early 2021 only six funds had been established as Investment Limited Partnerships (ILPs). The limited uptake in the use of this structure was not a result of a lack of interest by asset managers in establishing funds in Ireland using a regulated partnership structure but rather the consequence of the shortcomings of the legislation.

Significant enhancements to the ILP regime were introduced in the form of the Investment Limited Partnerships (Amendment) Act 2020 (the **2020 Act**). The aim of these amendments was to modernise the existing ILP legislation and further enhance Ireland's suite of legal structures available for fund formation, in particular its offering for investment funds with real estate, infrastructure, loan origination, private equity, or debt strategies or those seeking to invest in other types of illiquid assets. Since the effective date of these amendments, the number of ILPs authorised by the Central Bank has been steadily increasing. The number of ILPs listed on the Central Bank of Ireland (the **Central Bank**)'s authorised ILP register has over doubled in the last twelve months. There has also been an increase in enquiries as more managers consider using the ILP for their fund products. To date, managers have been using the ILP structure for private equity and debt strategies with sustainable or impact investment being a key focus for a number of these funds.

The ILP is a flexible structure that can be utilised by asset managers seeking to establish both open- or closed-ended investment funds through a regulated partnership structure. We expect to see managers using this fund structure across a broad range of asset classes, with the key focus being on those types of strategies for which partnership structures are typically used i.e., strategies relating to private equity or debt, real estate, infrastructure, or other types of illiquid assets.

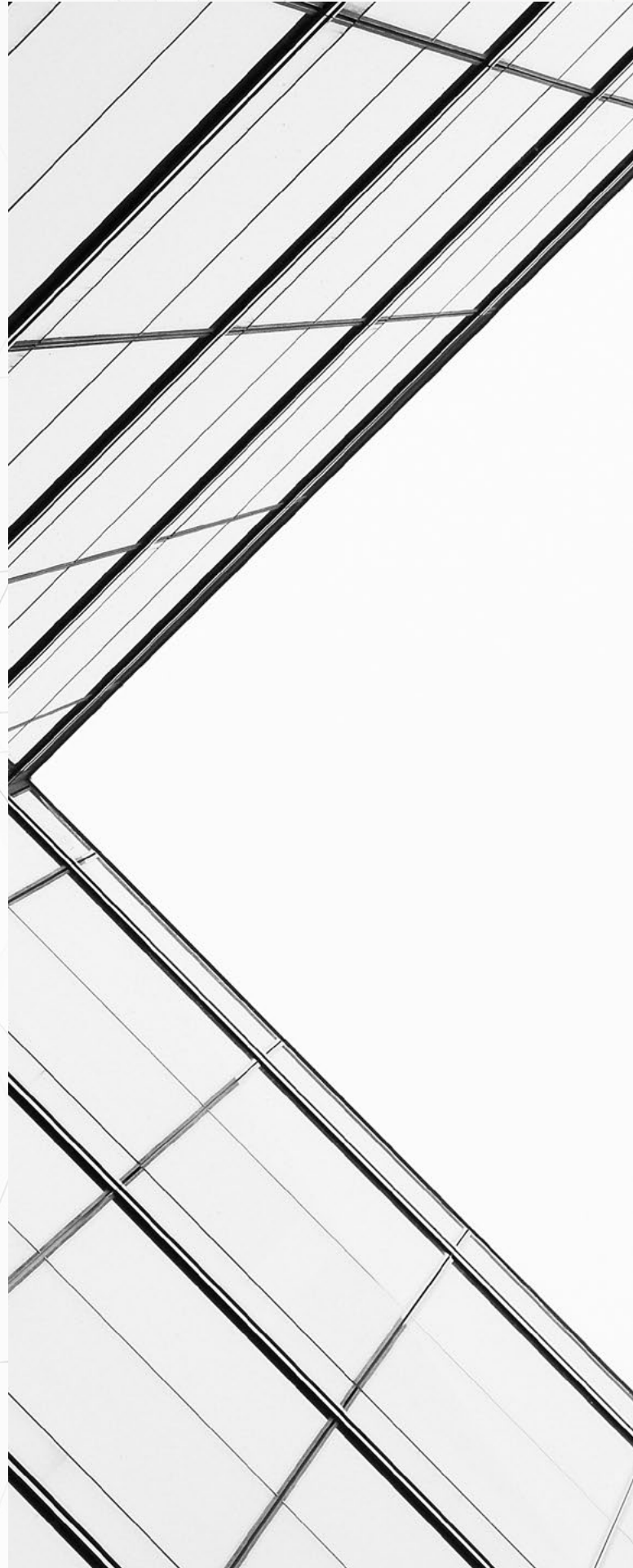
Key features of the ILP and other regulatory developments

The ILP is an Irish investment partnership vehicle that must be authorised and regulated by the Central Bank. It is a tax transparent structure and as such the income and gains of an ILP are treated as arising directly to each partner in proportion to the value of the interests beneficially owned by that partner.

