



AIMA

# AIMA JOURNAL

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*Where's my trader? The ins  
and outs of insourcing vs  
outsourcing*  
*Ergo Consultancy*

*What is DeFi?*  
*How blockchain may reshape  
capital markets*  
*RSM US LLP*

*Alternative data in China*  
*Man Group*

*And much more...*

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## PUBLICATION PLAN 2022

### • Q1 Edition 129

Deadline for submission 5pm UK time  
Monday 14th February | Publication  
Monday 21st March

Please note the deadline for reserving  
a spot for the Q1 2022 edition of the  
AIMA Journal is 5pm UK time, Friday 28  
January.

### • Q2 Edition 130

Deadline for submission 5pm UK  
time Monday 23rd May | Publication  
Monday 27th June

Please note the deadline for reserving  
a spot for the Q2 edition of the AIMA  
Journal is 5pm UK time Friday 6th May.

### • Q3 Edition 131

Deadline for submission 5pm UK  
time Monday 25th July | Publication  
Monday 19th September

Please note the deadline to reserve  
a spot for the Q3 edition of the AIMA  
Journal is 5pm UK time Friday 8th July.

### • Q4 Edition 132

Deadline for submission 5pm UK time  
Monday 24th October | Publication  
Monday 28th November

Please note the deadline to reserve  
a spot for the Q4 edition of the AIMA  
Journal is 5pm UK time Friday 7th  
October.

### Important:

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contributions once all the spots have  
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We kindly advise all contributors to  
email us prior to submitting to make  
sure we can include the contribution.  
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“

## Message from AIMA's CEO



**Jack Inglis**  
CEO, AIMA

In my previous foreword for this journal, I noted that change in the alternative investment industry was not only necessary but inevitable. The final AIMA Journal of 2021 enhances this point further and offers a guide on how to navigate this period of evolution, including managing external factors such as regulation and post-COVID central bank tapering through to adapting your operating model to thrive in the modern environment.

Firms must be “elastic”, embrace innovative technology, and fully leverage the maturing ecosystem of service providers where they offer superior solutions for any business function, including the front office, contributors argue. At the same time, conversations around improving company culture and supporting employee wellness remain a live issue in many firms.

Elsewhere, hedge funds are facing growing demands from investors for a greater diversity of products, including bespoke offerings, and investment strategies that conform to their new ESG policies.

Digital assets and access to private markets are among the most popular areas of exploration for hedge funds today and contributors provide insights on the execution and compliance challenges these markets bring, as well as outlining the opportunities.



However, contributors also advise hedge funds to avoid overburdening themselves with the operational complexities that these new strategies and tailored products present on their quest to meet the exposure requirements of their investors.

Naturally, ESG is a prominent theme throughout this edition, and contributors unpack the complexities of the market and its developing rules frameworks. Readers will also find out why they should beware of jellyfish, as well as swans and elephants, as they navigate the ESG landscape.

The other evergreen challenge of regulation is addressed in the round. The Cayman Islands gets a double-billing, and the UK is also highlighted among more general concerns around compliance.

Finally, readers are encouraged to make full use of the new [Articles Library on the AIMA website](#), which allows users to revisit individual articles from all previous editions. The library includes the functionality to filter by topic, region, country, or year and will hopefully prove to be a valuable resource.

**Jack Inglis**  
CEO, AIMA



# AIMA Events 2021/22

AIMA

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MANAGEMENT ASSOCIATION

AIMA continues to deliver a varied programme of events for members through virtual platforms. Hosting over 270 complimentary events annually, there is a wide selection of educational and thought leadership content for peer-to-peer learning.

**9 December**

AIMA China  
Live 2021

**10 December**

AIMA Australia  
Annual Forum  
2021

**24 January**

AIMA & ACC  
Private Credit  
Investor Forum  
2022

**10 March**

AIMA APAC  
Annual Forum  
2022

**21 April**

AIMA Singapore  
Annual Forum  
2022

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replays for continued learning here

View the full list of our  
upcoming events here





# AIMA & ACC'S PRIVATE CREDIT INVESTOR FORUM 2022

## SPEAKERS INCLUDE:



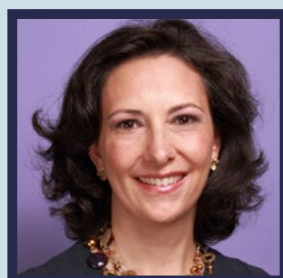
**Dwight Scott**  
Blackstone Credit

**Ashley Baum**  
Teacher Retirement  
System of Texas



**Richard Grimm**  
Cambridge  
Associates

**Nicole Byrns**  
CPPIB



**Monday,  
January 24 2022**



**9:00AM - 6:30PM EST**



**Fontainebleau  
Miami Beach**

For more information and to  
register, visit  
[www.aima.org/events](http://www.aima.org/events)



# How to be more elastic in an age of continuous disruption

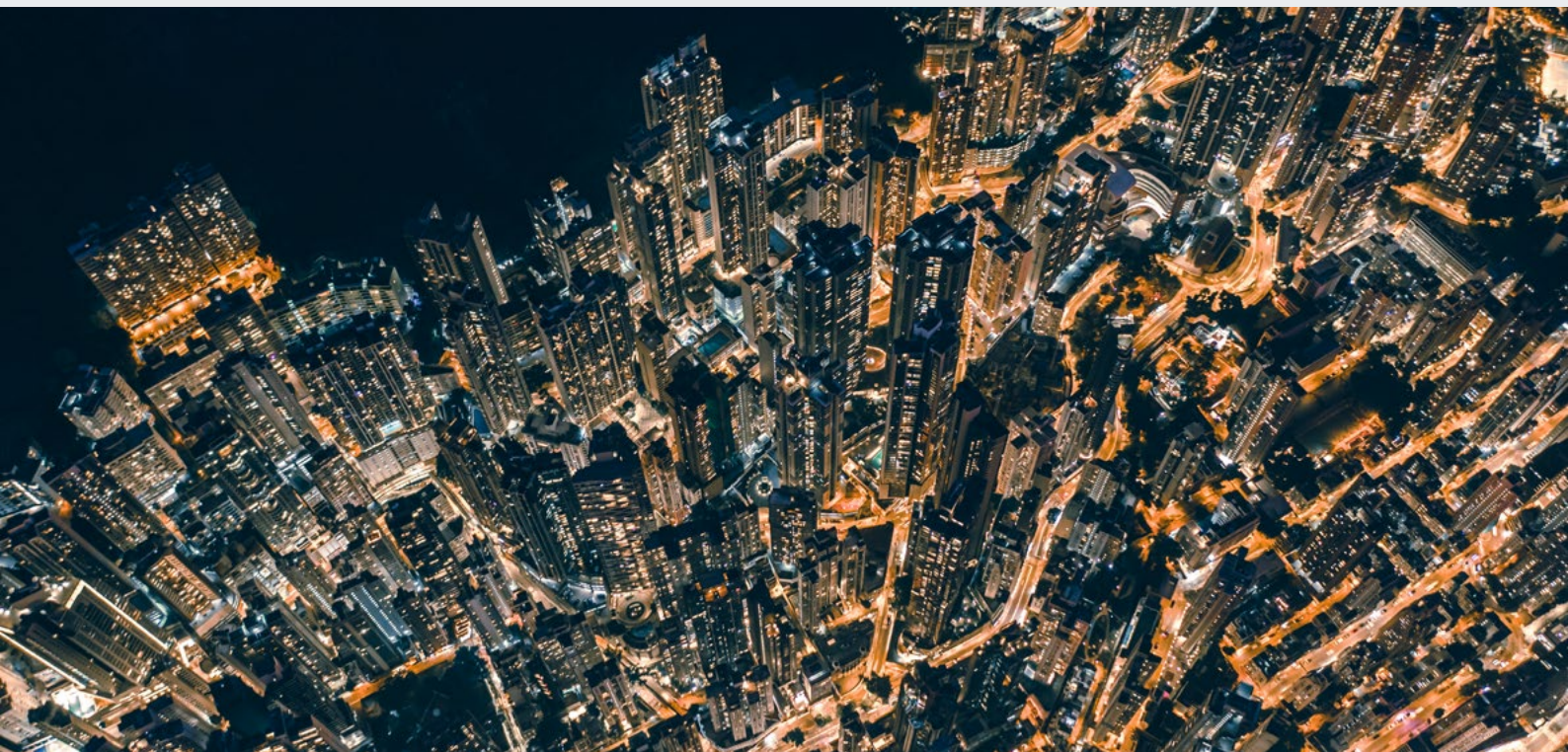


**Daniel Page**

Head of Asset Management Advisory

[KPMG in Ireland \(London\)](#)

[Email Daniel Page](#)



**G**iven the events of the past 18 months or so, I will spare you the diatribe on why Alternative Asset Managers (Managers) should focus on elasticity in their management companies. When I talk with Managers' Chief Executive Officers (CEOs) or Chief Operating Officers (COOs), I'm rarely asked why more flexibility is needed anymore. But I'm always asked how it can be achieved.

Ultimately, what Managers are looking to achieve is the ability to scale up and scale down, as needed and across their business, in an efficient way. More elasticity within their infrastructure can mean better control over operating margins. That, in turn, can make you both more resilient and more attractive to high-performing professionals. It doesn't matter whether you manage an AuM of US\$50 million or US\$5 billion, greater elasticity is critical to successful Enterprise Risk Management (ERM).



“

*“Not all CEOs and COOs have first-hand experience running corporations with shareholder accountability; it’s not always easy to take an independent and objective view when you are on the inside and have a complex business to run day-to-day.”*

### Think value

My advice to Managers? Make yourself accountable for stakeholder value as if you were a corporation – and one that you intend to sell. That means making every ERM decision with Enterprise Value (EV) in mind. That, in turn, can show you how to become more flexible, attract the right talent and focus on the right outputs.

“Easier said than done,” I hear you groan. And I’m not denying that enhancing elasticity in a Manager doesn’t take experience, industry insights and smart tools. Not all CEOs and COOs have first-hand experience running corporations with shareholder accountability; it’s not always easy to take an independent and objective view when you are on the inside and have a complex business to run day-to-day.

### Peeling back the complexities

Knowing where to start and how to balance the key considerations can often be a challenge. Take human capital, for example – it’s arguably the largest cost for any Manager. One way to enhance elasticity is by achieving a clear and independent view of your human capital – layer by layer – to understand exactly what flexibility you have and, therefore, how elastic your workforce is.



Workforce models should also be reviewed to identify where more elasticity and flexibility can be achieved – not only in terms of people and real estate costs, but also to identify areas of potential enhanced efficiency. Yet this raises some difficult questions: who must be in the office in order to create value; how do you empower those that are not in the office; and how do you ensure they remain accountable and compliant?

### Know where to look

Obviously, the need for greater elasticity should be managed against the realities of the business. Managers still need to compound returns for the long term to their investors, which is ultimately what investors hire them to do; they still need to reward and retain their high-performing staff; and they still need to ensure they abide by relevant laws and regulations. Those three pillars must remain protected.

But that still leaves significant room for Managers to enhance their elasticity – through greater use of outsourcing, through a more flexible and scalable IT environment, through smarter vendor management, through better talent retention and rewards, and more. The opportunities may not always be evident, but if you know where to look, they can deliver large rewards in terms of elasticity.

### Get help

This brings me to my final point: if you don't know how to enhance your management company's elasticity, you may want to consider tapping into a professional, or team, that does. You likely already use external vendors for support across your business. Why would you not do the same for your management company elasticity and an independent view of your ERM?



# New Reality for Asset Management. Getting fit for the future

Inspiring leaders in the asset management industry are guiding their organizations through significant change at a rapid pace. From sharpening focus on high opportunity areas and adapting to new ways of working, to implementing innovative technology and integrating ESG into investment decision making — KPMG professionals have the passion and expertise to help you make decisions about your business. We can make better decisions together to thrive in the new reality.

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# Where's my trader?

## The ins and outs of insourcing vs outsourcing



**David Berney**  
Principal Consultant  
**Ergo Consultancy Ltd.**  
[Email David Berney](#)



**Michael Broadbent**  
Principal Consultant  
**Ergo Consultancy Ltd.**  
[Email Michael Broadbent](#)

**T**he buy-side community has long wrestled with thorny build-versus-buy questions. Should a fund build its trading technology or buy it off the shelf? What about its algorithms? In recent years, however, such debates have broadened to include much more than just hardware and software.

These days, the question of build versus buy can extend to the entire trading desk. Should you build a desk by hiring your own team of traders, or 'buy' one by outsourcing your trading requirements to a third party? Or is there a third option?

At Ergo Consultancy, we've spent hundreds of hours with all manner of funds to help them work out the best way to address their trading requirements. Of course, there is no one-size-fits-all answer to be had here. It always comes down to the individual fund. But there are factors that every fund should take on board as they evaluate their execution needs and consider their strategy.

This article aims to help in that process. Whether it's building, buying or a hybrid option, there are pros and cons that need to be considered for each route.

### The outs

The trend towards outsourcing the trading desk has received a lot of attention in recent months, and with good reason.

Well before COVID-19, many funds had already discovered that the cost-benefit analysis for their firms favoured outsourcing solutions. But plenty of funds held fast to the view that their PMs and traders needed to be in the same room. After COVID struck and forced virtually every market participant to have their traders work from home, a whole new wave of funds learned just how far remote trading technology had come. With that perceived obstacle no longer in the way, the list of candidates for outsourcing only grew.

At the same time, a rising number of firms have begun to offer outsourced trading solutions, which has led to extensive efforts to educate the fund management community about how these solutions work and what they offer. Vendors say interest from prospective clients has surged as the benefits of outsourcing have become more understood.

So, what are the main benefits that a fund should be aware of? The first one may surprise you because it's not about costs. We call it the 'zero-to-hero' factor.



For a new fund, outsourcing allows it to get off the ground quickly, efficiently, and effectively. There are no trading systems to buy, traders to hire or relationships to form. A fund is up and running immediately. Not only that, but also it is able to run in any direction it chooses.

A second major benefit is that outsourcing creates massive flexibility. A single trader may be able to do perhaps a few dozen trades in a day. But for more complicated or difficult trades, that trader might be able to do only 10 well in a given day. It often simply takes a lot of time, as well as skill, to work out how to avoid moving the price. With an outsourced solution, a fund manager can throw out such heuristics. An outsourcing provider is not limited by the same bandwidth concerns. What is more, trading coverage for holidays or coverage for unplanned absences such as sickness becomes easy to arrange.

Another bonus comes from a network effect that emerges from an outsourced trading arrangement. An in-house trader will pick up a certain amount of market colour, which then can inform the trading strategy. But with an outsourcing provider, the amount of market colour grows exponentially because it gets shared among a large group of traders. We all know that such colour can be extremely valuable.

The eagle-eyed among you will notice that we have not even talked about cost savings yet. Many funds go into outsourcing arrangements in the expectation that they can sharply reduce their costs. That certainly is often the case, either directly or by allocating trading costs to funds rather than via the management company. But the takeaway here is that the cost savings are icing on the cake.

### The ins

One of the main reasons funds often opt for insourcing is based on the idea of control. While an outsourcing solution can offer plenty of scope for a fund manager to dictate the manner of execution, there are other aspects to having more direct control which may not be so immediately apparent. For instance, having control extends to compliance and trader-portfolio manager relationships.

A related issue concerns trade errors. The larger the fund, the more tickets, which translates to more middle-and back-office functions. It becomes a numbers game. If a fund is doing 100 tickets a day and three of them have issues, resolving them is not a big deal. But if a fund is doing thousands of tickets a day, that is another question. With an in-house team, it may be easier to address recurring trading issues by modifying procedures. There are fewer links in the chain, and that makes problem-solving that much simpler. The amount of middle office work can suddenly be reduced significantly.

Insourcing also allows for greater information control. Whether it's based in reality or not, there is a perception that having an outsourced trading solution increases the possibility for information leakage. Outsourcing vendors have well-developed methods for preventing this, but many fund managers will inevitably remain concerned. So, for those who do worry about this factor, the in-house option lets them sleep easier.

But perhaps the biggest argument for building the trading desk concerns specialisation and the opportunity to develop a team that is dedicated to excelling in the fund's particular area of focus. Leading outsourced trading vendors often promote the advantages of their services in terms of the high levels of experience

and skill their teams have. But there is no substitute for the expertise an in-house team can develop in terms of a fund's own particular flow. The trader-PM relationship is stronger and the synergies that result from that relationship are greater as a result.

Of course, the build option takes time. If outsourcing has a zero-to-hero factor, insourcing tends to be a much more gradual, incremental process.

### The hybrids

Signing up with a trading desk provider need not be an all-or-nothing proposition. For many funds, a hybrid option will make most sense.

This is particularly the case for funds that have a core area which they focus on, but where they may also have a number of other geographies or asset classes that regularly see some business. For such funds, having an in-house team that handles the core trading, and outsourcing other parts, can offer a best-of-both-worlds scenario.

The additional benefit to this model is that once a fund has set up an outsourcing arrangement to handle its non-core trading, it gains all the flexibility that comes with complete outsourced solutions. Fund managers no longer need to worry about coverage for holidays and illness. And if the fund wants to expand into a new area, everything is already in place. Never has it been so easy for a fund to dip its toes into lots of different waters.

### The next phase

For new funds, the decision on whether to build, buy or go hybrid is critical. But it's not permanent. Funds can review their trading arrangements at any time and move from one option to another.

The harder part, however, is not so much about selecting a pathway but about implementation. For the outs', choices need to be made about which vendor is most suitable, based on a myriad of factors. For 'the ins', there are choices in terms of technology and operations, not to mention hiring the traders. For the hybrids, there are choices in terms of both.

All of this takes time and resource. Given enough of either, most funds would get there on their own. But most funds don't have an endless supply of time or resource. Once a path has been settled on, they will generally want to move fast. That's where we come in. We do the legwork and set up the beauty parades by vendors. These are tasks that we specialise in, so we're able to quickly narrow the choices for a fund.

In the end, the optimum arrangement will depend on a broad range of factors, including size, trading focus, whether the fund is new or established, and what kind of capabilities it already has. But whether a firm decides it wants to insource, outsource, or go hybrid, we know we can help make the process a lot smoother, and much faster.



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# Pandemic post-mortem: The 1-2 technology punch for financial companies



**Ryan Thomas**  
EVP, Microsoft Collaboration  
Thrive



**Scott Jukofsky**  
EVP of Technical Account Management  
Thrive

**T**he beginning of the pandemic forced many companies to sprint toward achieving remote working capabilities to ensure business continuity. Remote access has traditionally been viewed as a luxury to be used essentially on weekends, nights, or in the case of necessity. We are in for the long haul of remote working and collaboration, and now, more than ever, financial companies must create a competitive advantage in this paradigm shift in the workforce.

According to [PwC's US remote work survey](#) of 50 executives and 144 employees at US financial services firms, before the pandemic, only 29% of employers had at least 60% of employees working from home once a week. Today, 69% expect at least three-fifths of their workforce to telecommute at least once a week.

The knee-jerk reaction to moving business operations off-site quickly at the beginning of the pandemic didn't account for the possibility of a long-term solution. This caused hedge funds to leverage specific sets of application stacks that weren't designed for remote access. Now with the initial remote workforce setup hurdles behind us, quick thinking, technology enablement, and agility previously used are still vital for financial firms to remain competitive and move forward.

The initial onset of shifting to remote work uncovered critical gaps in business operations and collaboration capabilities. So, what does a sustainable remote environment strategy that can have a positive impact look like for the financial industry? The answer is a 1-2 punch of SharePoint and Microsoft Teams in the Microsoft 365 ecosystem with an extra jab from Microsoft Power BI. This powerful combination of technology tools is already in place at many financial companies. The difference is the power of utilisation to tap into the true potential of achieving seamless and real-time collaboration with enhanced financial business processes.

Pre-pandemic businesses were accustomed to 'prairie dogging' - where you'd pop your head over a cubicle for banter and a mini collaboration session. However, that method of 'getting on the same page' has since been sophisticated and institutionalised over the past year and a half. But, we've only scratched the surface.

For example, financial services companies have an abundance of files nested in folders, emails, and Excel spreadsheets, which can slow down the relay of information stored. Those systems began to migrate to modern toolsets to accommodate the distributed workforce, however, now the real work is beginning, and financial firms are starting to realize the muscle of the Microsoft stack.





Data is ever-changing and financial services companies are stepping up to ensure access to tools that display and unite information discreetly. Microsoft Teams in the Microsoft 365 suite powers collaboration by serving as the window into all data with customised applications specific to your business.

Within Microsoft 365, businesses are able to view, edit, and share data in real-time with permission management to protect critical financial data. In SharePoint, employees can transform Excel files into a modern Cloud workplace application by eliminating multiple inputs and increasing the speed to drive business decisions. SharePoint also relieves time and fatigue by extrapolating data and communication from countless email threads to enhance business decisions.

Teams and SharePoint are revolutionizing collaboration, task management, and approval process workflows. However, there is one critical piece of the puzzle needed to transform businesses - that is often underutilised. The game-changing component to a financial business' IT infrastructure is tapping into Microsoft Power BI, a data analytics powerhouse that enables companies to capture, visualise, and analyse data that matters to most.

With Power BI, you can scrap the lengthy reports and access current data that is readable and understandable with eye-catching charts and graphs at your fingertips. No more waiting on figures, using data from old reports or being unable to find specific data sets. Power BI leverages its business intelligence technology to retrieve data and reports quickly using the most current data without tedious file searches and human error. The robust tool enables reports to be built on the fly and embed them in almost any place within the Microsoft 365 ecosystem. Connecting to live data sources like SharePoint, Salesforce, or most other third-party apps and tools, enables businesses to take action using that data, identifying issues, trends, and opportunities.

Financial businesses recognise the urgency of unleashing the full potential of the Microsoft stack and go beyond just accessing the tool. However, this digital transformation journey to modernise business processes and data isn't an easy path. An expert partner can help identify the key features of Microsoft 365 - whether it be Teams, SharePoint, Excel, Power BI, or more -to maximize your return on investment, empower a distributed workforce, and catalyse your financial business.