An ILP is constituted pursuant to a limited partnership agreement which is entered into between one or more general partners, who are responsible for the management of the business, and one or more limited partners. The liability of the limited partners is generally restricted to the amount of capital committed to the partnership except in circumstances where a limited partner is deemed to be involved in the management of the ILP. One of the key enhancements of the 2020 Act is the updates made to the list of activities that can be undertaken by a limited partner which will not result in the partner being deemed to be involved in the management of the ILP and as a consequence not liable for the debts of the ILP.

As regulated entities, ILPs can only be established as alternative investment funds (AIFs) and therefore are authorised by the Central Bank as either a retail investor AIF or a qualifying investor AIF. To date, ILPs have sought authorisation as qualifying investor AIFs and we would expect this to continue. This allows for the Central Bank's 24-hour fast track process to be availed of, noting that depending on the intended strategy of the ILP it may be necessary to submit a pre-submission to the Central Bank in advance of the application for authorisation of the ILP. A QIAIF can also avail of the marketing passport pursuant to the AIFMD.

While the Central Bank has clarified that the entity appointed to act as a general partner to an ILP does not need to be authorised by the Central Bank, the Central Bank has confirmed that such entities will be considered regulated financial services providers for the purposes of the Central Bank's fitness and probity regime. This means that directors of the general partner will be required to seek pre-approval from the Central Bank and comply with the requirements of the fitness and probity regime on an ongoing basis.





Similar to other Irish fund structures, the 2020 Act introduced the ability to establish umbrella ILPs with segregated liability between sub-funds, allowing the flexibility for asset managers to set up both open- and closed-ended funds with differing strategies within the same structure with the assets and liabilities of each sub-fund ring-fenced. In addition, in early 2021 the Central Bank published guidance relating to share class features of closed-ended QIAIFs which addressed a number of operational matters of relevance to the types of funds typically structured as ILPs including excuse and exclude provisions, management participation, stage investing and the issue of shares/units at a price other than the net asset value.

Looking ahead

The reform of the legislation governing the ILP and the Central Bank's willingness to consider updates to its requirements for qualifying investor AIFs demonstrates Ireland's continued commitment to grow its funds sector, in particular in the alternative assets space, and to remain a leading global fund domicile. The Irish funds industry is well positioned to become a key player in the alternative assets space globally with its robust regulatory regime, established infrastructure of fund service providers and strong reputation as a domicile of choice for investment funds. The new and improved ILP together with the range of other fund structures available in Ireland, including the ICAV, continue to increase the attractiveness of Ireland as a place to establish regulated alternative investment funds. Interest in the ILP is increasing steadily and we expect the number of ILPs authorised to follow that trend.



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Walking the walk on ESG: Mitigating greenwashing risk on the path to investing sustainably



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Investor demand, alongside a range of new regulatory developments, is driving the importance of integrating environmental, social and governance (ESG) considerations into asset managers' investment capabilities.

As this regulatory and commercial pressure ramps up, the risk increases that firms deliberately or inadvertently misrepresent their ESG credentials.

In this article, we discuss some practical measures for asset managers to effectively manage and mitigate this risk.

EU sustainable finance action plan

In the area of sustainable finance, a number of key measures come into effect in the EU shortly:

- From 2 August 2022:
 - o Sale agents or distributors authorised in the EU under the MiFID regime are required to take into account any sustainability preferences of a client (in addition to the client's investment objectives and risk tolerances) when assessing the suitability of financial services or products for recommendation.

Systematically asking investors at the outset of the sales process to indicate if they have a preference for ESG products, as envisaged, could cause a radical shift in the demand levels for ESG products.

- o EU authorised UCITS management companies and AIFMs must specifically factor the consideration of sustainability risks into their investment due diligence processes, risk management processes, and conflicts of interest policies.

This will require the integration of sustainability considerations and factors into firms' investment processes and risk management processes for all investment funds managed, not just ESG-focussed funds.

- 1 January 2023:
 - The introduction of the secondary phase (or Level 2) of the EU Sustainable Finance Disclosure Regulation (SFDR).