It's important to note that remote workforces aren't the only ones to reap the benefits of embracing technology innovation to achieve superior collaboration and performance. Businesses are embracing hybrid, on-site, and remote workers or a combination of all of the above. Whether it be fully remote, hybrid, or in the office, these Microsoft tools and power apps increase efficiencies in financial businesses - no matter what your workforce looks like. This forward-thinking IT architecture is a foundation that solves common challenges in modern workplaces and is a vehicle to untapped business processes and data that drive decisions financial companies can bank on.

# Alternative data in China

Hinesh Kalia

Director of Data Science

Man Group

## Introduction

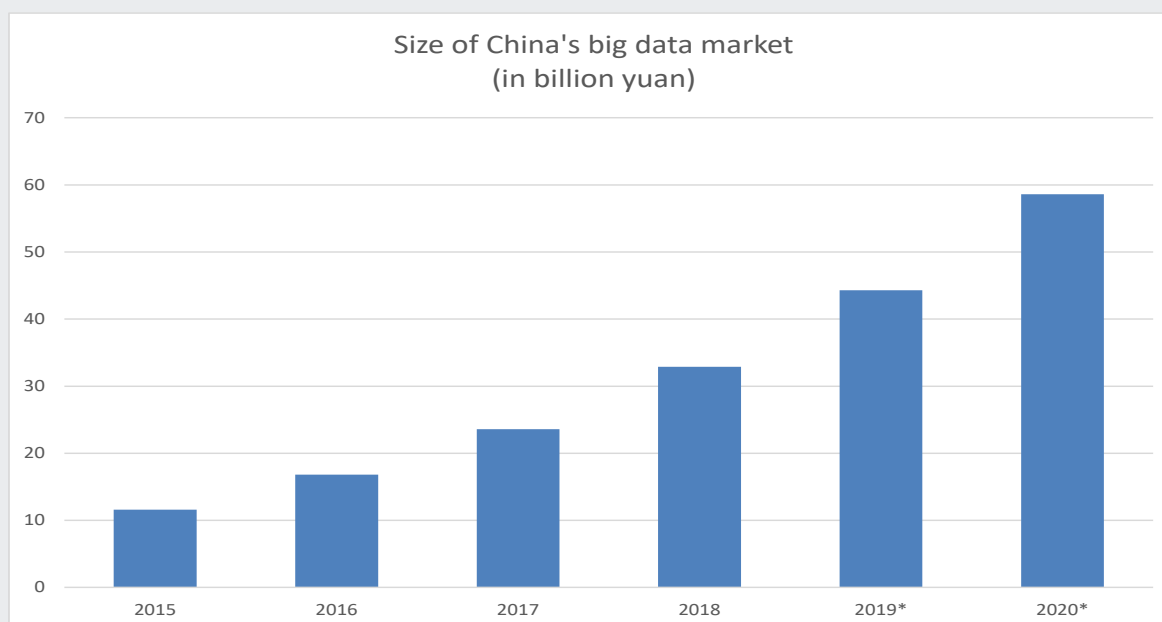
As the world's second-largest economy with roughly 1.3 billion tech savvy consumers, high rates of penetration for mobile internet and rapidly increasing disposable incomes, China is an enticing prospect for equity investors. Indeed, for some, it's the final frontier, a vast untapped market with the divergence to drive alpha returns and the economic growth to support beta. But these characteristics don't just make China an attractive equity market – they also mean that China generates a wealth of alternative data. As China opens its A-shares market to foreign investors, it has now become the perfect breeding ground for alternative data strategies.

In this article, we provide an overview of the growth of alternative data in China and the need to use local proxies instead of more established global alternative data providers.

## Big, big, bigger

The first thing to note is the sheer scale of the growth of the Chinese alternative data market. The size of the Chinese big data<sup>1</sup> market has grown by nearly 600% since 2015 (Figure 1, below). Indeed, on data scouting platform Neudata, there are now more than 1,100 China-specific data sets. Likewise, the number of China-related alternative data providers has also grown rapidly over the past few years (Figure 2, following page), showing the symbiosis of the two: the more that the size of the data market increases, the bigger the opportunity for alternative data providers.

Figure 1: Chinese big data market



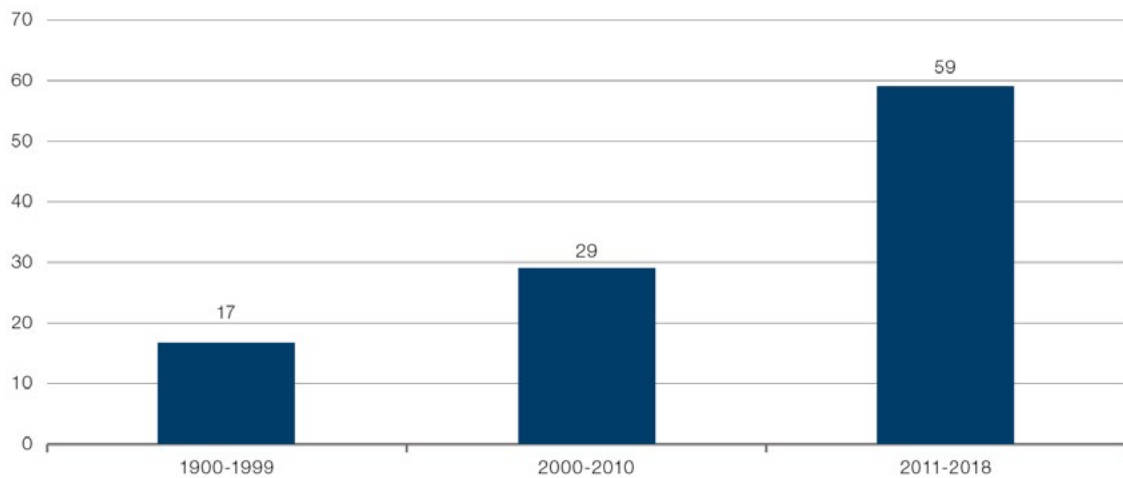
Source: Citi iResearch; as of 2020

\*Estimated

1 Please note that we use alternative data and big data interchangeably in the article.



Figure 2: Number of Neudata China-Focused Altdata Providers



Source: Neudata; as of February 2021

What makes this scale important is that it is somewhat lopsided compared with the size and sophistication of the Chinese equity market. China generates data in line with its status as the world's second-largest economy, creating datasets which are large and robust enough to have predictive power. In contrast, its equity markets have yet to reach the critical mass of institutional investors required to erode alpha, even though the data required to run sophisticated strategies is now plentiful, in our view.

### Local versus global

However, all the datasets in the world isn't enough if investors are unable to understand which has predictive power and which does not. The most important factor to understand is the unique way in which data is generated in China: the 1.3 billion Chinese consumers do not generate data via Google, Twitter or online forums such as Reddit's WallStreetBets in the same way that consumers do in the West. Instead, there is usually a Chinese proxy which fulfils the same function, generating equivalent types of alternative data (Figure 3). As a result, investors who use alternative data signals based on Google search trends or WallStreetBets in their global portfolios will need to consider a local proxy to generate similar insights in the Chinese market.

Figure 3: Global versus local data generators

Alt Data Taxonomy	Example Global Source	Example Local Source	Use Case Examples
Retail Investors	WallStreetBets	Guba Xueqiu	Using blogs or forums to identify retail sentiment
Online Search	Google Search Trends	Baidu	Gauging consumer trends
Consumer Transactions	Mastercard Visa	Unionpay Alipay WeChat pay	Gauging overall consumer spend of goods and services

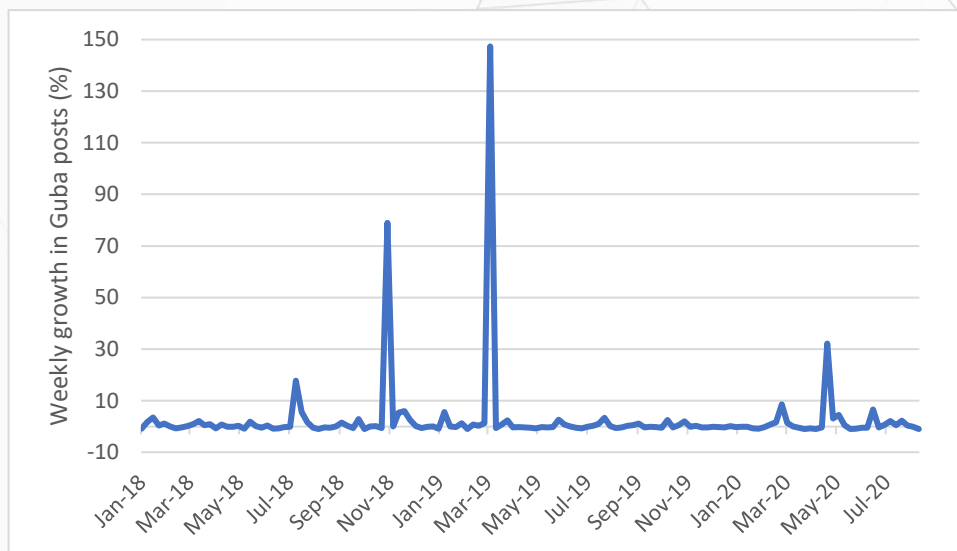
Alt Data Taxonomy	Example Global Source	Example Local Source	Use Case Examples
Pricing	Amazon	Tmall/Taobao Pinduoduo JD	Identifying relative pricing of e-commerce products
Reviews	Yelp Tripadvisor Google Reviews	Dianping	Determining sentiment for goods and services
Employment	Linkedin Glassdoor	Liepin 51 Job	Using companies' employment metrics as a proxy for growth
Social media	Facebook YouTube Instagram Twitter TikTok	WeChat Weibo Douyin Kuaishou Xiaohongshu	Gauging overall consumer trends, from sentiments to spend

Source: Man Group; as of May 2021.

### Case studies

To give an example of how this data can be applied, consider a Chinese hog producer listed in the CSI300 Index. A company with its characteristics is unlikely to appear on WallStreetBets or in popular global job websites. However, by using local equivalents, we can get near real-time insights into the company's activity through local information. In 2019, posts on China's internet stock message board website Guba showed increased retail interest towards the stock and accurately predicted a frenzy of buying. Likewise, rising numbers of job posts for the company indicated growth throughout early 2020, despite the ongoing pandemic (Figures 4-5).

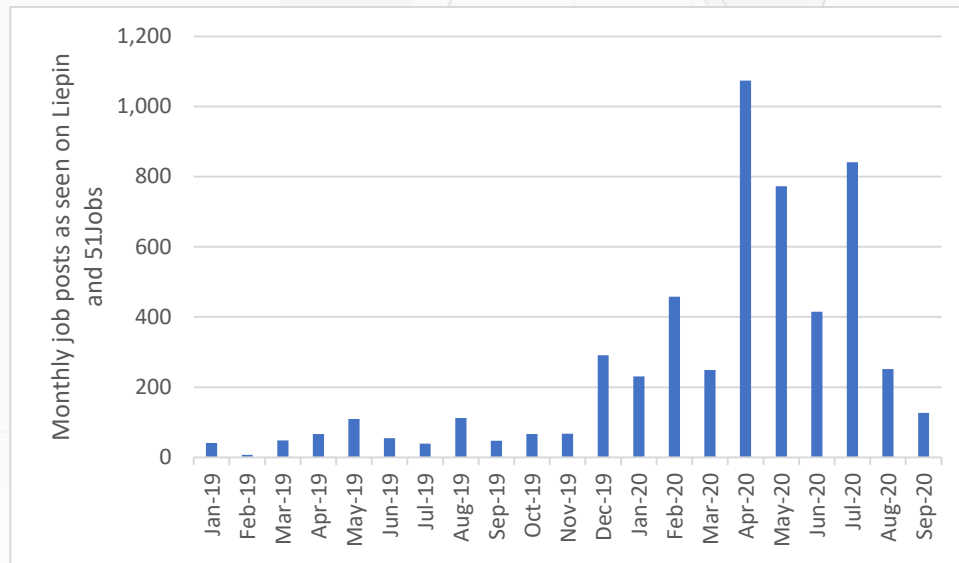
Figure 4: Weekly Guba posts – Chinese hog producer



Source: DataYes, Man Group; as of October 2020.



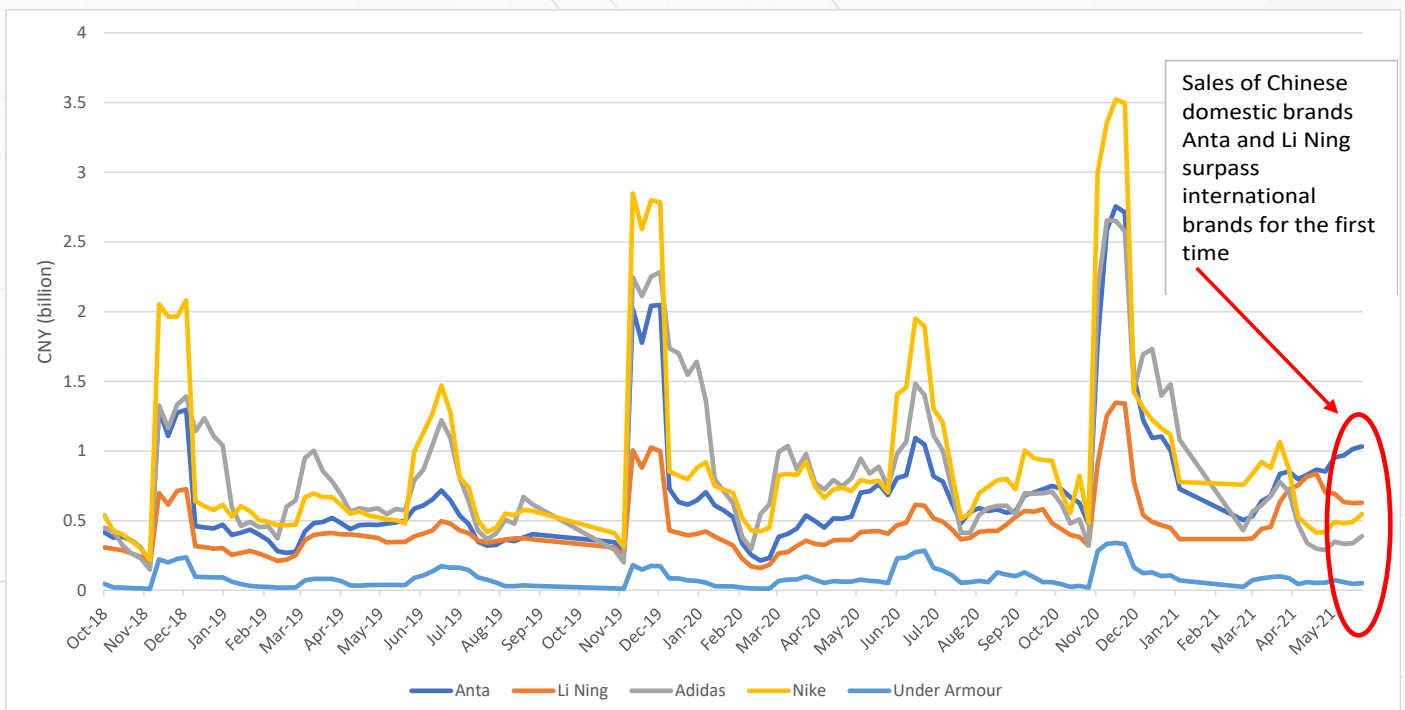
Figure 5: Monthly Job Posts – Chinese Hog Producer



Source: DataYes, Man Group as of September 2020.

Having a focus on local data can also provide an insight into changing consumer tastes. Data from Tmall (a business-to-consumer sales platform that is a Chinese Amazon-equivalent) showed how Chinese consumers shifted their purchases from international sportswear brands such as Nike and Adidas to more domestic brands such as Anta and Li Ning. Again, this insight (and any subsequent effect on stock prices) wouldn't be available using the normal alternative data channels, which focus on global consumption.

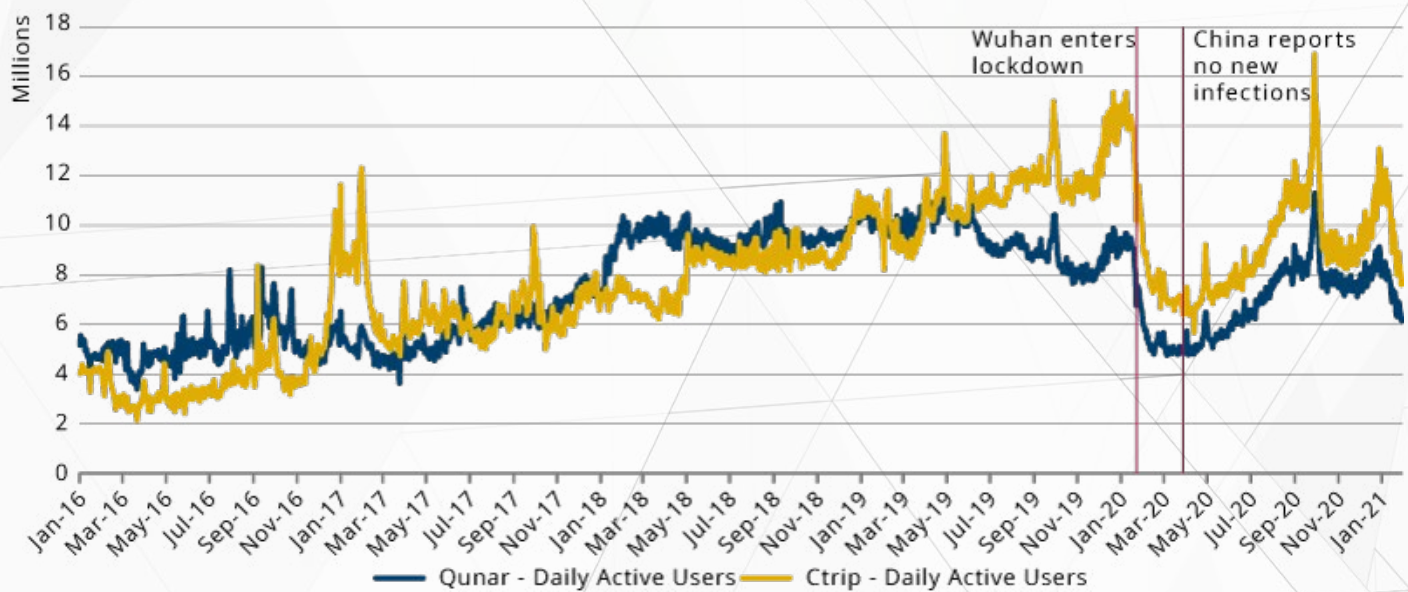
Figure 6: Tmall sportswear sales – by brand



Source: Yipit, Man Group; as of 31 May 2021.

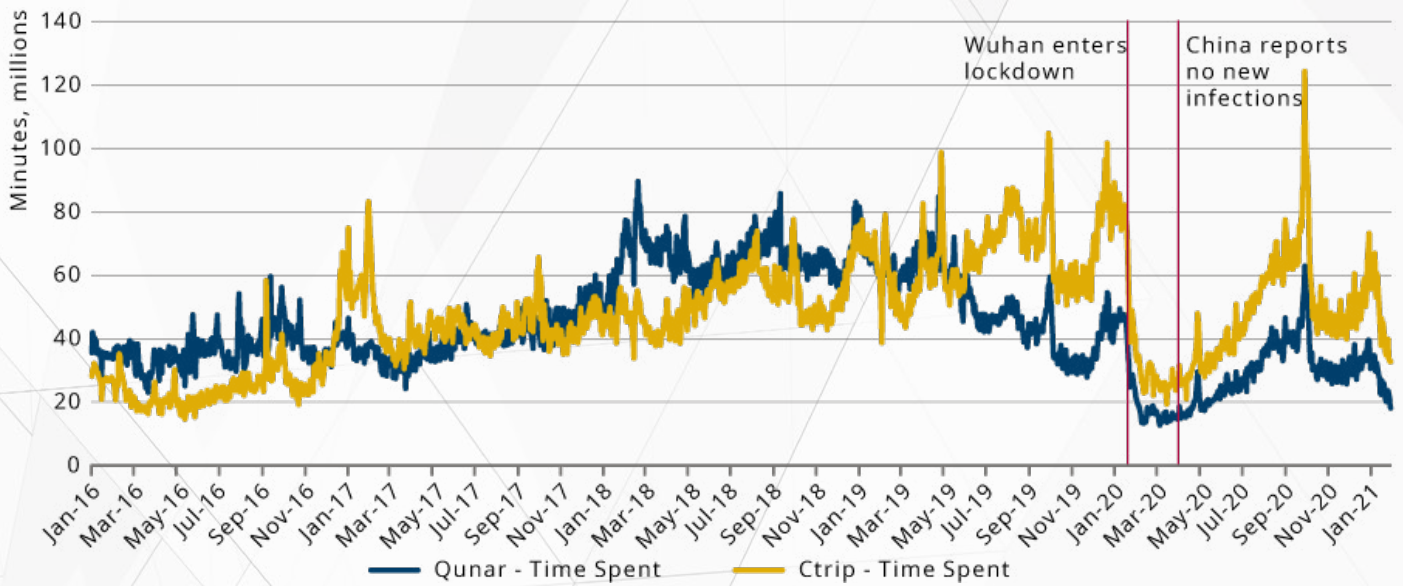
Similarly, industry-wide trends can be monitored effectively by using Chinese alternative data. In this case, we use data from Ctrip and Qunar, two travel apps which cater to Chinese consumers. Figure 7 shows the number of daily active users, total time spent on the app and time per user. As we would expect, usage fell dramatically with the onset of COVID-19. However, by monitoring ongoing usage, investors are able to observe the extent to which Chinese consumers have retained interest in travelling, monitoring its rise and fall in line with changing restrictions and the progress of new variants and cases.

Figure 7a: Chinese travel apps – daily active users



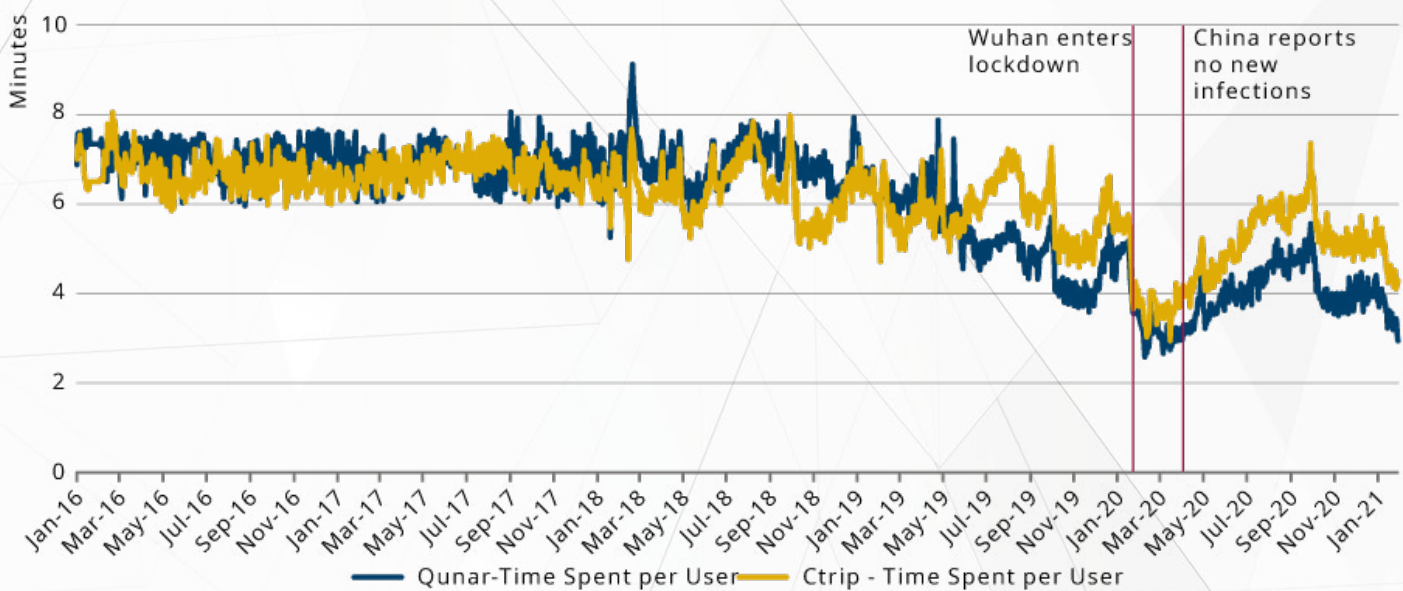
Source: Jiguang, Man Group; as of January 2021.

Figure 7b: Chinese travel apps – time spent



Source: Jiguang, Man Group; as of January 2021.

Figure 7c: Chinese travel apps – time spent per user



Source: Jiguang, Man Group; as of January 2021.



## Considerations when using Chinese alternative data

So, Chinese alternative data can provide investors with unique insights into the Chinese equity market. However, to handle the data effectively, firms must account for four factors:

1. **Local knowledge:** Local knowledge is required to know where valuable nuggets of data can be found, and, perhaps more importantly, to judge data quality and vendor methodologies. This knowledge can be quite nuanced, such as knowing the difference between Alibaba's Tmall versus Pinduoduo when using e-commerce data, or the terms consumers use when searching for luxury goods;
2. **Language skills:** These are required across a variety of touch points in the alternative data life cycle, from reaching out to a small local vendor to understanding data dictionaries and error messages to, ultimately, the understanding the data itself. Depending on what kind of analysis the user intends to perform, analysts may also benefit from a tech stack that can support a variety of Chinese dialects for natural language processing;
3. **Local vendors:** Some interesting, smaller vendors may not be as experienced as their global counterparts and may have different standards when it comes to data and compliance. In light of the fast-evolving space, vendors also risk becoming obsolete. Analysts must therefore have a deep understanding of the local vendor space, keeping abreast of both local trends and best practice
4. **Local regulation:** The use of Chinese alternative data is subject to an evolving legal and; regulatory regime, including the Data Security Law which will come into force in September 2021. Practitioners must be aware of regulation which covers cross-border transfer of certain data types.

These challenges indisputably add to complexity and barriers to entry when exploring alternative data in China. As more data and vendors enter the space, those firms who are able to invest the time and resources, both in terms of skilled analysts and data platforms, give themselves the best chance of extracting signals from the ever-increasing noise.

## Conclusion

China is already one of the largest markets in the world when it comes to equities.<sup>2</sup> It also remains an opportunity-rich market, which gives rise to a growing demand for data. While some global alternative datasets may be accurate for the onshore market, as more and more Chinese data is created, local alternative data is becoming an increasingly important source of insight.

To use this new data well, investors should seek to adapt their processes to take account of the different way that Chinese data is generated: partnering with local data providers, looking at unfamiliar but popular websites instead of those more common globally, and ensuring that technology stacks and researchers are able to handle the nuances of the new Chinese data.

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2 <https://www.man.com/maninstitute/hot-commodity>

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# What is DeFi?

## How blockchain may reshape capital markets



Jamison Sites

Senior Manager, Financial Services Senior Analyst  
RSM US LLP

Decentralised finance (known as DeFi) refers to a new financial infrastructure - built on blockchain technology - that allows for transparent, permissionless and borderless financial interactions in which the fees traditionally charged by intermediaries are fed back to the DeFi participants. Using distributed ledger technology and smart contracts, decentralised applications built on blockchains like Ethereum enable trustless, peer-to-peer financial transactions that remove centralised entities and intermediaries. From simple prediction markets to the tokenised factoring of trade receivables, DeFi is growing.

To understand DeFi as a whole, it is crucial to understand the concepts of the smart contract, the token, and the exchange. This piece will explain these elements of DeFi, explore their transformational potential, highlight associated risks, and consider the impact DeFi may have on traditional market structure.

### Core elements

The backbone of DeFi is the smart contract. Unlike the Bitcoin blockchain, Ethereum and other smart contract-enabled blockchains run like a large, decentralised computer with network participants. These network participants process transactions of Ethereum's native currency ether (ETH) and run the lines of code for smart contracts and power decentralised applications. Smart contracts can range from a simple "if this, then that" self-executing contract, or they can run complex computer programmes and replace centralised broker-dealers.

Tokens, another key element of DeFi, are created and managed with smart contracts. They allow for assets other than ETH to be traded on top of the Ethereum network. Tokens come in many different flavours, from utility tokens that operate as a form of payment within their own unique ecosystem to tokens that intend to represent an asset in the physical world.

One example of the latter is stablecoins, which are central to the DeFi ecosystem. Most commonly pegged to the dollar, stablecoins can maintain their peg through centralised reserves held by the issuer or programmatically with a smart contract. Over the past 18 months, the market cap for stablecoins tied to the US dollar



has grown from US\$5 billion to over US\$100 billion, according to Coin Metrics. In a mid-July meeting of the President's Working Group on Financial Markets, Treasury Secretary Janet Yellen stressed the need for a US regulatory framework for stablecoins. The working group "expects to issue recommendations in the coming months," according to the Treasury Department.

The third piece of critical infrastructure for the DeFi economy is the exchange. DeFi has largely replaced the functions of centralised entities with smart contracts. With a decentralised exchange (DEX), a smart contract operates the platform and enables the trading of tokens. The largest DEX, Uniswap, launched in November 2018 and its trading volume grew from US\$330 million in June 2020 to a peak of US\$83 billion in May 2021, according to data from CoinGecko and The Block.

### DeFi's growing impact

The use of DeFi is growing at a rapid pace. The share of DEX trading volume compared to centralised exchanges has risen from 1% in January of 2020 to over 9% as of June 2021, according to CoinGecko data. Another sign of growth is that the gross value of assets locked in Ethereum smart contracts has swelled from US\$845 million on 1 June 2020, to US\$57.1 billion one year later according to data from DeBank and The Block. DEX trading volume was US\$162.5 billion in May, but that number is a drop in the bucket compared to the US\$10.9 trillion in US equities trading volume for the same month, according to data from Cboe.

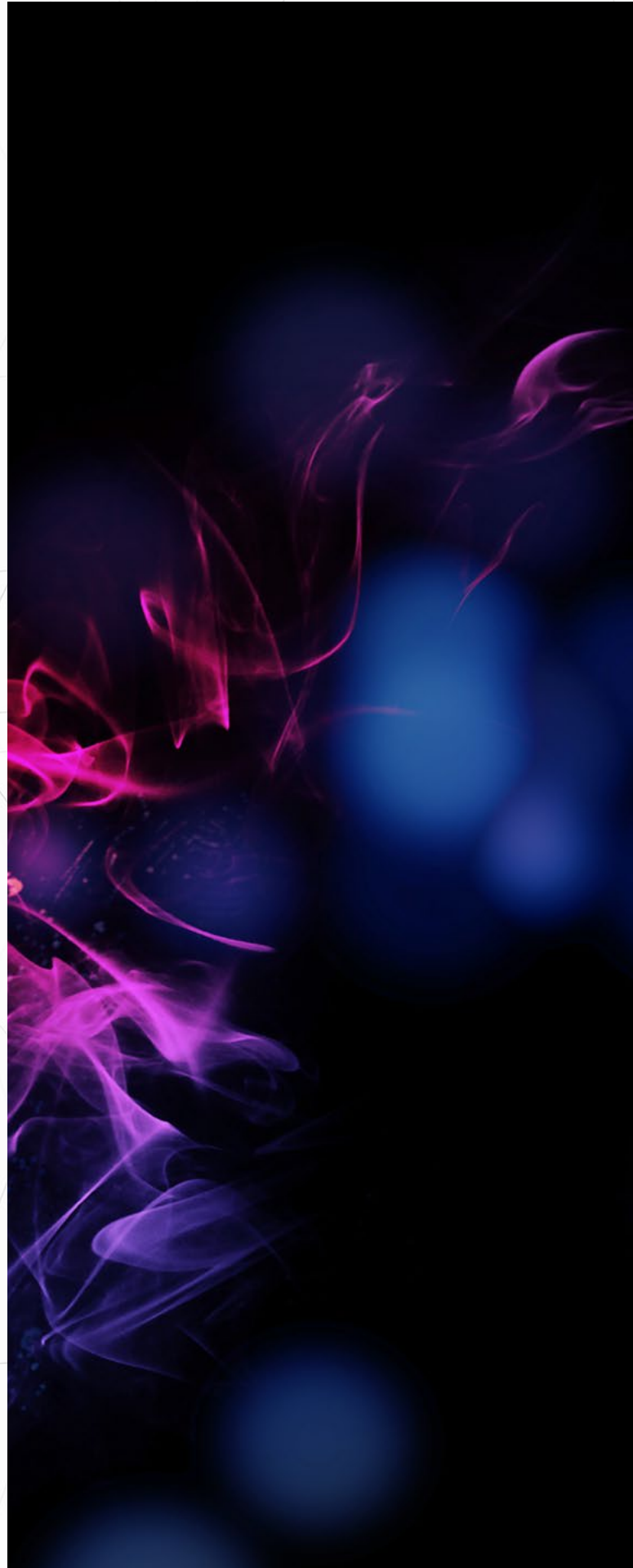
DeFi is also rapidly expanding beyond lending and exchanges. The recent rise of non-fungible tokens has broadened DeFi into the world of collectibles and art trading. DeFi is also expanding into more complex financial instrument markets as well, from derivatives, futures, and swaps to complex platforms enabling the tokenisation of factored trade receivables.

The question remains as to whether DeFi can continue its rate of capital inflow. While attention from traditional capital market participants is likely to fuel continued DeFi growth, in order to maintain its exponential rate of growth, DeFi will need to overcome some of its traditional limitations.

One criticism of DeFi has been its inefficient use of capital. Historically most decentralised lending apps have required 150% to 200% over-collateralisation. Newer platforms such as Liquity are offering stablecoin loans with as little as 110% collateral. Uniswap has even recently launched a new version of its app to allow liquidity providers to make their capital available within specific price ranges rather than among all possible prices; thus, enlarging their percentage of the liquidity pool within their specified price range and allowing them to earn more in terms of trading fees.

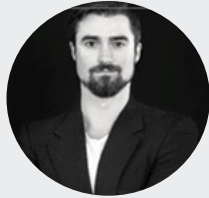
It is difficult to gauge whether DeFi will ultimately become a significant disrupting force to the traditional capital market structure. Given its rapid growth, it is likely worth some level of attention, and those active in the current capital market structure will likely see some effects from this growth.

Continued education on more advanced DeFi topics may yield insights and opportunities to leverage this innovation into a first-mover advantage. Those with just a passing interest may want to simply stay alert for news coverage of DeFi trends and evaluate when a more serious study may be necessary.





# How will KYC/onboarding change in the age of blockchain?



**Tony Peccatiello**  
CEO and Co-Founder  
Parallel Markets



**Suzanne Elovic**  
President  
Parallel Markets

**B**lockchain technology and the promise of a new decentralised Web 3.0 is rapidly gaining attention in the financial services industry. The most famous use case for this new technology is, of course, crypto currency. But blockchain is also being deployed for payments and money movement, trading, clearance and settlement, non-fungible tokens, and even in the management of some hedge funds. Each of these topics could be an article all to itself but for this one we are going to focus on how onboarding and know-your-customer (KYC) could be forever changed through the adoption of processes enabled with this technology.

Trillions of dollars move every day all over the globe and the current framework to prevent bad actors from laundering ill-gotten gains through our markets costs our financial services industry billions of dollars each year. Blockchain can eliminate some of the inefficient redundancies that are endemic to that framework while enhancing the effectiveness of KYC. However, while the blockchain enabled future has a lot to offer, it is critical that we make sure to do so in a way that both highlights and enables the benefits of decentralisation but also supports and ideally improves regulatory compliance.

KYC is a critical element of every asset manager's anti-money laundering programme and doing it effectively and efficiently is a constant challenge (Parallel Markets' blog post [Customer Due Diligence: The Ultimate Guide](#) provides a helpful primer on regulatory KYC requirements). Traditionally, financial institutions have utilised manual processes to gather and assess information about their customers and more recently, various tools have emerged to automate aspects of those processes. Even with automation, there remain a number of pain points including the opportunity for fraud and the reality that financial institutions dedicate significant resources to perform KYC checks on the same individuals and entities who have already gone through similar checks by numerous other financial institutions. Parallel Markets' blogpost [It's Time to Fix Onboarding](#) describes these pain points in further detail.

There is a hope that the use of blockchain to create digital identities is potentially a game changer in terms of efficiency, elimination of redundancy and enhanced reliability that can reduce the risk of fraud. At the same time, there are certain challenges that will have to be carefully considered in order to ensure that the regulatory requirements relating to KYC and customer due diligence (CDD) are fully achieved.

### Using blockchain to create a single identity profile

Blockchain technology is frequently discussed as a potential solution to reliable portable identity verification. Because the blockchain is an immutable, distributed ledger, a verified identity could be added to the ledger by the identity owner who would then have full control to grant access to third parties. Those third parties could be financial institutions, exchanges, or even other individuals/entities with whom the identity owner chooses to transact directly. The challenge will be to ensure that the information is secure, compliant, current and meets all privacy regulations.

One way to achieve this would be for individuals to load personally identifiable information (PII) such as their driver's licence, passport, social security number, etc. in an encrypted form to the blockchain and then to be able to grant permission to access that information to whomever they choose. This creation of a single identity profile that could be used repeatedly would relieve individuals who are seeking to onboard with multiple financial institutions from the burden of having to reload and resend documentation each time they establish a new relationship. It would also be a more reliable source of information for financial institutions because each one would be conducting its KYC process based on the same data. Additionally, because the identity profile holder would be the only one who can authorize access, this would facilitate financial institutions' compliance with privacy regulations.

Even so, the creation of the identity profile on the blockchain alleviates the burden on the individual but does not reduce the redundancy of the KYC checks for financial institutions or meaningfully diminish the opportunity for fraud because the centralised data has not been verified or validated. As a result, each financial institution would still have to perform its own process to verify the PII data that would be duplicative of the verifications performed by other financial institutions on that same data.

### Using blockchain for identity verification

But what if that identity profile not only included an individual's PII but also confirmation data that the identity has been verified and how that verification was performed? Such a construct





would enable individuals to have self-sovereignty over who can view their PII while simultaneously providing financial institutions with confidence that the identity data provided is reliable and accurate. To achieve this, an individual's PII would be provided to a storage platform and then reviewed and validated by an independent third-party. That third-party's verification data would then be loaded to the blockchain. The individual would then have full control over the release of the verification data and/or the underlying PII. With the inclusion of this third-party validation layer, the distributed ledger could act as a single source of truth confirming that the person is who they claim to be. This would significantly ease the current burden of every financial institution conducting its own separate identity verification process.

In those instances where individuals and/or entities choose to engage in a fully decentralised transaction, without the involvement of regulated financial institutions, they can act in a fully self-sovereign manner - enabling access to the fact of the identity verification on the blockchain without sharing their PII.

Notably, for this process to be effective and compliant, there would also be a need to keep the data current. The same independent third-party that houses the central source of documentation would also engage in periodic refreshes of each profile. While each financial institution will have some process to follow to periodically review their customers for unique profile information such as expected transaction types and size, the periodic refreshes of address, name changes, beneficial ownership, marital status, etc. could all be done centrally thereby, again, eliminating the inefficient redundancy that is endemic to current processes.

### **Adding other KYC validations to the blockchain identity profile**

It is important to note that while the process described above would be a significant step forward in eliminating inefficiencies in the KYC process as well as building critical infrastructure for Web 3.0, identity verification is only one piece of the KYC journey. As noted above, financial institutions are also required to verify a host of information about the individual or corporate entity once they have confirmed identity. For example, is the person subject to sanctions or has



there been news that would suggest a heightened level of risk? Is the individual a politically exposed person? For corporate entities, beneficial ownership has to be ascertained and then the same identity checks must be conducted on each of the beneficial owners.

Designed correctly, the output of all these checks could be added to identity profiles on blockchain. This would eliminate the redundancy of these checks and ensuring a consistent level of safety and reliability across all the participants who have the responsibility to protect our financial markets. Additionally, as use cases for sharing a digital identity profile evolve, elements of the profile could be separated so that the dataset released by the profile holder could be customised depending on what is needed by the end user.

### Self-sovereign identity (SSI)

The establishment of the protocol described above is a step in the direction of creating a truly self-sovereign identity, i.e., the model for managing digital identities in which an individual or business has sole ownership over the ability to control their personal data. The ultimate objectives of SSI are to ensure confidentiality and privacy while still providing a mechanism for trust between parties to a transaction and full regulatory compliance. Individuals and corporate entities with verified identity profiles on the blockchain could conceivably engage in certain types of transactions with other verified individuals without the involvement of an intermediary financial institution. However, when a financial institution is facilitating the transaction, the current regulatory scheme would not permit the participants to be anonymous. The financial institution is obligated to know the customer's identity.

So, while there are great opportunities for using blockchain to significantly streamline and enhance effectiveness of the KYC process, for now, the underlying source data that ultimately supports the verification of a customer's identity and all the other KYC checks still must be part of the identity profile collected by financial institutions.

For more information, please feel free to reach out directly to [suzanne@parallelmarkets.com](mailto:suzanne@parallelmarkets.com).



# Building trust and managing risk in cryptoasset markets: The role of the custodian



**Alasdair Pitt**  
Head of Legal  
**Zodia Custody**  
[Email Alasdair Pitt](#)



**Luke Dorney**  
Head of Client Coverage  
**Zodia Custody**  
[Email Luke Dorney](#)

**W**ith continued growth of interest in cryptoassets across investor segments - from retail to institutional - and, in many cases, non-existent or developing regulatory frameworks governing the asset class, it is worthwhile for investors and sponsors of new investment vehicles to pause and consider legal, operational, and other risk safeguards associated with the custody arrangements they are considering underpinning their investments. Undoubtedly, cryptoassets pose a unique combination of risk management issues. If the custody arrangements represent a substantial single point of failure for an investor, then, regardless of the investment strategy being pursued, investors may be exposed to an unacceptable risk of loss. In this respect, not all custody service providers are equal.

## Trust for investors

The role of the custodian is to reduce risk and provide operational independence to investors. Trust, in its broadest sense, is a key component of custodian engagement. Let us break trust down into its non-legal and legal components. First, trust in the sense that a person is good, honest, sincere and that they will do what you expect of them or do the right thing. While failures of trust are certainly not unique to cryptoasset players, there has been no shortage of well-publicised incidents relating to bad actors, poor operating standards and insecure technologies and processes causing losses to investors or difficulty in recovering manipulated cryptoassets. As the cryptoasset markets mature, investors now have a greater choice of custody provider. Fintech startups are facing competition from custodians with substantial institutional backing in the form of financial and intellectual capital. These custodians present investors with a deep understanding of client segments and utilise institutional-quality frameworks for compliance, risk-management, and governance on a par with those designed to meet or exceed regulated standards in traditional markets. And, of course, longstanding track-records of applying those standards to their markets.

As part of their due diligence, investors should ask potential custodians 'searching questions' about their risk management frameworks. For example, what are their anti-money laundering standards? Do they adhere to FATF Recommendation 16 (known as the travel rule) whereby custodians ought to obtain and exchange accurate originator and beneficiary information prior to effecting transactions and make this information available to the authorities if required as part of the fight against financial crime? In environments where blockchain addresses are public and there is nothing that can be done to prevent improper transfers in to or out of a public address, deployment by the



custodian of transaction screening procedures is essential to mitigate the risk of 'dusting', whereby a legitimate public address is contaminated by transfer in of a quantity of a cryptoasset from a public address with a dubious history, or simply an erroneous transfer out. More on preventing erroneous transfers below in relation to operational risk. Potential conflicts of interest can arise in service providers that utilise business models combining customer pricing/execution and proprietary trading functions with custody. This risk can be mitigated by selecting a specialist custodian that is dedicated solely to the provision of custody services and managed with transparent and effective governance.