This will require EU financial products that seek to promote ESG characteristics or have a sustainable investment objective, i.e. 'Article 8 financial products' and 'Article 9 financial products' respectively, to make detailed pre-contractual and financial statements disclosures in a prescribed and easily comparable form.

Room for misalignment

As asset managers prepare for these regulatory changes and investor demand continues to gather pace, it is becoming increasingly commercially compelling for many EU asset managers to both enhance and promote their ESG credentials.

EU regulators have acknowledged this issue and appreciate the risks it presents. In its Sustainable Finance Roadmap 2022-2024 issued in February 2022, ESMA stated:

*"The combination of growing investor demand, a fast-evolving market and legislative/regulatory measures which can only apply with a certain time lag creates **room for misalignment** between demands for investments that can make a sustainability impact and the available investing opportunities marketed as sustainable. "*

ESMA noted that this "room for misalignment" creates "the risk of mis-selling".

Consistent with this, concerns have been expressed publicly, by senior EU policy makers that investment funds are being categorised as Article 8 financial products or Article 9 financial products "not because the nature of the assets underlying those funds are necessarily more sustainable, but because it is just a commercial imperative to become more visible and more active in the sustainability space".¹

Greenwashing

In an EU financial services context, ESMA consider 'greenwashing' to be market practices where a financial product's publicly disclosed sustainability features do not properly reflect the underlying sustainability risks and impacts. In simple terms, an asset manager engages in greenwashing where the sustainability claims it makes are untrue or overstated. This can occur both intentionally and unintentionally, and in that regard, greenwashing can also occur where claims are made without proper foundation, and where they cannot be reasonably substantiated.

¹ Comments attributable to Alain Deckers, Head of the Asset Management Unit at the European Commission. Source: Ignites, 10 May 2022.

Factors driving greenwashing risk

The risk of unintentionally misstating ESG credentials is greater in the current context due to a combination of factors including: (i) new and quickly evolving law and regulation; (ii) varying levels of sustainable finance expertise across the industry (including within regulators); and (iii) gaps in ESG data / inaccurate or unverified data from investee companies.

As noted above, the 'commercial imperative' presents a risk that asset managers will present their investment funds or services as more sustainable, without being able to deliver in practice.

Where investors choose financial products or services on the basis of untrue or overstated sustainability claims, this can potentially have a range of negative implications for the relevant asset manager, including:

- *Investor legal recourse* – an investment fund or its manager could be held liable for false claims made on sustainability related issues in the prospectus or associated pre-sales marketing materials. In Europe, so far, there have been a limited number of actions for greenwashing but this will likely change with the evolving regulatory environment, and as investors become more sophisticated and focussed on sustainability. In many EU jurisdictions, liability for misstatements in prospectuses and statutory causes of action already exist - allowing consumers to pursue damages against regulated financial service providers. This will be enhanced further in early 2023 with the introduction of the EU Collective Redress Directive.
- *Regulatory sanctions* – in 2021 the European Commission's Renewed Sustainable Finance Strategy called on EU regulators to ensure that investors and consumers are protected against unsubstantiated sustainability claims. In its Sustainable Finance Roadmap in February 2022, ESMA noted the "real need [for regulators] to address greenwashing without delay" and referred to the key role regulators have in "monitoring compliance with sustainable finance regulation and making full use of their legal mandates and powers to ensure that investors and consumers are protected against unsubstantiated sustainability claims." Regulatory scrutiny of ESG-related disclosures in fund documents is set to increase significantly. Additional supervisory initiatives such as thematic inspections can also be expected. Where regulators identify failures in firms' practices in this regard, the outcome could include fines and public censure.
- *Reputational harm* – through various means including investigative journalism and whistleblowing (as well as media coverage of any investor actions or regulatory sanctions, as considered above), asset managers making untrue or overstated sustainability claims run the risk of it being exposed publicly, with significant adverse reputational and credibility ramifications.

Given these wide-ranging potential implications, asset managers should consider assurance measures to effectively manage and mitigate the risk of greenwashing.

Three key areas for consideration to mitigate greenwashing risk

(i) *Operational framework*

It is critical that firms put in place an effective operational framework that takes into account the need to substantiate sustainability claims throughout the fund lifecycle, from initial concept and design onwards.

A key element initially will be to agree the parameters of the fund's sustainability focus and ensure this is factored into the fund's investment guidelines. This should also be factored into the operational due diligence, oversight of the portfolio manager and investment reporting.

Assurance testing of sustainability criteria should also be built into the compliance and risk monitoring framework.