Second, trust in a legal sense. If cryptoassets are not held on legal terms that ring-fence them from a theoretical insolvency of the custodian, then they may be subject to claims by third parties. If the cryptoassets are held by the custodian on a segregated legal trust, this can be an effective way to protect against loss in the event of custodian insolvency. In the UK, the UK Jurisdiction Taskforce<sup>1</sup> published its Legal statement on cryptoassets and smart contracts<sup>2</sup> in 2019 to bring greater certainty to the treatment of cryptoassets under English law.

The statement concluded that, in principle, criteria applied under English common law to determine whether tangible or intangible objects can be subject to rights of property - such as ownership - should also be capable of application to cryptoassets domiciled in the UK. Instinctively, this might seem like an obvious conclusion, but it is important that an alternative characterisation - that cryptoassets consist merely of data or information, which is not capable of private ownership - was considered and distinguished. The UKJT's reasoning and conclusion that cryptoassets can be the subject of legal title or owned has since been cited and recognised in a growing number of cases decided in common law jurisdictions. The importance of establishing a clear legal domicile for cryptoassets recorded on a distributed ledger and corresponding recognition of rights of ownership of cryptoassets is crucial for investors to have confidence that their rights are capable of enforcement against third parties, including the custodian itself.

Recognition of title also underpins the ability for cryptoassets to be held by a custodian on trust. If cryptoasset wallets are not legally (and operationally) ring-fenced from insolvency of the custodian or other clients or creditors of the custodian, then the cryptoassets in those wallets might be subject to the claims of other creditors of the custodian.

A trust, therefore, provides a flexible and robust legal mechanism that is protective of investors' rights relating to their cryptoassets. But beyond selection of the right legal structure to use for custodianship of cryptoassets must also lie implementation by the custodian of a matching operating framework (paired with a suitable audit right): after all, while the creation of a trust of cryptoassets may well be one effective legal structure for investors to protect against custodian insolvency, the practicalities and procedures for recovering cryptoassets in the event of insolvency may be more complex and specialist than recovery of traditional assets and require deeper insight into the management of the custodian.

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1 A group of eminent legal professionals working under the umbrella of the LawTech Delivery Panel

2 available at <https://technation.io/about-us/lawtech-panel>



If, for example, encrypted private keys necessary to transfer cryptoassets from public addresses exist within the confines of hardware security modules, then in the event of a custodian insolvency how would investor assets be moved in accordance with investor's instructions post-insolvency?

In this regard investors should satisfy themselves that there is a credible resolution plan that the custodian has designed and will update to facilitate the task in the event of a worst-case.

### **Risk management for investors**

In relation to fiat currencies, we regularly read of human error or so-called fat-finger syndrome being the cause of erroneous transfers. It is sometimes, and sometimes not, possible for these errors to be traced and unwound. Given the immutable and often anonymous nature of transfers made on the blockchain, any similar error may not be so easy to correct. It is therefore important that the process for effecting a transfer be designed to eliminate human error and that transfers be limited to whitelisted addresses (addresses where the custodian has identified the beneficiary in advance).

No single person ought to have sole authority to execute a transfer instruction and the processes for initiating and authorising the instruction should be separated through segregated entitlements while being flexible enough to reflect a client's own governance and authorization structures. Once an instruction has been correctly initiated and authorised then it should be processed by the custodian without manual intervention to eliminate the possibility of error being introduced. These processes should be efficient, cost effective, and scalable to suit the needs of active investors.

Given cybersecurity risk, insurance is a crucial part of a custodian risk management approach. Insurance will help mitigate the risk of loss from theft, hacking, damage, or destruction of cryptoassets whilst under the custodian's care. Additionally, insurance solutions should provide protection against the impact of a cyber incident as well as civil and criminal liabilities that may arise from a failure of service.





As well as the comfort that certain losses are covered, insurance also provides the custodian with an important economic incentive to ensure that its processes are risk-assessed and managed with the right behaviors in mind. Cybercrime and IT security risks also require close attention.

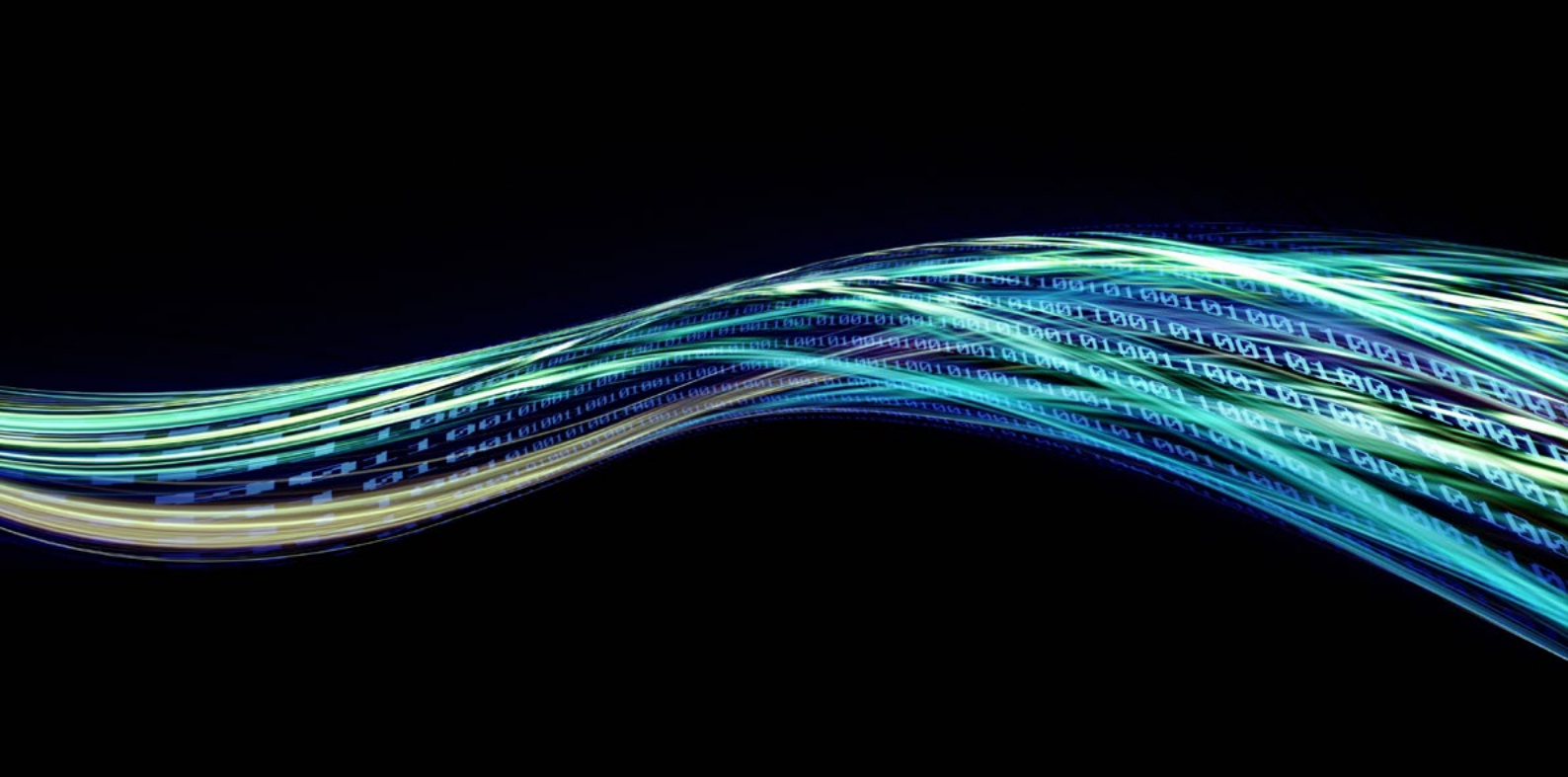
Beyond compliance with international and widely cited security standards such as ISO 27001 (for organisational security) & FIPS 140-2 (for safe storage of private keys), it is essential for custodians to demonstrate a risk management framework for continuous improvement as the threat landscape for cryptoassets evolves. This should involve regular analysis of internal and external threat intelligence and deployment of strategic and operational enhancements to the crypto custody service. This will ensure that the crypto custody service continues to be effective and resilient against evolving threats. Lastly, while the custodian may not be thought of traditionally as having a role to play in mitigating market risk if the custodian has – for the benefit of its clients - innovated by developing connectivity to trading platforms, whether exchanges, brokers or directly with potential counterparties, then it will have facilitated access to liquidity for market risk management purposes.

### In conclusion

Cryptoassets present novel risk management issues for investors and the industry players who support them. The solutions required are a combination of the traditional and the non-traditional. Safe custody is the foundation on which any investment, whether in cryptoassets or otherwise, is built. Given the range of players and solutions available, both new and traditional, investors should carry out rigorous due diligence on any proposed custody solution.

Risk can never be eliminated entirely but due diligence that results in an informed choice of custody solution can provide a trustworthy platform for cryptoasset investors, whilst minimising the level of residual risk.





# Data Matters: Accounting and Reporting

## Operational requirements for special situation opportunities

Darren Berkowicz

Managing Director, Fund Services

SS&C Technologies

[Email Darren Berkowicz](#)

**H**edge funds have experienced healthy growth throughout the pandemic, thanks to an abundance of opportunities to tap into a disrupted market.

The diverse and alternative investment landscape has bolstered creativity in the hedge fund world, with managers using special situation accounts such as side pockets to tap into opportunities outside of their core strategy and mandate. Managers are using them in pursuit of asset classes with the potential for significant outperformance, including private equity and real estate investments, temporarily distressed, de-listed or thinly traded stocks, derivatives, and even cryptocurrencies. Such strategies require special care when dealing with data, especially in the context of accounting and reporting.

During the financial crisis of 2008-2009, regulators initially viewed these discretionary strategies with suspicion, concerned about the potential for abuse, opacity, over-valuation of assets leading to higher fees, and inadequate disclosures to investors. In the years since, however, side pockets have gained respect as a useful tool for investors. They protect funds from having to sell hard-to-value holdings to meet redemption demands while providing general and limited partners additional upside potential commensurate with the risks involved.

That said, side pockets pose complex operational, accounting and reporting challenges in order to deliver the accuracy and transparency that will satisfy both investors and regulators. Fund managers looking to take advantage of opportunities via side pockets should be aware of those challenges and the solutions needed to meet them.



## Understanding side pockets

The intent of side pockets is to segregate illiquid and often higher-risk investments from the more liquid and traditional investments in a portfolio, but all within the context of a single legal entity. Side pocket investments may include new acquisitions or existing holdings that are reclassified as illiquid. Funds may have several side pockets at any given time.

At the time a side pocket is created, existing investors in the fund receive pro-rated shares in the side pocket through the conversion of a portion of their existing shares. The investors are then locked into their side pocket allocations until the underlying assets are liquidated or returned to the main portfolio, even if they redeem some or all of their shares in the general fund in the meantime. Investors thus retain a measure of liquidity with their general fund holdings while sharing in the potential upside (and risks) of the side pocket. Investors who come into the fund after the side pocket is created do not hold shares in the side pocket, nor do they participate in its profits or losses.

## The operational impact

Understanding the inherent complexity of side pockets, some of the operational challenges become readily apparent:

**Segregated and aggregated accounting:** For accounting purposes, side pockets need to be tracked and values calculated on a stand-alone basis. However, accounting for the full fund entity must also include the side pocket. Since the true value of the side pocket asset is not realized until the liquidity event, managers must have and document a methodology for determining fair value during any accounting period. Fund firms need systems to perform both the segregated and aggregated accounting and deliver accurate and reliable net-asset -value calculations.

**Investor accounting and reporting:** With some fund investors participating in both the general portfolio and the side pocket, and others only invested in the general fund, managers need reporting capabilities to clearly show investors what they own and how their assets are performing.

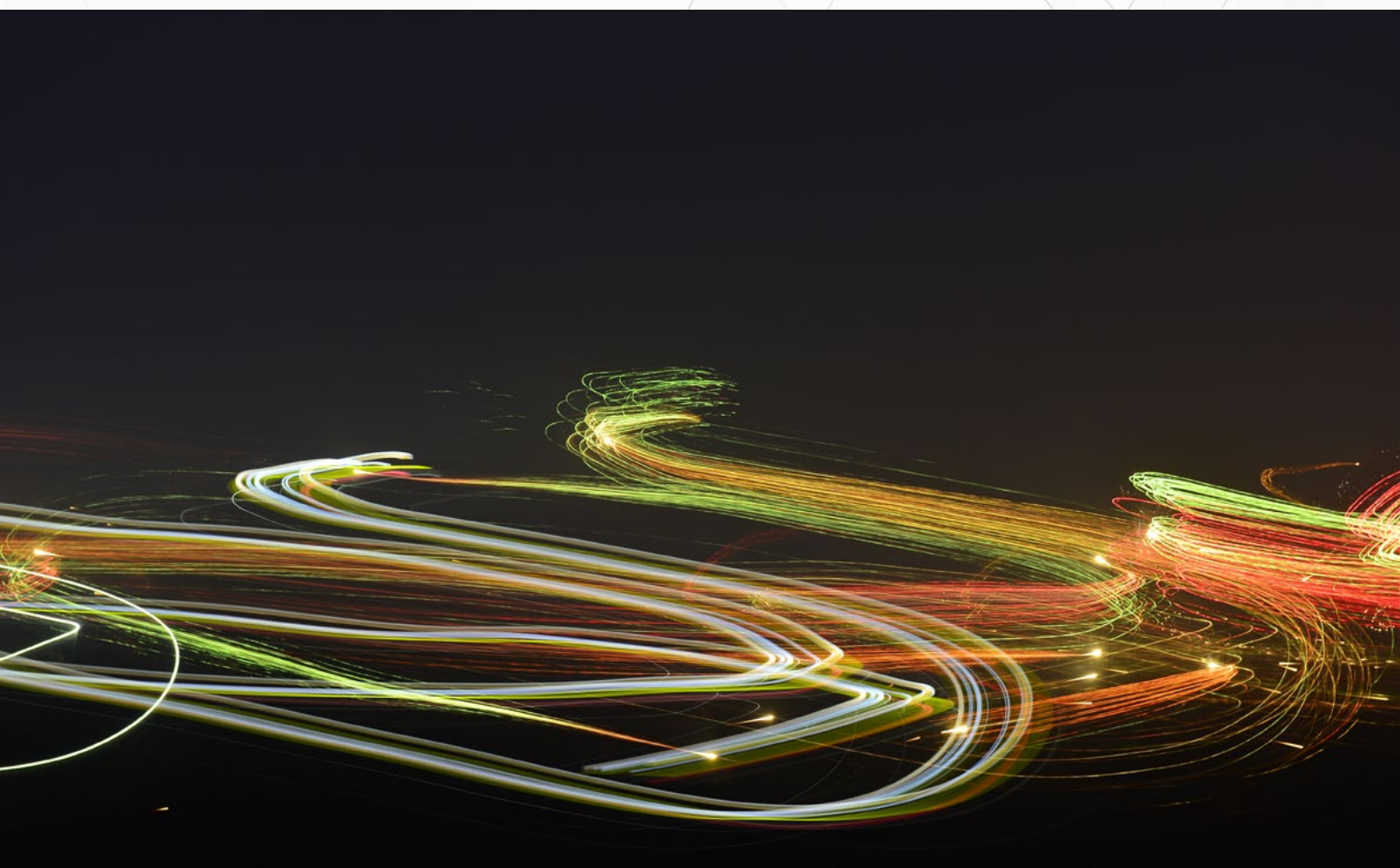
**Performance and management fee calculations:** Fund managers must determine and disclose whether they are going to charge fees periodically throughout the side pocket duration or at the end when the actual return on the investment is realised. The former scenario applies primarily to management fees and involves a complex accrual and reconciliation process to ensure investors are charged fairly and accurately. Performance fees are usually not charged until the side pocket is liquidated and the true performance of the investment can be calculated. At a time when most investors are eschewing the traditional 2/20 fee model in favour of more customised arrangements, side pockets add another layer.

### It pays to outsource

While the intelligent use of side pockets presents enticing opportunities for potential gains, these vehicles can also impose enormous operational burdens. Many firms may be discouraged from side pocket ventures simply because they lack the operational infrastructure to support them. Others may discover too late their systems are not up to the task, raising a high risk of accounting errors, liquidity strains, regulatory scrutiny and investor dissatisfaction.

These issues can be mitigated by outsourcing to technology and operational service provider that has both a proven infrastructure and the specialised expertise to support side pocket investments. Those capabilities should encompass both portfolio and investor accounting and reporting for complex fund structures, as well as the ability to automate fee calculations and accommodate multiple bespoke fee schedules. Most importantly, the provider should have the capability to manage data complexity, ensuring a steady flow of clean, reconciled data throughout a hedge fund's ecosystem.

By assigning these responsibilities to an experienced provider, investment teams can take care of the operational complexities and focus on finding the right investment opportunities for their clients.







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# Funds seek gains from private debt boom



Aman Bahel

Managing Director, Business Development  
Apex Group

**T**he future of private debt looks bright. The pandemic reinforced the case for private assets and the opportunity set in sub-sectors, such as distressed debt, has been bolstered by recent events. Notably, non-bank lenders have become more important in the post-COVID world.

To be clear, the pandemic had initially dampened activity. Private debt fundraising fell 10% in 2020 compared with the previous year. However, with 200 funds raising a total of US\$118 billion, 2020 was still a very active year by anyone's standards.

The fundraising process became more protracted. Infrastructure funds, for example, took an average of 21 months to close, 24% longer than the previous year, according to Preqin data.

However, short-term hitches don't detract from the bigger picture – one of solid growth in the private debt market as a whole. Some sub-sectors have even been strengthened because of the pandemic.

## Distressed funds gain

The special situations, credit opportunities and distressed debt universes are among those to have benefitted from these market conditions. The number of special situations funds raising money at the start of 2021 rose fivefold from a year earlier, to 79. Distressed debt fund managers accounted for 17% of the market, up five percentage points in 2019.

Similarly, the proportion of managers active in special situations rose by four percentage points, to 19%.

The pandemic also served to concentrate assets under management (AuM) among fewer players. Limited partners (LPs) turned to experienced managers, amid a 'flight to quality'.

Across the top 10 private debt funds having reached close in 2020, the smallest was US\$2 billion, and the largest was US\$11 billion. Among individual deals in private debt, the biggest was Apollo's US\$4 billion financing for car rental company Hertz.

Prolonged low interest rates have boosted the case for private and infrastructure debt. Low default rates have also helped.

A report by Preqin in 2020 pointed to optimism among investors. Nearly half of those surveyed said they were likely to increase their allocation to private debt, with 93% intending to commit as much capital, or more, to infrastructure as an asset class in 2021 as in 2020, according to Preqin's report, which forecasts that private debt AuM will rise to US\$1.46 trillion by 2025, up from US\$848 billion at the end of 2020.

Historically, major North American private equity firms, such as Blackstone, KKR, and Oaktree Capital Management, have dominated in private debt. But more mainstream fund groups from across the globe have turned to the asset class. Europe-focused AuM now makes up around 30% of the total, up from just over a quarter five years ago.

### Direct lending appeal

Among the strategies, direct lending is set to continue drawing the most interest. Managers raised US\$33.5 billion across 28 vehicles in the first half of 2021 globally, already three-quarters of the amount raised during the whole of 2020. Infrastructure debt will be playing a key part in funding what is commonly referred to as the 'infrastructure gap'.

The G20 Global Infrastructure Hub estimates that global infrastructure investment needs will rise to US\$94 trillion by 2040 to keep pace with economic growth and meet the UN's Sustainable Development Goals (SDGs).

The annual shortfall, according to its main forecast, will rise from around US\$460 billion in 2020 to around US\$820 billion by 2040. Closing the gap would require annual infrastructure investment to increase from the current level of 3.17% of global GDP to 3.7%. Meeting SDGs will increase this need to closer to 4% by 2030.

### Data is key

"For fund groups seeking to enter the private debt markets, data is key," says Floris Hovingh, Managing Director at Alvarez and Marsal Debt Advisory, and one of the contributors of our market report on [The Factors Shaping the Private Debt Market](#).

"It is a very data driven space, especially in fund raising. The more data you get to show how you have managed the portfolio, and particularly in difficult situations, the better. You need data to back up your statements. A cornerstone investor who can validate your investment strategy is also very helpful."

Although not as mature as private equity, the private credit market is now commoditised, so a differentiated offering is also essential.

### Service provider importance

Private debt consultant, Agnes Mazurek, who also contributed to our report, underscores the importance of innovation, and stresses the importance of having the right support.

"In my experience, having trusted advisers and service providers are essential. You cannot ignore how real the competitive advantage is of having the right partners or technology in place," she says.

"Infrastructure debt, for example, is a very work intensive asset class, with long lead times from sourcing to execution of investments – several months is the norm. Why would you waste all that effort by messing up capital calls or cutting corners on the quality of investor reporting?"

Ultimately, to be competitive, market players will need to get the balance right between internalising operations and finding external resources to successfully tackle the complexity of the asset class.

There are multiple considerations including tax, compliance and structuring complexity and a host of investor demands from a geographically diverse base.

Fund managers can reduce operating costs and risk and by putting a trusted partner in place. This can also help streamline processes and leverage economies of scale. It is essential that any partner has global reach, but also has all the required local knowledge.

Technology is almost always a key consideration. The change in business practices over the past 18 months has only served to intensify the need for digital enablement across operational processes.

LPs need more transparency in reporting at borrower, asset, and fund level. They also require more sophisticated key performance indicators (KPIs), requiring sufficiently robust systems and automation. More importantly, this needs a partnership-style approach where managers can leverage the creativity of the service providers and focus on their core activities.

Finally, environmental, social and governance (ESG) issues are an increasingly important factor in private debt strategies, as with the wider market.

Fund managers are having to cope with more regulation and disclosure requirements. The EU's Sustainable Finance Disclosure Regulation is reason for that. It has stepped up the need for the availability of accurate and meaningful data to monitor and track ESG practices.

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# Rising to the data challenge in the private markets



**Jennifer Tribush**

Global Head of Alternatives Product  
State Street



**Tom Vogt**

Global Head of Customer Success  
Mercatus, a State Street company

The private markets are in the midst of a dramatic, two-pronged shift. First, investors are pouring money into this asset class as they hunt for alpha and opportunities to diversify. According to Preqin, assets under management in the private markets are expected to grow by nearly 13 percent annually to US\$12 trillion by 2025.<sup>1</sup> And second, private market assets such as real estate, infrastructure, private equity, and private debt, which were previously available mainly to institutional investors, are increasingly becoming commoditised as they become available to more retail channels.

This is all great news for asset managers in the private markets. But are they ready for it? A crucial factor in the changing nature of private market investing revolves around data. Managers need to become more effective and efficient at managing, analysing, and reporting on the vast quantities of complex and unstructured data related to existing and prospective investments. Improvements in these areas could be a significant driver of alpha, but more pressingly, asset owners are demanding it. They need greater transparency on holdings, the investment process, costs and on sustainability criteria, placing tremendous strain on the existing reporting capabilities of many asset managers.

To find out if they are prepared to handle this data challenge, we surveyed 85 asset managers and 85 asset owners in the private markets in August and September 2021. What we found is that many institutional investors want to do more with their own analytics and modelling, and they need greater levels of detail from asset managers. They have become accustomed to the high bar of transparency that public markets have set in terms of data quality and accessibility. Furthermore, regulators are demanding greater accountability for all stewards of capital, which requires more robust reporting from asset managers. Our survey also found that many asset managers are struggling to keep up with increased demands from their investors. Their data is often siloed and not standardised, requiring manual intervention, which makes producing a unified, overall view of private market portfolios difficult, and a public-private portfolio view a dream.

## What asset owners want

Generally, asset owners want to plough more money into private markets investments, but several issues are constraining their ability to do so. Asked how they believed data and technology could boost private markets allocations, asset owners cited improved transparency, product availability and higher quality data. These were particularly important issues for wealth management organisations such as private banks, family offices, discretionary fund managers and independent wealth managers. Many of these client groups are entering private equity for the first time and are likely bringing high expectations set by experience in public markets.

<sup>1</sup> [Preqin Markets in Focus: Alternative Assets in the Americas](#)

Private market investors need consistent asset-level data across their portfolios for a variety of purposes, such as performing forward-looking scenario analysis, helping with deal origination, calculating valuations, portfolio monitoring and risk management.

More than two-thirds of asset owners say there is a significant opportunity cost because of problematic private markets data. Sourcing high quality opportunities, collecting and processing the necessary data, and other related administrative tasks all take up more time in private markets, leaving staff with less time for other tasks and limiting their ability to expand the portfolio. Solving or mitigating these issues takes a significant amount of staff time for asset owners, meaning these allocations are resource intensive. Some asset owners are particularly sensitive to this: public sector pension funds in the US have been criticised in recent years for the high cost of their private equity portfolios relative to public markets funds and holdings.

It is no surprise, therefore, to discover that checking data management and quality formed an important part of asset owners' due diligence processes when selecting private markets managers. More than half (58%) agreed that managers operating in the private markets sectors needed to upgrade their technology and data management systems to improve their service, including making greater use of application programming interfaces (APIs), for example. This means that having a robust data management architecture will increasingly be seen as a competitive advantage for asset managers.

### Breaking down silos

Despite asset owners' wishes, many asset managers acknowledge their data management systems may lack the capabilities to fully meet client demand. More than two-thirds of asset manager respondents (69%) said they provide 'siloe'd' data reports to investors – i.e., a format that does not

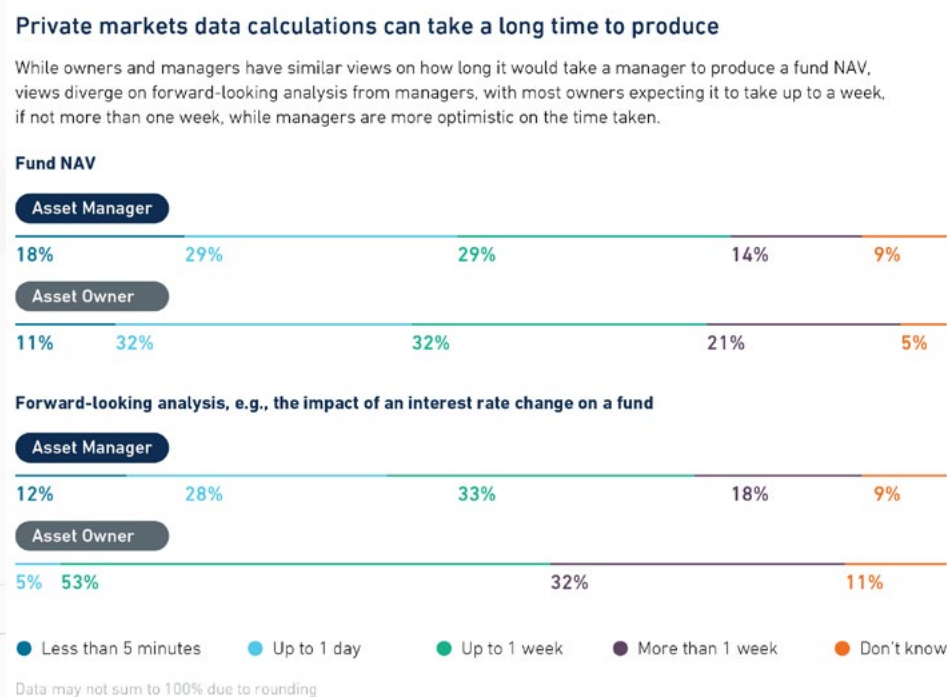


allow for the data to be directly integrated into investors' systems, such as in spreadsheets or PDFs. A similar proportion said they provide ad-hoc reporting customized to investor requirements. These ways of working are resource intensive and can make obtaining a unified, overall portfolio view difficult for both asset managers and asset owners. Relevant data resides in disparate systems and documents with no cohesive approach or standard format. Outdated processes such as the use of spreadsheets and macros increase the time required to process information and are more error-prone. In addition, it can be harder to scale up strategies if the technology being used cannot keep up with additional demand for information or increasing numbers of inputs.



This manual approach to data management leads to long delays for asset managers to deliver sometimes very basic real-time information to their investors. We asked both groups for their views on how long it takes to generate the net asset value (NAV) of a portfolio, and to put together forward-looking analysis based on a market event such as an interest rate increase.

While managers and owners are fairly aligned on how long it takes to strike a fund NAV – almost half of managers said it takes up to a week or more – the difference in perception on time required to run forward-looking analysis was stark. More than half (51%) of asset managers and 85% of asset owners say it takes up to a week or more to run scenarios across their portfolios.



There is little automation around these reports. Four in five (81%) asset managers said forward-looking analysis relied on manual processes to some extent – including 44% that said manual inputs were relied upon “to a very large extent”. More than three quarters (76%) said a fund NAV calculation relied on manual processes to some extent, leaving plenty of room for improvement.

## The path forward

To truly capture the next stage of growth in private markets and meet rising investor expectations, asset managers will have to put money to work improving their data management and reporting processes. Integration is a key element of most solutions in private markets. Having one integrated platform allows a manager to confidently venture into new asset classes with scale, flexibility, and adaptability. For institutional investors, access to insights, and performance capabilities designed specifically for private markets, can help generate alpha. An integrated platform allows managers to access data and fund servicing specialists for consolidated information, reporting, and insights. The right platform can also provide agility, with faster responses to client and reporting demands, and enhance risk management. It should also improve access to flexible cloud-based asset management tools such as deal management, environmental, social, and governance (ESG) reporting, investor relations and portfolio monitoring.

The private markets world is changing. Demand is growing for existing and novel types of investments and data, both from existing investors and from a whole new class of investors – and expectations are high. Investors want data fed directly into their systems as they are accustomed to with public assets. Operating models based on outdated systems and processes cannot be expected to cope with the challenges of today, never mind tomorrow. The opportunity is vast, and those that recognise the importance of modernising their technology will be in good stead to capitalise.



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# Investor protection to societal protection? With proposed amendments and recent probe, SEC takes concrete steps to increase ESG-related disclosures by public companies and investment managers



On 29 September 2021, the US Securities and Exchange Commission (SEC) proposed amendments to Form N-PX under the Investment Company Act of 1940, to increase the amount of information that mutual funds, exchange-traded funds, closed-end funds and certain other registered investment companies must report about their proxy voting practices. The proposed rules also require certain investment managers to annually report how they voted proxies regarding executive compensation and other matters on the Form N-PX. Managers would be required to categorise each proxy voting matter from a specified list of categories and subcategories, including compensation, corporate governance, the environment, diversity, and human rights or human capital.

The amendments are part of a broader initiative to mandate more granular, specific disclosures on environmental, social, and governance (ESG) concerns by public companies and other securities industry participants. The SEC is emphasising the policy view that investors are demanding more ESG-related information when formulating investment decisions. This focus on providing investors with ESG information appears to reflect a shift in the SEC's more traditional view that public disclosure should focus on more objective data and be predicated on the company's business operations or an investment company's underlying investments. The SEC's recently-announced investigation into Activision for failing to disclose sexual harassment and other allegations of corporate misconduct may also be instructive in understanding the kinds of ESG-related actions the SEC intends to pursue moving forward.

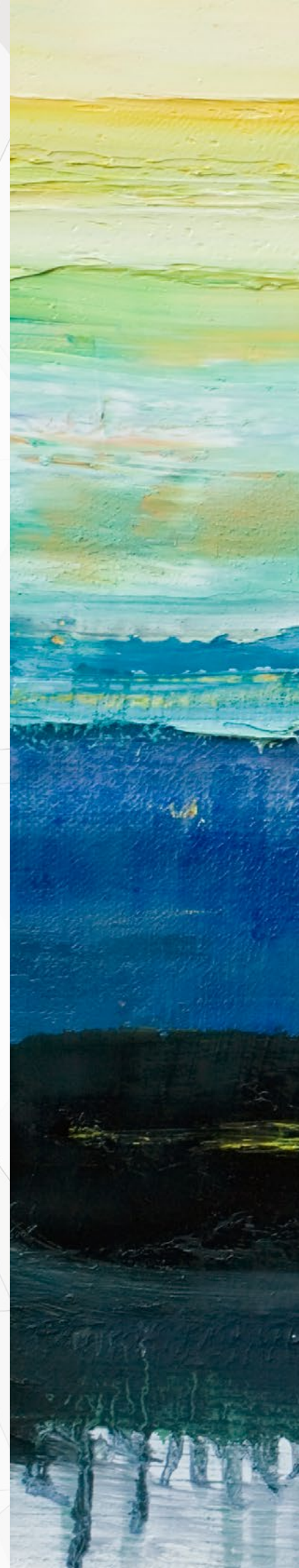


## Recent developments in human capital management disclosure

Efforts by the SEC to address investors' concerns relating to ESG disclosure have increased in recent years. In August of 2020, the SEC [adopted](#) amendments to Regulation S-K requiring "as a disclosure topic, a description of the registrant's human capital resources to the extent such disclosures would be material to an understanding of the registrant's business". Such a description could contain "any human capital measures or objectives that the registrant focuses on in managing the business" as well as various "measures or objectives that address the attraction, development, and retention of personnel" are listed by the SEC as "non-exclusive examples of subjects that may be material, depending on the nature of the registrant's business and workforce". What was deemed material for these human capital disclosures was largely determined by public companies with a specific focus on human capital issues that the company believed could have a material impact on its business.

SEC Commissioners Lee and Crenshaw dissented from the Regulation S-K amendments because they believed that they did not go far enough. Lee in particular [argued](#) that "generalised materiality determinations will not provide the kind of consistent, comparable ESG or climate data that investors seek."

While the commissioners were unable to convince then-SEC Chair Jay Clayton to require more specific disclosures in 2020, Clayton's successor, Gary Gensler, is very focused on creating a detailed human capital management disclosure regime for public companies. Gensler [stated](#) in a June 2021 speech at London City Week, and again reiterated on [Twitter](#) later in August of 2021, that he wanted SEC staff to generate new, more specific recommendations pertaining to human capital disclosures. These recommendations could include, for example, requiring companies to report on a "number of metrics, such as workforce turnover, skills and development training, compensation, benefits, workforce demographics including diversity, and health and safety". Gensler's reporting mandates appear designed to move away from allowing companies to ascertain what information is "material" enough to their business operations to be disclosed, and to instead require companies to disclose whatever information the SEC determines is "material" to their investors.



## The SEC's probe into Activision

The SEC's new focus on ESG issues can be illustrated by its recent probe into Activision Blizzard, which the video game company [confirmed](#) on 21 September 2021. The investigation comes after a turbulent summer, with the company facing a class action and scrutiny by multiple other governmental bodies such as the California Department of Fair Employment and Housing (DFEH), the Equal Employment Opportunity Commission (EEOC), and the National Labor Relations Board (NLRB). While Activision recently [settled](#) with the EEOC for US\$18 million dollars, the other investigations and class action are still ongoing.

At the core of these investigations are questions about Activision's employment practices in relation to accusations "of sexual misconduct and workplace discrimination". The California DFEH, in particular, [alleges](#) that Activision "fostered a sexist culture and paid women less than men despite women doing substantially similar work, assigned women to lower level jobs and promoted them at slower rates than men, and fired or forced women to quit at higher frequencies than men".

Additionally, Activision has been accused of having an environment in which "women were subjected to constant sexual harassment, including groping, comments and advances," and it is also alleged that the company's upper levels of management and human resources department knew of this behaviour and "failed to take reasonable steps to prevent the unlawful conduct, [...] instead retaliat[ing] against women who complained". Shareholders involved in the [class action](#) target much of the same behaviour, alleging that the "company made 'false and misleading statements' between 4 August 2016, and 27 July 2021, in SEC filings that failed to disclose the company was actually a hostile workplace for women and minorities, that numerous complaints had been made to its HR department over the years, and that DFEH had launched an investigation as a result".

The SEC's investigation seems focused on similar issues. The SEC's subpoena [demands](#) "minutes from Activision board meetings since 2019, personnel files of six former employees and separation agreements the company has reached this year with staffers". Additionally, the SEC is asking for communications between senior executives and Activision's CEO, Bobby Kotick, pertaining to "complaints of sexual harassment or discrimination by Activision employees or contractors".

These requests focus generally on more recent documents, but future requests may dredge up older documents if the SEC broadens the scope of its investigation. The purpose of the SEC's requests appears to be two-fold: first, a concern that Activision and its executives did not adequately share allegations of sexual assault and workplace discrimination with investors; and second, that the disclosures should have been shared at an earlier time with both investors and other groups.

Many questions about Activision's duty to disclose its internal sexual assault -and workplace discrimination issues remain. For example, the SEC's human capital reporting requirement did not take effect until November 2020 and allowed companies to determine the "materiality" of an event based on its potential to impact the company's business. Regardless of the ultimate outcome, the mere existence of an SEC investigation can pose significant financial and reputational risks to a public company.

Moreover, the SEC's recently proposed amendments to Form N-PX identify a wide array of potentially confusing categories and sub-categories of information that investment managers must report on – presumably because the SEC believes that these categories are of material interest to investors. SEC examiners, the plaintiffs' bar, or other regulators may interpret this to mean that each category and sub-category of information identified in the proposed amendments can serve as the basis for a lawsuit and/or enforcement action alleging a failure to disclose such information deemed subjectively material to certain investors.



## New terms and definitional confusion

The SEC's proposed ESG proxy reporting categories and sub-categories raise definitional questions that investment managers and public companies must contend with. The list of reportable ESG categories and sub-categories include:

- **Environment or climate** – with the following subcategories: greenhouse gas (GHG) emissions, transition planning or reporting, biodiversity or ecosystem risk, chemical footprint, renewable energy or energy efficiency, water issues, waste or pollution, deforestation or land use, say-on-climate, environmental justice, or other environment or climate matters.
- **Human rights or human capital/workforce** – with the following subcategories: workforce-related mandatory arbitration, supply chain exposure to human rights risks, outsourcing or offshoring, workplace sexual harassment, or other human rights or human capital/workforce matters.
- **Diversity, equity, and inclusion** – with the following subcategories: board diversity, pay gap, or other diversity, equity, and inclusion matters.
- **Political activities** – with the following subcategories: lobbying, political contributions, or other political activity matters.
- **Other social** – with the following subcategories: data privacy, responsible tax policies, charitable contributions, consumer protection, or other social matters.

While some of the topics above (e.g., GHG emissions) are generally understood and/or are defined by sustainability reporting standards organisations (e.g., the GRI Standards Glossary), other sub-categories may not be well understood. For example, the new environmental or climate category includes reporting on 'water issues' and 'environmental justice'. The SEC does not define these terms in its proposing release and the meanings are likely unclear to public companies, investment managers, and even the investors intended to benefit from the new disclosures.

Thus, we expect industry participants to push the SEC to provide clear definitions of each new term in Form N-PX and to align its definitions with those used by international standards organisations. It also will be important for the SEC to align the definitions of each new terms in Form N-PX with the definitions used in any other ESG-related reporting requirements that the SEC proposes in the coming years. Any disconnect in terminology could make it difficult for investment managers to correctly classify ESG-related issues when completing Form N-PX.



### What industry participants can do now to mitigate risk

While the exact parameters are yet to be defined, the trend toward increasing the breadth and depth of ESG-related disclosure will continue. Thus companies should prepare now for new disclosure requirements, consider participating in the SEC notice-and-comment process for the proposed rule individually or through industry bodies, and begin managing the risks associated with the SEC's evolving views on ESG. For example:

- What has your company disclosed in the past that it believes is material? Is there information in light of the proposed amendments and the Activision probe that should have been shared with investors?
- Relatedly, do you have a mechanism or system through which you could efficiently gather information pertaining to the categories of information outlined in the SEC's proposed amendments to Form N-PX?
- Given the number of categories outlined in the proposed rules, and a lack of more specific definitions, have you internally discussed how broadly to define these categories and sub-categories of information and what information you would include?
- Which function within your company is charged with the responsibility for monitoring these areas, and is the relevant governance structure appropriate for the upcoming changes?
- Has your board discussed ways to improve the reporting of ESG-related issues in case of future requests by regulators?
- Have you considered, or spoken with industry trade groups about, commenting on the proposed Form N-PX amendments and its vague terminology in particular?
- If you are an investment adviser to an ESG-focused fund or an adviser that takes ESG-related issues into consideration when making investments, have you conducted an in-depth assessment of your compliance practices in preparation for inevitable questions about them from SEC examiners?



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## TESTING 1, 2, ESG

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# Unpacking the ESG complexity for alternative investment vehicles

*A need for authentic commitment, clear strategies, and a grasp of context*



**Angela Jhanji**  
Director, ESG and  
Sustainability Services  
Grant Thornton



**Renee Stock**  
Senior Manager, ESG and  
Sustainability Services  
Grant Thornton



**Michael C. Patanella**  
Industry Managing Partner,  
Asset Management  
Grant Thornton

The environmental, social governance (ESG) space for alternative investments, including hedge funds and private equity, and for registered investment companies, such as mutual funds and ETFs, can be difficult to navigate. The landscape is populated by both authentic practitioners who have built their investment approaches on coherent strategies and entrants who are responding to trends and exploring marketing opportunities.

As the market has grown, increasingly sophisticated approaches have evolved. Like all investment strategies, ESG requires strategic coherence, ongoing management, attention to the detail, context, and objectives of opportunities; and a pool of investment professionals who understand its unique challenges. Regulations already exist in Europe, and SEC action appears to be on the horizon in the United States. To strategically pre-empt market trends and forthcoming requirements, companies are beginning to embed strategies informed by expertise and rooted in data and best practices.