Operational ESG controls should also be factored into staff training, the complaints handling process and, where relevant, the internal audit programme.

Any sustainability statements that are integral to the investment strategy should be carefully considered. All statements (particularly quantitative statements) should be assessed for codifiable elements that can be independently verified. Open-ended and unverifiable statements should be avoided. This may involve limiting the level of ESG-related 'sales speak'.

(ii) Monitoring disclosures

Once the text on ESG credentials is constructed, it should be deployed consistently through all fund materials, i.e. sales and marketing material, prospectus, KIID, financial statements and regulatory submissions.

This may merit a centrally controlled library of disclosures as well as a control framework to monitor consistency across all fund materials.

For SFDR Level 2 projects, a large amount of work will be required to develop the mandatory disclosure templates for (i) prospectuses; and (ii) periodic reports for investment funds qualifying as Article 8 financial products and Article 9 financial products.

These two aspects should be looked at side-by-side as they are effectively ex ante and ex post disclosures of the same detailed information.

So if, for example, a prospectus promises a minimum proportion of sustainable investments, the annual report will need to disclose whether this commitment was met or not during the relevant reporting period.

This brings a level of accountability to the disclosures and emphasises the need to consider, from the outset, the ultimate deliverability of sustainability claims being made.

(iii) Governance controls

There should be a robust review of ESG aspects of investment strategy in the fund launch phase, including specific consideration of this element, as part of the board approval.

In simple terms, a framework and culture should pervade the firm in order to self-regulate any claims or representations being made on sustainability.

Conclusion

As we move into this critical phase of the EU sustainable finance action plan implementation and pressures mount for asset managers to factor ESG credentials into their offerings, it is important to ensure that any sustainability claims made are accurate and can be validated now and in the future.

Firms should take the time to evaluate the implications of operating in this space across all aspects of their business as they move towards investing sustainably.



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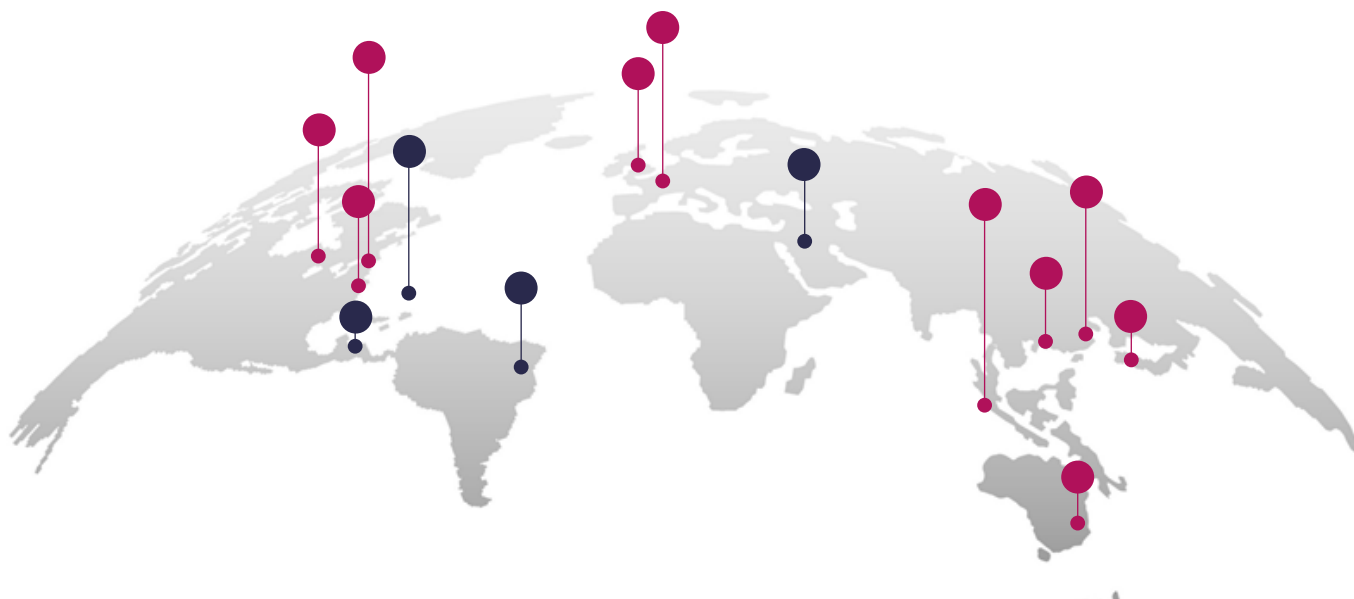
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