## An evolving approach to ESG

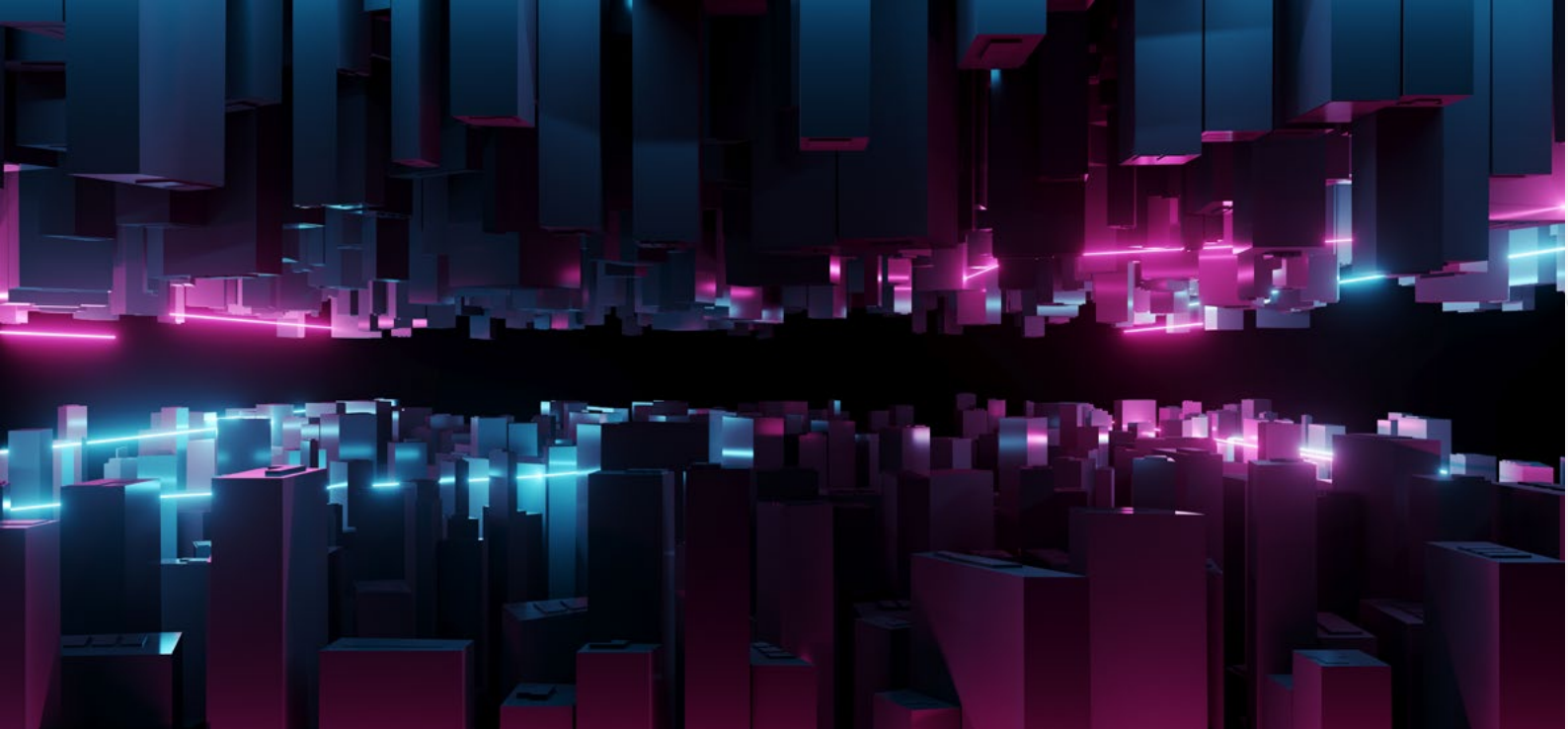
The current ESG investment approach has evolved from an earlier model which emphasized divestiture and negative screens. Many approaches now consider whether an investee is addressing the important ESG issues impacting its business. Such an assessment might include the following considerations of the investee:

- Directionality: Are they moving toward their goals?
- Optionality: Is there opportunity for engagement and change?
- Intentionality: Have they articulated a strategy and a mandate to change?
- Materiality: Are financial material topics understood and disclosed?
- Impact: If they change their behavior, will a larger issue, such as climate change, be significantly closer to being solved?
- Leadership: Are they setting benchmarks for ESG success?

This multi-factor approach seeks to replace rigid hurdles with rigorous analysis. It allows investors to engage with imperfect companies which show potential for improvement.

In private equity, general partners are shifting quickly to address limited partner pressures to further ESG insight and performance. The combination of changing demographics, regulatory uncertainty, and general risk mitigation postures continue to drive ESG into the agenda. From due diligence, to





unpacking financial materiality gain and return on investment insight, the race to translate ESG intervention into quantitative reports is on. As they unpack the vast number of ESG topics material to their portfolio companies, many firms look to one another and to outside support in creating, and customising, templates and frameworks.

Central to a rigorous ESG engagement and reporting approach is the ability to track and report underlying metrics. They inform investment decisions, determinations about KPIs, which methodologies are followed, how proxies are voted, and what engagement strategies are deployed. Furthermore, the transparency pillar of ESG investing demands a level of reporting and sharing to ensure no one is caught out and there is no suggestion of fraud.

ESG investing has evolved past its early days of often concessionary returns. Building a portfolio on strong strategic foundations is now one and the same as building an ESG- aligned portfolio.

#### **The role of Climate Action 100+**

One of the emerging drivers of ESG momentum is collective action enabled by deep research and agreed-upon approaches. Climate Action 100+ is an investor-led initiative to drive climate change from a group of focus companies. It grew out of the Intergovernmental Panel on Climate Change (IPCC) which, after reviewing decades of climate research, concluded that climate risk is threatening humans, supply chains, food supplies, global infrastructure, and global economy—and predicted trillions of dollars of loss if changes aren't made.

Research suggesting that 167 companies have contributed to more than 80% of all global industrial emissions further informed the initiative's distinctive approach: engage those specific companies on behalf of hundreds of global investors representing trillions in investable assets and challenge them to set science-based targets, align with the Paris agreements, and conform to TCFD (Task Force on Climate-Related Disclosures) reporting requirements.

## Managing responsible funds in an imperfect world

ESG funds pose ongoing and complex management challenges. So, it is important to start with a coherent approach. From a responsible universal investor applying larger ESG considerations across its portfolio to a sector-specific fund with a deep understanding of the metrics, business models, and local regulatory environment. Each strategy should consider varying levels of available reporting and insight into performance, opportunities and challenges, and the agility of the players in pivoting within volatile environments. Other strategies that may be more pragmatic include funds that shape a strategy around holdings, proxy voting, or engagement.

Each opportunity needs to be closely scrutinized, requiring both experience and talent for rigorous evaluation. For example, a natural gas company may have significantly reduced their carbon emissions but still reflect them on their balance sheet. Alternately, two cell phone tower providers may have similar top line metrics for carbon data. But, after considering different business models and geographical locations – which have unique reporting requirements – a careful, in-depth comparison may reveal significant differences. In general, top-level comparison is easy, but meaningful granular comparisons are challenging. The ability to get them right, though, can help further real change.

Given the low correlation between major data reporting services, reporting which indicates top line ESG performance for two companies shouldn't be taken at face value. It's important to assess whether two reports share the same methodology, as well as how robust, up to date, complete, and rigorous they may be. Furthermore, do they explain their assumptions and reflect their context? In fact, many argue that you can look at two companies with similar top line metrics and arrive at a different carbon number. Careful analysis and attention to data quality help distinguish substantive reporting from smoke and mirrors.

By its nature, ESG is emotional, and so experts are often trying to focus on the facts. Investors may be too invested in a given metric. With the current desperation for data, companies may portray themselves as market leading with a small amount of transparency which is carefully authored and articulated. What's missing from the equation is proactive management of material topics that often make the headlines. Looking at societal trends, and mega-trends, how are companies keeping up and who is the leadership behind the decision making? There is a balance between anticipation and execution, and those able to do both will survive the waters and continually adapt for the coming tides.

Given this complexity and the different way of thinking about ESG impact, there are two useful rules of thumb.

1. **Has a company made ESG a part of its strategy?** Are responsible investing concerns reflected in their decision-making?
2. **Have they established an ESG mandate?** Do they hold themselves accountable for progress?

If so, they may be a good candidate for consideration for inclusion in an ESG portfolio. The decision to include depends on what matters to you, what aligns with your strategy, and whether the information you have supports your evaluation.



## Useful tools for navigating the ESG investment industry

- **SASB (Sustainable Accounting Standards Board):** SASB “connects businesses and investors on the financial impacts of sustainability.”
- **UN Sustainable Development Goals:** Seventeen goals which address poverty, health and education, inequality, economic growth, climate change, and conservation of oceans and forests.
- **UN PRI (Principles for Responsible Investing):** Signed by the vast majority of global investment managers—works to understand the investment implications of ESG factors; and to support its international network of investor signatories in incorporating these factors into their investment and ownership decisions
- **Morningstar ‘Sustainable’ Stock Designations:** Allows investors to understand how the companies in their portfolios are managing their ESG risks relative to their peers.





# The 'ESG' label



**William Bryant**  
Head of Advisory  
**NorthPeak Advisory**  
[Contact NorthPeak Advisory](#)

## Asset owner focus

The focus from asset owners on responsible investment continues to grow week by week. With each new industry survey, the requirement to consider responsible investment is increasingly important for an ever-growing number of investors. As beneficiaries and stakeholders look to make sure their investment activity fully incorporates societal views and expectations on a range of issues.

Almost all due diligence conversations that fund managers, including hedge funds, now have with allocators will at some stage come round to the topic of responsible investing, typically in the question – 'How do you think about ESG?'.

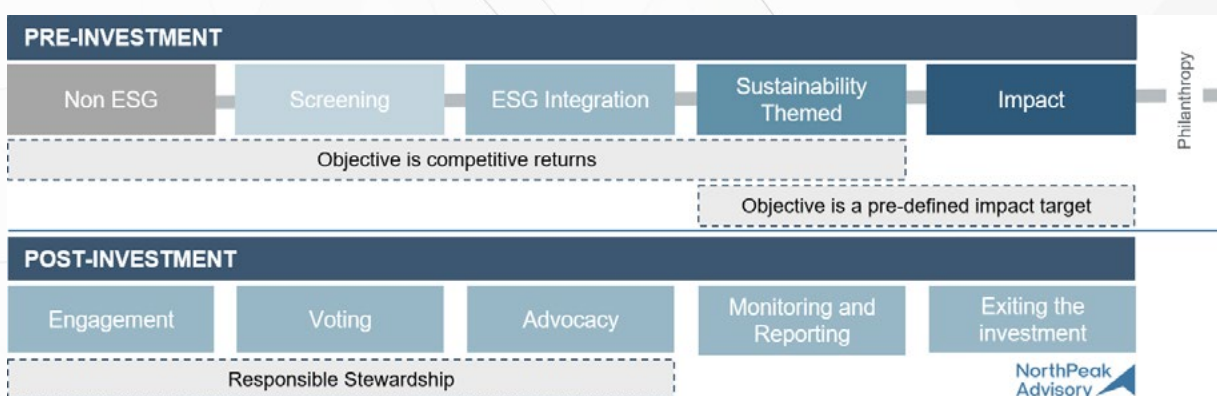
## Manager response

At NorthPeak Advisory we support fund managers with how to best incorporate environmental, social and governance (ESG) factors into their investment processes. Fund managers often express the desire for advice and support with becoming 'ESG compliant' or to create a version of an existing fund that can be labelled an 'ESG fund'. This may stem from the belief that they can label a product and then raise capital from investors that have an ESG investment bucket.

In practice this can be problematic. The range of implementations expected by investors, as it relates to responsible investment, and the expectation of seeing ESG considerations be integrated into all investment decisions, as best they can, means that a one-size-fits-all label is not suitable. Labels can be relevant where there is a specific defined investment approach. This might be appropriate for an impact strategy or for a fund that focuses on a specific sustainability theme. However, the term 'ESG' now encompasses such a broad range of approaches that using it as a label can be confusing or even misleading.

## The spectrum of responsible investment / ESG investing

At this stage, it is probably worthwhile defining what responsible investing is. The UN supported Principles for Responsible Investment (PRI) define responsible investment as 'a strategy and practice to incorporate ESG factors in the investment decisions and active ownership'. In practice, responsible investment is an umbrella term that can be used to describe a number of different approaches. These may include exclusions, positive screens, integration of ESG information, sustainability themed investments, and impact investing. Additionally, along with investment approaches and security selection, stewardship and ownership responsibilities can be included, even including support of well-functioning markets. There are a significant number of different ways to implement responsible investing, and often these are all captured by the supposed ESG label.



The definition of what is responsible investment from the asset owner perspective varies. For some it is about avoiding certain sectors, for others it is looking to have a significant positive impact on ESG issues with their investments, while others are more concerned with fully understanding all the risks that an investment is exposed to, including ESG risks. There is therefore diversity of opinion among investors as to how best to implement responsible investment. There is no one prescribed implementation approach that is 'responsible investment' or 'ESG', there are many approaches.



## Differences of opinion

I remember a meeting at the PRI's offices in 2010, during which the issue of short selling came up. In the conversation, two investors took completely opposite sides on shorting from a responsible investment perspective. One saying that profiting from shorting a company was against their responsible investment framework. While the other felt it was an appropriate way to articulate a view on a security when taking into account all information, including ESG related information. This divergence of view stemmed from different perspectives of how responsible investment should be implemented for those specific investors. Short selling is a topic that both AIMA and the PRI have published papers on, articulating the issues and the role that shorting can play within the context of responsible investing. More than a decade later there is rightfully still a lack of agreement around the topic due to different investor viewpoints. Ultimately, diversity in the execution of responsible investment within investment strategies as a whole exists because there is not one single approach.

At all levels of the investment process there are implementation differences, whether it is asset class, strategy, time period, turnover rate or region, and this is also true for responsible investment. Even when assessing a single company there is often significant difference of opinion when it comes to the ESG credentials of that company. This challenge has been widely discussed and is evidenced by the disagreement in ESG ratings across third-party data providers. These different judgments are then compounded when trying to assess ESG credentials within the context of financial performance.

Whether an individual investment is strong from an ESG perspective is dependent on many factors, including the investment approach being taken. For example, is an investment in an oil producer an 'ESG compliant' investment? For some fund managers they may want to exclude this outright, for others engaging to influence future strategy and shift to renewables may make it attractive. Both can be described as a responsible investment or ESG strategy.

## Not a product

As much as many fund managers would wish it to be so, ESG (as many now use the term) is not a product. A specific investment product may utilise a range of responsible investment techniques as part of the investment process. ESG information is another tool or lens through which the investment opportunity set can be assessed.



### What investors are looking for

Understanding the ESG characteristics of a security can help fund managers comprehend the opportunities and risks that the security is exposed to in a more holistic manner. While some hedge fund investors will no doubt want to see certain securities excluded from the investment universe to align with their views, a more widely accepted approach, is one of ESG integration. With an integrated approach, financially relevant ESG information on the security issuer is taken into account alongside other traditional financial analysis practices in order to inform the investment decision. Under an integrated approach ESG simply further informs the investment due diligence process.

In the majority of cases investors are looking for managers to elaborate how they include responsible investment approaches into their existing investment strategies. Typically they want to understand how the fund manager thinks about ESG impacting their investment decisions, how they go about collecting and integrating financially relevant ESG information, and how they monitor that information during the holding period of the investment; all of this in a systematic and repeatable process. Since there are numerous approaches that can be applied, and their relevance depends on the investment strategy at hand, trying to bucket all these differences under one 'ESG label' makes little sense.

### The end of ESG

One thing that many of us who have been focused on ESG and responsible investment for some time agree upon, is that the discussion around ESG investing will eventually disappear. Instead, simply thinking about investments through an ESG lens will become part of routine investment due diligence along with other investment relevant factors.

### Avoiding greenwashing

Both regulators and investors are focused on understanding the discrepancy between what managers are saying versus what is implemented in practice. Also, with investors placing ever more scrutiny on the ESG credentials of a manager, having a clear and accurate articulation of how responsible investment is implemented and the framework for integrating relevant ESG information into the investment process is going to help managers address the key question – 'How do you think about ESG?' and to avoid, the worst label: 'greenwashing'.



# Time to open your eyes to an environmental emergency (or get stung by a jellyfish!)



**Adam Sweidan**  
CIO  
Aurum Research Limited



**Emily Forsyth-Davies**  
Head of ESG  
Aurum Research Limited

## The problem

Over the past two years, we've seen irrefutable evidence that climate change and the extinction crisis are real and are causing significant social turmoil.<sup>1</sup> There has been both direct disruption, such as the increase in extreme weather events, and indirect, such as the rise in more dramatic events driven by biodiversity loss which increase the likelihood of zoonotic diseases which pass from animals to humans, such as COVID-19.

It's now hard to imagine a day without a headline about the environmental emergency. Especially the pressing rise in global temperatures – with the world on average having already heated by 1°C since the pre-industrial era. To put this into context, at a temperature rise of 1.5°C, it is estimated that 14% of the world's population will be hit by severe heatwaves once every five years. At 2°C, this number jumps to more than a third of the global population.<sup>2</sup>

The biodiversity crisis is often overlooked relative to climate change, but is perhaps even more pressing. One million, or a quarter of all known species,<sup>3</sup> are threatened with extinction by 2050. Over the past two years the COVID-19 pandemic has highlighted the interconnected relationship between reduced biodiversity and destruction of forests, and increased likelihood of future pandemics and infectious diseases.

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1 <https://iopscience.iop.org/article/10.1088/1748-9326/ac2966>

2 <https://www.theguardian.com/environment/ng-interactive/2021/oct/14/climate-change-happening-now-stats-graphs-maps-cop26>

3 <https://www.un.org/sustainabledevelopment/blog/2019/05/nature-decline-unprecedented-report/>

The human cost of these events is huge, COVID-19 has been incredibly destructive with an estimated 4.9 million deaths. To put some context around this it is broadly equivalent to the estimated five million excess deaths<sup>4</sup> that are already directly related to temperature change each year, which is likely to be a vast underestimate relative to the full impact of climate change.

In addition, there is also an interlinked social emergency directly linked to the increase in carbon emissions and the associated habitat and biodiversity loss.



The World Health Organisation (WHO) estimated in 2012 that nearly 13 million people die each year<sup>5</sup> from environmentally related health risks, a number which is highly likely to have risen since. The WHO currently estimate around 99% of the world's population<sup>6</sup> live in places where air quality levels exceed WHO guideline limits. One in five premature deaths are linked to air pollution.<sup>7</sup> In 2020, one in four people lacked access to safe drinking water in their homes<sup>8</sup>, and more than 2 billion did not have access to enough safe and nutritious food<sup>9</sup> or essential medicines.<sup>10</sup>

Equally as alarming is the prevalence of micro plastics. For those people fortunate enough to have access to adequate food and water, it is estimated the average person is consuming five grams of plastic each week,<sup>11</sup> roughly equivalent to a credit card.

4 [https://www.thelancet.com/journals/lanph/article/PIIS2542-5196\(21\)00081-4/fulltext](https://www.thelancet.com/journals/lanph/article/PIIS2542-5196(21)00081-4/fulltext)

5 <https://www.who.int/news/item/15-03-2016-an-estimated-12-6-million-deaths-each-year-are-attributable-to-unhealthy-environments>

6 [https://www.who.int/health-topics/air-pollution#tab=tab\\_1](https://www.who.int/health-topics/air-pollution#tab=tab_1)

7 <https://www.hsph.harvard.edu/c-change/news/fossil-fuel-air-pollution-responsible-for-1-in-5-deaths-worldwide/>

8 <https://www.unicef.org/press-releases/billions-people-will-lack-access-safe-water-sanitation-and-hygiene-2030-unless>

9 <https://www.actionagainsthunger.org.uk/why-hunger/world-hunger-facts>

10 <https://www.who.int/publications/10-year-review/chapter-medicines.pdf?ua=1>

11 [https://www.panda.org/wwf\\_news/2348371/Could-you-be-eating-a-credit-card-a-week](https://www.panda.org/wwf_news/2348371/Could-you-be-eating-a-credit-card-a-week)





Western thinking often separates human health from the health of our environment. However, in the absence of healthy ecosystems, we no longer have access to critical resources for a healthy functioning society, such as breathable air, drinkable water and hospitable weather. The environmental crisis is also a social crisis, a fact that is often overlooked. Any solutions which benefit the environment should also be designed to have a positive impact on the people who live in it.

### Are we thinking about the problem in the right way?

Around the 2008 Global Financial Crisis, the term 'Black Swan' was popularised in Nassim Taleb's book of the same name. A Black Swan is a rare and unpredictable outlier event that is high impact, with the pro-active action typically focusing on building resilience. In the mid-2010s, this thinking evolved to speaking about Black Elephants, which was developed by Vinay Gupta and Dougald Hine.<sup>12</sup> These are a cross between a Black Swan event and the proverbial 'elephant in the room'. A Black Elephant is a problem which is well known and understood and yet no-one wants to address. This is despite the awareness that one day it will have devastating Black Swan-like consequences. This can lead to claims of a Black Swan event when, in fact, it is a Black Elephant that has been ignored. More recently, the Black Jellyfish has become another favoured term. A Black Jellyfish event is also a high-impact phenomenon, which becomes more prevalent by positive feedback and has the potential to escalate rapidly. For example, the continuing rise in ocean temperatures, and corresponding acidity levels, are creating conditions for jellyfish blooms to become more and more common. These blooms have forced shut-downs at coastal power plants around the world, including Oskarshamn plant in Sweden in 2013 (the site of one of the world's largest nuclear reactors).<sup>13</sup>

A jellyfish is a particularly apt animal to represent climate change in this context, given the painful sting caused by their long tentacles, alongside their dramatic effect on the world's water systems. The Black Jellyfish analogy is also particularly suitable to describe the accelerating negative social impact of climate change and biodiversity loss in terms of the global pandemic.

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12 <https://dougald.nu/black-elephants-skull-jackets-a-conversation-with-vinay-gupta/>

13 <https://www.theguardian.com/world/2013/oct/01/jellyfish-clog-swedish-nuclear-reactor-shutdown>

The COVID-19 pandemic itself was an event that many have attempted to pass off as a Black Swan. Such events have, though, become more likely due to environmental changes. In fact, some sort of pandemic event was widely predicted prior to COVID-19, but it wasn't addressed. Indeed pandemics have occurred regularly throughout history, but the possibility increases with deforestation and biodiversity loss. Deforestation leads to increased interactions between humans and wildlife. A loss in biodiversity usually results in a few species replacing many — and these species tend to be the ones hosting pathogens that can spread to humans.

There are clear parallels here with climate change, in the sense that it was a risk that was known about, but not addressed. The heat-trapping properties of carbon dioxide have been known since as far back as 1856 when Eunice Foote presented her short paper on how carbon dioxide in the atmosphere would cause global warming.<sup>14</sup> President Lyndon B. Johnson had detailed reports written on climate change in 1965 when climate scientists summarised the risks associated with rising carbon pollution.

### So how do we solve the problem?

Against the enormity of the problem described above, taking action can often feel meaningless and futile. The International Monetary Fund's recent report showed that the fossil fuel industry benefitted from US\$5.9 trillion of government subsidies in 2020.<sup>15</sup> That is US\$11 million every minute. However, there's a popular Chinese proverb that says: "The best time to plant a tree was 20 years ago. The second best time is today." And this seems particularly apt here. We can't focus on the mistakes of the past, we need to focus our efforts on acting now if we are to avert environmental and human catastrophe.

And we need to recognise that these two aspects, environmental and social, are intrinsically linked. To solve one, you have to solve the other.

A similar relationship applies between investment choices and their associated environmental and social impact. This means investors have the power to make positive changes in both environmental and social areas simultaneously. According to The Carbon Majors Database, published by the Carbon Disclosure Project (CDP), 70% of fossil fuel emissions in the period 1998 - 2017 came from 100 companies, with 32% of emissions coming from public investor-owned companies.<sup>16</sup> This means investors are key to the transition to a sustainable economy.

Solving these problems is not just about identifying a cluster of black creatures and their impact. It's about preparing for the changes or challenges such events represent and making sure that you don't neglect to maintain the cages that will constrain your menagerie. Or, sticking with the animal analogy, it's about looking for ways to encourage the jellyfish's natural predators – the leatherback turtles and ocean sunfish – to restore equilibrium. As the challenges being faced are, by definition, global in nature, this equilibrium will need to be achieved by worldwide consensus.

14 <https://physicstoday.scitation.org/doi/10.1063/PT.6.4.20210823a/full/>

15 <https://www.imf.org/en/Publications/WP/Issues/2021/09/23/Still-Not-Getting-Energy-Prices-Right-A-Global-and-Country-Update-of-Fossil-Fuel-Subsidies-466004>

16 <https://www.cdp.net/en/articles/media/new-report-shows-just-100-companies-are-source-of-over-70-of-emissions>



Given the time and physical investment required, there can often be a reluctance for private companies to undertake such a challenge without a significant globally endorsed government policy shift.

The most important, and arguably most difficult, thing to do is to shift behaviours and mindsets from the current unsustainable system of over-consumption of planetary resources. However, as solutions are implemented it will be critical to ensure the intrinsic link between environmental and social outcomes is considered.

Given the scale of the challenge, it will require forward-thinking companies to employ a range of innovative concepts and to collaborate across different disciplines. It will also require a reassessment of how we as a society measure growth and what it means to be a successful society.

Every investment and personal choice we make is intrinsically linked to the planet and its inhabitants' health, but for too long we have been focused on economic growth and GDP to the detriment of the environment and human health. We need to shift this mindset. To measure a nation's success we should be looking at measures such as the health of the population and whether a country is consuming within boundaries that do not impact the long-term health of the planet.







### How the alternatives sector can help

We believe the alternative investments sector's resources, knowledge and lobbying power mean it has a critical role to play in contributing to and enabling public discourse that supports the case for systemic change. Similar to how a business is more resilient with a wide range of diversity dimensions involved in decision making, a biodiverse ecosystem is more resilient and a better carbon sink if there are abundant species, rather than a monoculture.

As a first step, this is about promoting awareness of the carbon emissions and carbon intensity of business activities and encouraging action to reduce this where possible. We then need to address how to mitigate the impact of carbon emissions and how to help local communities build climate resilience. The next 10 years will be critical to ensure the planet does not become uninhabitable, so now is the time to invest in philanthropic initiatives focusing on environmental and social wellbeing.

Once you've decided to adapt to a sustainable economy it will be critical to create a compelling business case. But that shouldn't be too difficult, because without a swift and significant change in mindset there will be no planet on which to do business.

# ESG in funds finance



**Jen Yee Chan**  
Partner  
Simmons & Simmons



**Anika Rahman**  
Supervising Associate  
Simmons & Simmons



**Karina Brown**  
Trainee Solicitor  
Simmons & Simmons

## Introduction

ESG has increasingly become a key consideration in funds financing transactions for both lenders and funds alike. Recent events like COP26 have generated an increased focus on what the funds industry and their lenders are doing to tackle the climate emergency and other environmental, social and governance issues. This article explores some of the key documentation trends emerging in the funds finance market.

## Documentation trends: Fund finance ESG

Two primary products are being used in the provision of sustainability-linked finance in the funds finance space: notably, firstly in the form of a traditional revolving corporate facility, and secondly, in the form of a subscription-line facility with built-in ESG provisions. Green loans (i.e., those that specify in the 'use of proceeds' the specific purpose that any funds advanced need to be utilised for) are less commonly used in the UK and European market as they are considered to afford the fund with less flexibility and thus remain less popular to date.

Despite the bespoke nature of many ESG-linked funds finance facilities, many of these now have recognisable sustainability-linked features, some of which we mention below. We note these remain to be developed as the market continues to evolve.

- **Margin/pricing:** Similar to sustainability-linked loans in the corporate space, whilst initially margin adjustments have been one way or binary with an increase or reduction dependent on compliance with the ESG pre-defined criteria and/or key performance indicators (KPIs), we are increasingly seeing a more dynamic structure with the margin ratchet fluctuating both ways. Equally, the range of adjustment in respect of some facilities is being pegged to the number of sustainability criterion and/or KPIs being met. There have also been discussions around the application of any margin savings/premiums and whether this should be ring fenced for specific ESG related purposes.
- **Representations:** Tailored representations are being included on the compliance by the fund parties with all laws, regulations and/or policies which are key or central to the sustainability framework for the specific fund. A representation is now also commonly made that all information provided in connection with such sustainability framework and sustainability performance targets is true, complete, and accurate in all material respects.
- **Information undertakings:** Information undertakings specific to the sustainability framework are typically expected. The specific drafting of these depends on the ability of the GP or the manager to provide periodic qualitative or quantitative reporting on its KPIs. The frequency of reporting and methodology of disclosure, as well as the use of any external third party to facilitate the meeting of any reporting requirements, are generally negotiated on a case-by-case basis and tailored to the sustainability framework of the fund.



- **Reporting:** Finance parties may be granted additional rights to review, certify, and verify any individual rating or information provided in respect of the sustainability framework. However, this largely depends on whether the fund parties will be self-certifying compliance with the sustainability framework and KPIs or the extent to which an external third party is involved in these instances. Reporting on sustainability performance targets and KPIs to the finance parties is typically seen to be provided at least once per annum. The use of external third parties to report on the sustainability framework largely depends on the status of the fund's internal ESG framework and its advancement. Where a fund already has rigorous established processes for ESG then it should be queried whether additional costs in outsourcing any reporting requirements are necessary or required.
- **KPIs:** KPIs (or key performance indicators) are often included to monitor compliance of the fund with the overall sustainability framework. The substantive KPIs, their nature, number and complexity will depend on the sector(s) in which the fund and its investments are made. The trend has been to select KPIs that are industry-specific based on the activity of investments and/or portfolio investments and which the GP, manager and LPs are able to actively monitor and assess. The United Nation's supported Principles for Responsible Investment (UNPRI) published guidance on ESG specific KPIs, as well as industry guidance from the Sustainability Accounting Standards Board and the European Federation of Financial Analysts Societies as well as organisations like Science Based Targets, provide some basis for KPI-modelling for funds in funds finance transactions. The weighting of specific KPIs in terms of monitoring compliance with the relevant sustainability performance targets will depend on what is being measured as well as its importance to the fund's overall ESG framework.
- **Events of default:** Whilst it is uncommon for a breach of the sustainability framework or sustainable performance targets to specifically lead to an event of default, typically, a failure to report on ESG KPIs will lead to an event of default under the facility agreement. However, it is noted that different lenders take varying approaches on this. Depending on the negotiated position, a breach of any reporting obligations or failure to deliver information may lead to a drawstop in further loans or result in a pricing adjustment alone instead of triggering an event of default.
- **Side letter provisions, private placement memorandums (PPMs) and limited partnership agreements (LPAs):** It is not uncommon to see ESG-related provisions being included in fund terms, whether in the PPM, LPA or in side letters to formalise the parameters of how the fund may invest in a manner that is compliant with its ESG framework. ESG provisions in fund terms typically encompass: (i) commitments to ESG policy and/or regulation; (ii) investment restrictions and the decision-making process, (iii) exclusion or excuse rights; and (iv) ESG reporting and incident reporting to limited partners. Fund participants may look to ease the process by including such provisions where possible directly in the LPA, or alternatively in a side letter with the GP. However, it should be noted that there may be reluctance amongst participants to include responsible investment or ESG related language formally in an LPA or side letter where, for instance, the fund's ESG framework is still developing or where there is doubt in making a principles-based or value-based policy legally enforceable.



### The market view: LPs and GPs

There appears to be strong indication in the market that LPs are being increasingly driven by ESG issues; for example, there are reports of carried interest being linked to ESG targets.

Globally, some of the largest public funds and pension funds have been actively exploring commitments to buyout and fund managers whose strategies are aligned to climate change and energy transition. General partners (GPs) are additionally factoring in ESG due diligence in the fund's decision making. Some of the most prominent GPs in the market already have well established ESG frameworks in place to support their investments and assess ESG risks. LPs in turn have turned their interest to ESG factors, demanding more from their GPs on ESG, including increasingly relying on GPs to provide ESG-specific reporting relevant to the fund.

Many GPs are already developing ESG codes to address aspects relevant to their portfolio companies and the sectors in which they operate. As part of the process, some GPs have engaged ESG experts whether internally and/or externally to ensure that adequate ESG metrics are included in the fund's disclosure and in management reporting to meet LP demands.

Not only is implementing ESG seen to be key for new investments, but the tracking and maintenance of ESG policies and metrics are necessary in order to verify the adequacy of and any progress made in the existing portfolio and, in some cases, preparing for an exit prior to divestment.

### The market view: Deal trends

The funds finance market has seen a lot of recent activity in ESG-linked loans some examples of which, taken from publicly available information is set out below.

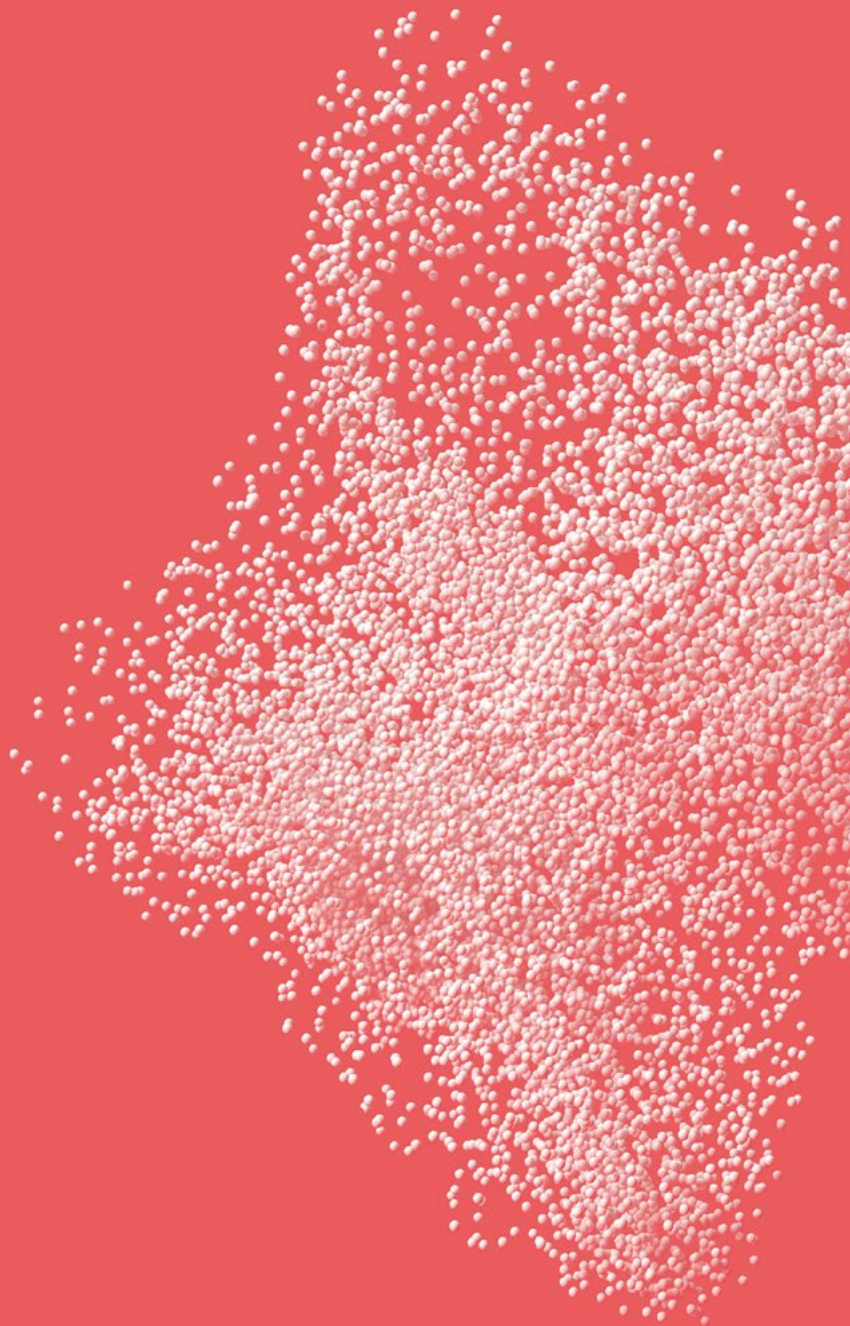
- ING's sustainability improvement capital call facility to Singapore-based Quadria Capital Management in 2019
- Standard Chartered and Morgan Stanley financed one of the first sustainable 'use of proceeds' fund financing loans with KKR's Global Impact Fund in 2020. KKR will use proceeds to bridge investments in companies that are providing commercial solutions for environmental or social problems in line with the United Nations Sustainable Development Goals
- Swedish firm EQT has an ESG-linked fund level bridge facility with an upper level of €5bn, backed by BNP Paribas, SEB and others. The facility is intended to improve portfolio companies' ESG performance by linking sustainability objectives to financial incentives
- Carlyle launched a €2.3 bn ESG-linked umbrella debt facility in Sept 2021 with targets that include getting 100% of its majority-owned companies to disclose carbon emissions footprint data, achieving 30% board diversity across its majority-owned portfolio companies over the next three years and improving governance by providing ESG-competent board training for all Carlyle board directors.

### Conclusion

ESG is, and continues to remain, a focal talking point and key consideration in structuring fund finance transactions. The drivers behind ESG-linked financings derive not only from lenders but also from LPs themselves. As a result, our view is that ESG-linked funds finance transactions will continue to increase and evolve over time driven both by regulatory changes and investor needs.

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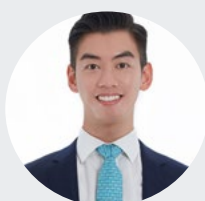




# Consultation conclusions on the management and disclosure of climate-related risks of fund managers



**Michael P. Wong**  
Partner  
[Dechert](#)



**Jason Chan**  
Associate  
[Dechert](#)



**Stanley Tiu**  
Associate, Registered Foreign  
Lawyer in Hong Kong  
[Dechert](#)

In August 2021, the Securities and Futures Commission of Hong Kong (SFC) published the “Consultation conclusions on the management and disclosure of climate-related risks by fund managers” (consultation conclusions),<sup>1</sup> that sets out the SFC’s expectations as to how fund managers should consider climate-related risks in carrying out investment and risk management, and how to make appropriate disclosures of the same. The publication (i) forms part of the SFC’s plans, as set out in the 2018 Strategic Framework for Green Finance,<sup>2</sup> to enhance asset manager consideration for and disclosure of ESG factors, especially environmental and climate risks; and (ii) reflects the SFC’s findings, as set out in the SFC circular dated March 2019 on the Survey on Integrating Environmental, Social and Governance Factors and Climate Risks in Asset Management<sup>3</sup>, that climate-related risks are a source of financial risk that need to be considered and managed by fund managers.

The requirements proposed in the consultation conclusions (new requirements) will apply to all fund managers licenced in Hong Kong and will be reflected as amendments to the SFC Fund Manager Code of Conduct. This briefing sets out a summary of the new requirements under the consultation conclusions. The new requirements take effect from as early as 20 August 2022 for large fund managers (as defined below) and 20 November 2022 for all other fund managers.

## 1. Scope and applicability

The new requirements will apply to Type 9 (asset management) licenced corporations who exercise discretionary investment management over the assets of investment fund(s) (fund managers), including both authorised and private funds (e.g., private equity, private credit, mutual funds, and hedge funds). Fund managers who only manage discretionary accounts are currently out of scope.

The new requirements are formulated in two tiers, and in-scope fund managers will need to determine the extent to which the new requirements will apply to them. Baseline requirements will apply to all fund managers and enhanced requirements will apply in addition to the baseline requirements to fund managers who qualify as large fund managers.<sup>4</sup>

<sup>1</sup> The consultation conclusions are available [here](#)

<sup>2</sup> The 2018 Strategic Framework for Green Finance is available [here](#)

<sup>3</sup> The March 2019 Circular is available [here](#)

<sup>4</sup> Large fund managers are defined in the consultation conclusions as fund managers with assets under management (AuM) of HK\$8 billion or above for any three months during the preceding 12 months (exclusive of AuM from discretionary accounts)

## 2. Governance

### *Baseline requirements*

The new requirements require a fund manager to ensure that both its board and management are engaged in the integration of climate-related risks across the fund manager's organisation. The board of the fund manager should be responsible for overseeing the climate-related risks and their incorporation into the investment management and risk management processes of the fund manager. At the management level, the fund manager should also ensure that it has sufficient technical and human resources, as well as governance structures (e.g., internal controls and written procedures), to manage climate-related risk and the ongoing compliance with such governance structures.

The consultation conclusion also clarify that while a fund manager belonging to a group of entities may leverage on group resources and staff (such as via group policies and procedures) and may rely on group procedures, provided that those procedures satisfy the new requirements, the local fund manager retains full responsibility for compliance with the new requirements.

## 3. Investment management

### *Baseline requirements*

The consultation conclusions require a fund manager to ensure that climate-related risks are considered in investment management processes. A fund manager will be required to:

- Identify relevant and material physical and transitional climate-related risks for each investment strategy and fund it manages
- Where relevant, factor the material climate-related risks into the investment management process. For example, a fund manager can incorporate climate-related risks into its investment philosophy and investment strategies, as well as integrate climate-related data into its research and analysis process
- Take reasonable steps to assess the impact of these risks on the performance of underlying investments.

To the extent that a fund manager considers that climate-related risks are not relevant nor material to the investment management and risk management processes of the strategies managed by it, it must disclose the basis of this determination in its offering materials. This assessment should be re-evaluated at least annually, and disclosures should be revised accordingly where appropriate.



## 4. Risk management

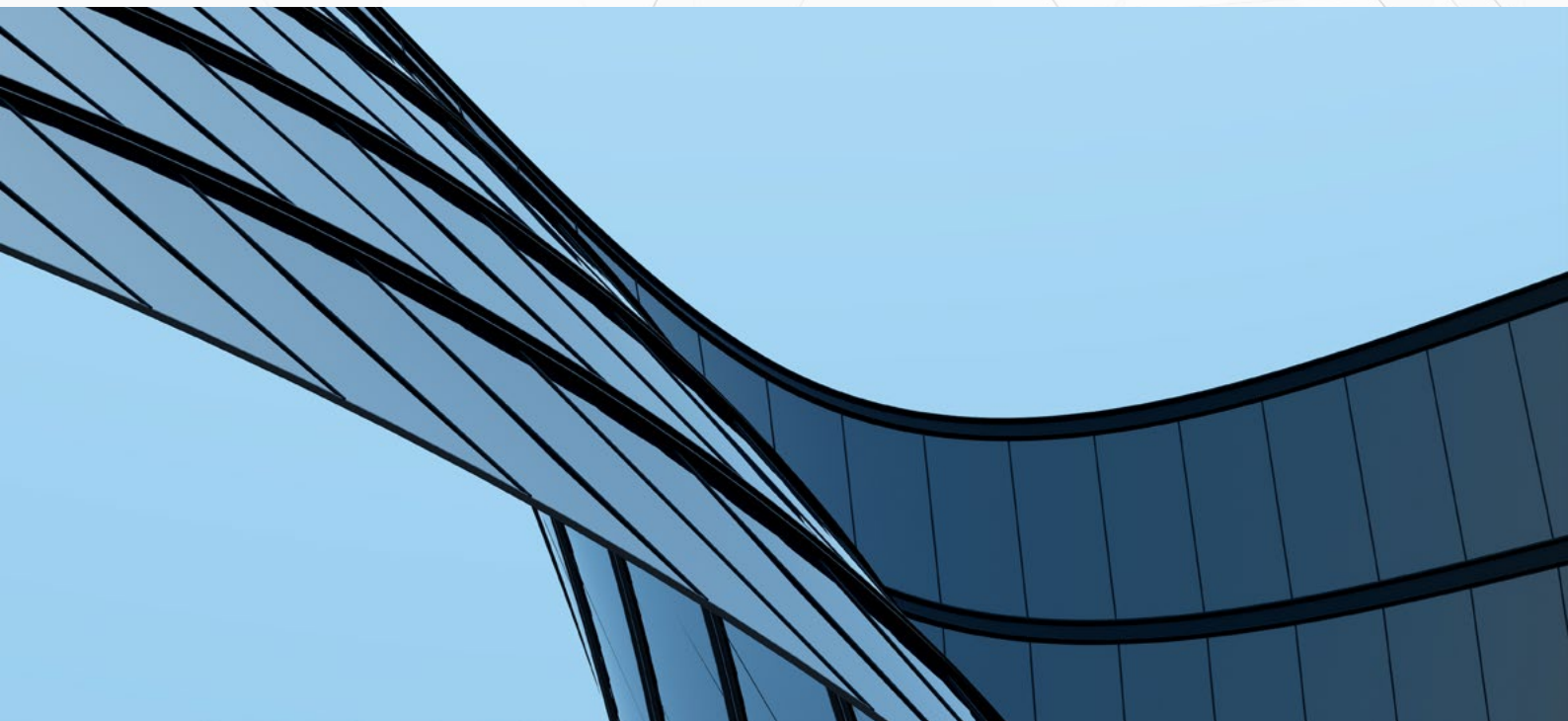
### *Baseline requirements*

The SFC considers climate-related risks as a financial risk, and its expectation is that climate-related risks should be treated in the same manner as other material risks, such as market and liquidity risks. Therefore, a fund manager is required to take climate related risks into consideration in risk management procedures and ensure that appropriate steps are taken to identify, assess, manage, and monitor the relevant and material climate-related risks for each investment strategy and fund it manages. Appropriate tools and metrics, including carbon footprint-related metrics, forward-looking metrics and physical climate related metrics are expected to be used as part of the baseline requirements.

### *Enhanced requirements*

In addition, large fund managers are expected to adopt more robust and systematic approaches to climate-related risk management. In particular, if climate risks are assessed and considered to be material to an investment strategy or a fund that a large fund manager manages:

- The large fund manager should make reasonable efforts to acquire or estimate the weighted average carbon intensity of Scope 1 and Scope 2 greenhouse gas (GHG) emissions for funds under its management. The large fund manager is also encouraged to include Scope 3 GHG emissions (if data is available) in its calculations
- The large fund manager should also assess the relevance and utility of scenario analysis in evaluating the resilience of investment strategies to climate-related risks under different pathways and to keep an internal record of the assessment. Such scenario analysis is expected to involve analysis of the risks and opportunities arising from climate change, and evaluation of the exposure of investment strategies to such risks and opportunities in different scenarios. If the assessment result is deemed to be relevant and useful, then the large fund manager should develop and implement the scenario analysis in a way that is commensurate with its size and the nature of its business within a reasonable timeframe.





## 5. Disclosure

### *Baseline requirements*

A fund manager responsible for the overall operation of an investment fund is required to make adequate disclosures, such as in its offering documents, relating to climate related risks to allow investors to make an informed judgement about their investments in the fund, including (i) its governance arrangement for oversight of climate-related risks; (ii) the board's and the management's respective roles and oversight; and (iii) how it takes climate related risks into account in its investment and risk management processes, including the tools and metrics used to identify, assess, manage and monitor the risks. If climate-related risks have been assessed and are deemed not to be relevant to certain types of strategies, then the fund manager should disclose such exceptions.

### *Enhanced requirements*

In addition to the baseline requirements, a large fund manager is also expected to comply with the following additional disclosure requirements:

- Describing the engagement policy at the entity level and preferably providing examples to illustrate how material climate-related risks are managed in practice, including how the fund manager's engagement policy is implemented
- At a minimum, providing the portfolio carbon footprints of the Scope 1 and Scope 2 GHG emissions associated with the funds' underlying investments at the fund level (where data is available or can be reasonably estimated), and indicating the calculation methodology, underlying assumptions, its limitations, and the proportion of investments (e.g., in terms of the net asset value of funds) which are assessed or covered.



## Implementation timeline

Large fund managers will have until 20 August 2022 to comply with the baseline requirements, and 20 November 2022 to comply the enhanced requirements. Fund managers who are not large fund managers will need to comply with the baseline requirements by 20 November 2022.

In the meantime, fund managers of funds that are also subject to the Regulation (EU) 2019/2088 of the European Parliament and of the council of 27 November 2019 on sustainability related disclosures in the financial services sector as amended by Regulation (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment (SFDR) will also need to consider whether an integrated approach to investment and risk management processes, as well as disclosure will be warranted.

## Conclusion

The new requirements will have a significant impact on in-scope fund managers. It is important to note that the New Requirements apply to all fund managers, not just those that follow 'sustainable' or 'ESG' strategies. Further, the SFC has clarified in the consultation conclusions that a 'comply or explain' approach will not be accepted, so all fund managers will need to consider the extent to which the new requirements will apply to them.

Although fund managers have until Q3 and Q4 2022 to comply with the baseline requirements and the enhanced requirements, if applicable, the obligations are detailed and potentially complex for fund managers who have until now been unaffected by climate-related or ESG-related regulations. Fund managers are advised to start reviewing policies and processes now to ensure that they are in a position to comply with the mandatory baseline and enhanced requirements – this may require seeking service or data providers (e.g., on GHG emissions) in advance of the deadlines.



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# Further details of EU requirements for green funds released



**Mark Browne**  
Partner  
Clerkin Lynch LLP

The European Union (EU) has been adopting legislation to assist in progressing the drive towards fund products that acknowledge environmental, social and governance (ESG) factors in recent years as part of its action plan on sustainable growth and the European Green Deal. The relevant primary level legislation was designed to be supplemented by more granular detail contained in regulatory technical standards (RTS) and the final report on related draft RTS<sup>1</sup> (the “Final Report”) was issued by the European Supervisory Authorities (ESAs) on 22nd October 2021.

## Background

The Sustainable Finance Disclosure Regulation<sup>2</sup> (SFDR) and the Taxonomy Regulation<sup>3</sup> were two key pieces of legislation adopted in recent years in the EU relating to ESG considerations for funds as part of the “Action Plan: Financing Sustainable Growth”.<sup>4</sup> Other key legislation included the Climate Benchmarks Regulation.<sup>5</sup> The Taxonomy Regulation sets out a classification system and list of acknowledged environmentally sustainable economic activities. The underlying rationale is that by providing for appropriate definitions under which economic activities can be considered environmentally sustainable it should protect against misleading or false claims in this regard (often referred to as ‘greenwashing’), facilitate comparisons across sectors and assist companies to become more climate friendly.

The SFDR, whose provisions commenced from March 2021, provides for both manager and product level disclosure requirements. These include requirements pertaining to pre-contractual disclosures, website disclosures, periodic reporting, and marketing. There are specific and heightened requirements pertaining to funds which promote ESG aims, known as ‘light green’ funds (Article 8) and those which have sustainable investment as their objective, known as ‘dark green funds’ (Article 9). The Final Report was prepared through a joint committee of the ESAs and primarily relates to the content and presentation of disclosures for the abovementioned ‘green funds’ falling under Article 8 or 9 respectively.

## The Final Report

The Final Report includes templates for pre-contractual (prospectus and marketing) and periodic (financial statement) disclosures for related products. The approach taken has been to amend the existing draft RTSs (published 4th February 2021) to form a single rulebook in order to minimise duplication and complexity. The amended RTS require both the identification of the environmental

- 1 “Final Report on draft Regulatory Technical Standards with regard to the content and presentation of disclosures pursuant to Article 8(4), 9(6) and 11(5) of Regulation (EU) 2019/2088”, Joint Committee of the European Supervisory Authorities, 22nd October 2021
- 2 Regulation (EU) 2019/2088
- 3 Regulation (EU) 2020/852
- 4 European Commission, 3 March 2018
- 5 Regulation (EU) 2019/2089 amending Regulation (EU) 2016/1011

objectives which underlying investments of a relevant fund contribute to and the inclusion of substantial disclosures on 'how and to what extent' they qualify as environmentally sustainable investments. In order to comply with the first of these requirements there will be an obligation to include an indication as to whether an auditor or other appropriate third party has assessed the compliance of the underlying investments with such environmentally sustainable economic activities (and if so to cite the name of this entity). In the case of pre-contractual disclosures there should be an indication as to whether such an assessment will be performed. In relation to the latter aspect, in order to disclose the extent of underlying investments that qualify as environmentally sustainable, pre-contractual disclosures will be required to contain a graphical representation of this as a key performance indicator (KPI) as well as including related narrative disclosures.

The RTS include rules for the calculation of the environmental contribution (in terms of relevant activities as defined under the Taxonomy Regulation) of non-financial entities invested in. Similarly, the required periodic disclosures must contain graphical representations of the extent to which investments in non-financial entities undertaken qualify as environmentally sustainable and there will be additional narrative disclosures including an analysis of activities invested in distinguished by environmental objectives and whether the activities are enabling or transitional (as defined).

To better ensure transparency and comparability a dual approach to the preparation of the KPIs is provided for - one including sovereign exposures in the overall calculations and one excluding this sector. This will assist in avoiding distortions of KPIs for funds with high sovereign exposure, a differentiator which has been deemed appropriate to highlight given the absence of a reliable methodology to ascertain the extent of related activities that fall under the headings of the Taxonomy Regulation. Again, specific rules for the calculation of KPIs, including relating to constituents of their numerator and denominator in respective cases are included. There are also separate rules set out in this regard for 'green bonds' to be issued under the (pending) EU Green Bond Standard.

Other changes to the existing requirements addressed in the amended RTS include an obligation to identify whether sustainable investments are environmental or social in focus and in the case of environmentally sustainable investments whether they are aligned with the headings under the Taxonomy Regulation. The pre-contractual disclosures will be required to disclose not only whether but also how principal adverse impacts on sustainability factors are considered in relation to a financial product. This also needs to be given greater prominence in the pre-contractual documentation – appearing above the description of the investment strategy. It should be noted that the templates included in the RTS contain new provisions that also relate to funds other than light and dark green funds (i.e., Article 5 and 6 funds) to the extent that they contain taxonomy aligned investments.

### **Timelines and next steps**

It was originally indicated that the application date of the new RTS would be 1 January 2022. However, it is anticipated that this will now be moved out to 1 July 2022 following correspondence from the European Commission and in light of acknowledgement of this by the ESAs in the Final Report. For the moment Managers should assess whether, and the manner in which, their funds fall within the scope of the RTS and would be advised to commence a review of their materials to ensure they are in a position to comply with these provisions as early as possible.

Given not just the disclosure requirements but also the ongoing reporting obligations contained in the RTS consideration should be given to the adoption of appropriate policies and procedures to ensure the analysis of relevant data and the production of relevant outputs. Fund boards will need to consider ensuring not just initial compliance but also the extent to which existing service providers will be able to assist in meeting these ongoing requirements and whether any additional specialist assistance would be required or appropriate.



# Health and wellbeing: Addressing new challenges facing the asset management sector



**Robbie Weston**

Executive Director, Asset Management and Legal Sector  
Howden Employee Benefits & Wellbeing

COVID-19 has changed the world of work forever. Millions of us were forced to switch to working from home overnight, quickly adapting to combining our work and home lives. Now, as people return to the physical workplace, employers in the asset management sector find themselves having to create a 'new normal' as they navigate the post-pandemic landscape.

What is clear is that the pandemic has put our health and wellbeing firmly under the spotlight and as a result, it's fast rising up the corporate agenda. Howden has recently undertaken two research reports (Employee Benefits & Wellbeing in the Asset Management Sector<sup>1</sup> and The Workplace Physical Wellbeing Dilemma<sup>2</sup>) to understand the impact of the pandemic on the asset management sector specifically and physical workplace wellbeing in general.

The findings highlight that the pandemic has impacted employees' health in a number of ways, as people have had to cope with the sudden and unexpected challenges that the crisis has presented. Existing mental health issues have been exacerbated during the pandemic and some employees have reported new mental health problems as a result of lockdowns, prolonged social isolation and digital fatigue. In addition, sleep deprivation, poor nutrition, alcohol and drug misuse, a lack of motivation to exercise and musculoskeletal disorders are other key health risks impacting employees' health and wellbeing. These effects are likely to be felt for some time to come, as we grapple with the aftermath of the pandemic and establish a 'new normal'.

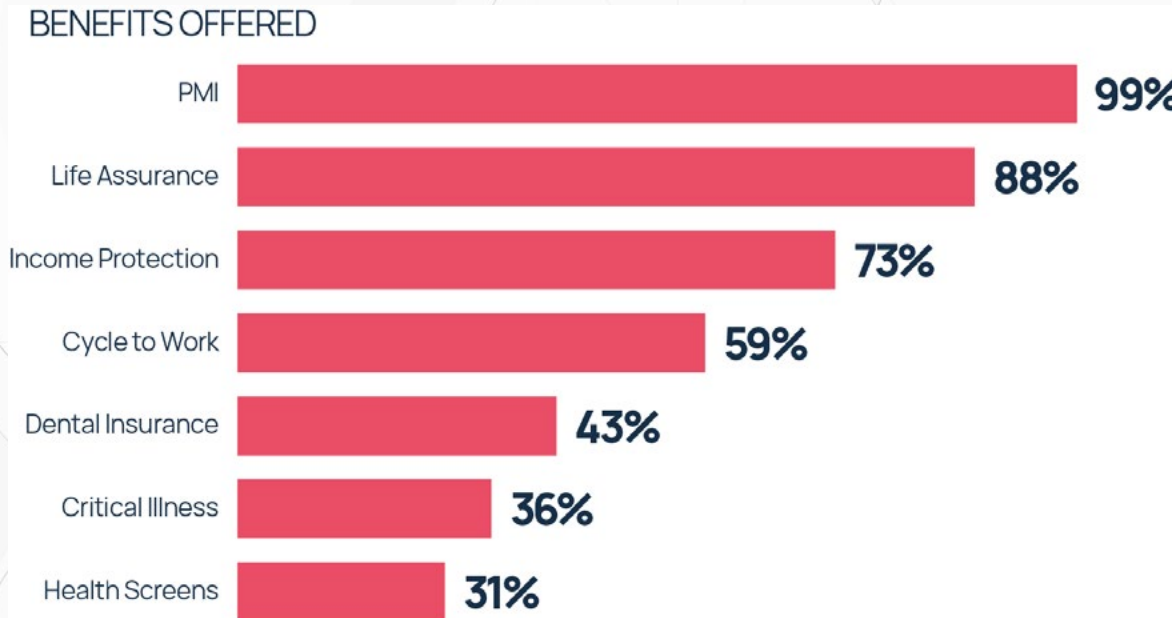
Couple this with the fact that the NHS, which was already under strain pre-COVID, now faces unprecedented demands for services. The total NHS waiting list is currently sitting at a record high 5.72 million people and continues to grow.<sup>3</sup> It's clear therefore that supporting employee health and wellbeing is likely to be a high priority for asset managers in the months and years ahead.

## A sector that invests in its people

Our research revealed that the asset management sector is already ahead of many industries and provides a rich level of employee benefits to those working within it. The results reveal that highly valued benefits such as private medical insurance (PMI), death in service and group income protection

- 1 Employee Benefits & Wellbeing in the Asset Management Sector (Howden, 2021) <https://view.publitas.com/howden-uk-group/asset-management-survey-report-april-2021>
- 2 The Workplace Physical Wellbeing Dilemma (Howden/REBA research 2021) <https://eb.howdengroup.co.uk/en/reba-research-the-workplace-physical-wellbeing-dilemma>
- 3 NHS Digital: <https://www.england.nhs.uk/statistics/statistical-work-areas/rtt-waiting-times/rtt-data-2020-21/>

are regularly being included within reward packages as standard. As employers start to understand the new working landscape, it is important to consider whether the benefits offered continue to be fit for purpose to meet businesses' and employees' evolving needs. And importantly that employees are aware of the full range of wider services available to them through the benefits offered.



For example, PMI, is often regarded as a benefit which traditionally provides a more reactive solution. However, many policies include value-added features designed to prevent and identify health problems early, such as virtual GPs, mental health support and online tools and resources. Good communication is essential so that employees understand and appreciate the full range of services available to them and how to access them when needed.

Asset managers may also want to consider how they can personalise the benefits they offer their people. We are increasingly speaking to firms who are introducing greater choice over benefits, often through flexible benefits platforms, so that employees can select the type of benefits that best suit their individual lifestyle and wellbeing needs. The findings reveal that despite a high investment into employee benefits by the sector, there is 'a disconnect' in how these benefits support employees' wellbeing. Only 12% of small-business respondents state that they have a formal wellbeing strategy in place. Larger organisations within this sector are leading the way with 22%, but this is still much lower than research by HR group CIPD in 2020, which revealed that 44% of organisations have a standalone wellbeing strategy.

It is important for asset management firms to start to consider how they can develop their own wellbeing strategies, which address any unique challenges or concerns, as well as identifying and plugging any gaps spotted in existing packages.

### The risk of burnout

Some would argue that, anecdotally, employees in the asset management sector have fewer financial and health and wellbeing concerns due to having greater material wealth and access to a wide range of benefits and insurance.

However, according to the TUC, City of London workers suffer from the worst mental health in the UK, with 94% of financial services personnel working beyond their contracted hours on a weekly basis to cope with workloads, and half not leaving the office or take a break at lunch. The culture that encourages 'soldiering on' even when employees are experiencing poor health and wellbeing has created a catalyst for burnout and this has only been exacerbated by the pandemic.



Asset Managers and their employees face a unique set of wellbeing challenges and therefore require a unique approach that meets the individual needs of each firm and the people working within it.

### Building an effective wellbeing strategy

It's important to consider that workplace wellbeing relates to all aspects of the organisation, from the quality of the physical environment, to how employees feel about their jobs and the organisational culture. All these things can affect a person's sense of physical, mental, social and financial health.

A good strategy will link the cultural and environmental aspects with insurance and wellbeing-based products, services and technologies to support employees, helping them understand what's available to them, and when it would be most useful. Wellbeing can mean different things to different people, so the strategy needs to gain meaningful feedback from employees to ensure policies and practices are tailored to meet the unique requirements of a particular organisation and the specific needs of its workforce.

### Getting the message across

One of the biggest problems lies in communications. To ensure that benefit spend is going where it is needed, it's essential to get regular feedback from employees. Right now, more than half of Asset Management firms do not conduct these checks – and potentially spend money where it is not needed or appreciated.

Communications also have a role in letting employees know how they can gain access to services. Our research shows that Employee Assistance Programmes are rarely used by the workforce – the number stands at a shockingly low 3-5%. One of the issues is that they are often reactive schemes, kicking in when a problem has already manifested itself. Well signposted EAPs that encourage people to access them as part of everyday practice can create a culture that can help prevent physical or mental ill health from occurring in the first place.

Interestingly our research indicates that the majority of money that needs spending to create a robust wellbeing strategy is already being spent as the insured policies form the largest part of the costs, however the overarching wellbeing strategy and communications are lacking which will help employees make the most of their benefits.

### What steps can asset managers take?

- Look at existing data (employee absence data, insurance and claims data, staff surveys etc) to understand what is happening within the organisation and identify any particular wellbeing challenges that need to be addressed
- Carefully consider what is right for the business, its people and budget. This may require thinking beyond usual solutions to focus on desired outcomes
- Research the market to deliver what is needed. It's important to consider any legislative and/or regulatory complexities
- Align employee benefits with company culture and consider how these can be maximised to support talent recruitment and retention efforts
- Communicate with employees to help bring benefits to life through regular, targeted multi-channel communications
- Provide market-leading technology to help manage data and benefits, which in turn can continue to provide the insights needed to keep the strategy relevant and appropriate.

At a time when the culture of the asset management working world is changing, firms may want to seek guidance from a specialist advisor that understands your sector, can research and negotiate benefits on your behalf, to create a benefits and wellbeing strategy that addresses your specific concerns and supports your firm's wellbeing.

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# Holistic surveillance: To trading activity and beyond



**Matthew Girandola**  
Senior Principal Consultant  
**ACA Group**  
[Email Matthew Girandola](#)



**Eddie Cogan**  
Partner  
**ACA Group**  
[Email Eddie Cogan](#)

**T**he growth of the alternative investment management industry and the steady march of technological innovation are beginning to converge with greater emphasis. Catalysed in part by the recent global pandemic, managers have demonstrated an increasing reliance on technology to proactively monitor and manage risk. These tools have empowered compliance and risk teams to allocate resources in a more efficient manner and to administer their compliance programmes more effectively.

The private sector is not alone in its appetite for technological innovation. Financial regulatory bodies across the globe have similarly demonstrated an increased reliance on technologies and systems to monitor, manage, and mitigate systemic risk. The US Securities and Exchange Commission (SEC), for example, has adopted tools and systems such as the National Exam Analytics Tool (NEAT) and the Market Information Data Analytics System (MIDAS), which rely on the application of sophisticated algorithms to market-wide trading activity to uncover anomalous or improbably profitable trading activity that, for example, may suggest trading on insider information. The SEC relies on these tools to target its examination efforts more effectively. Similarly, the UK's Financial Conduct Authority (FCA) has recently indicated that it intends to allocate significant resources to developing its data and intelligence capabilities and to become "more data-driven to find and stop harm quicker..."<sup>1</sup>

These developments on the regulatory front continue to highlight that diligent and targeted monitoring, surveillance, and forensic testing are critical to meeting regulatory expectations, keeping pace with regulators' own technological capabilities, and most importantly, preventing fraud.<sup>2</sup>

Accomplishing this task demands that managers adopt a holistic approach to surveillance.

1 See <https://www.fca.org.uk/publication/business-plans/business-plan-2021-22.pdf#page=6>

2 According to the [2021 Investment Management Compliance Testing Survey](#) co-sponsored by ACA Group featuring 350 respondents, the number of firms who indicated that Electronic Communications Surveillance testing falls within the top ten most important areas increased by 19% from 2020-2021.

## What is holistic surveillance?

A holistic surveillance programme combines surveillance technology with human expertise to normalise unstructured data sets from multiple sources, run sophisticated analytics, and evaluate the totality of information to obtain a comprehensive view of activity and behaviour.

## Challenges of traditional compliance monitoring

Compared to a holistic surveillance approach, a traditional compliance monitoring programme, relying exclusively on human oversight and manual review, may incorporate a number of exercises, including, but not limited to:

- Manual trade surveillance, which may entail a periodic Excel-based review of a firm's or individuals' personal trading activity against a 'restricted' or 'watch' list
- Manual electronic communications surveillance, which may entail keyword-based and/or Boolean operator searches within a firm's electronic communications archival system and a sample-based review of the resulting output
- Manual review of historical interactions with 'expert networks,' political intelligence consultants, or public company executives to evaluate whether inside information was improperly or inadvertently communicated

While these exercises represent valuable tools in a compliance professional's surveillance toolbox, there are several potential drawbacks to this traditional approach.

1. The inherent limitations of a manual or spreadsheet/keyword-based review will call upon the diligent compliance officer to navigate a minefield of false positives. This analysis demands incremental time, effort, and expense that could otherwise be channeled toward more productive and fruitful efforts. For example, if a hypothetical keyword search or Excel macro produces a sample of 200 data points (e.g., emails or trades) out of a universe of 1000, and 33% of that sample (66 data points) represents false positives, the compliance officer is operating at 66% efficiency and will require 50% more time to achieve the desired coverage rate.
2. These reviews are typically conducted on a 'lookback' basis. Depending on the testing cadence, it may be possible for a potential issue to go unnoticed for a week, month, or quarter. Issues that are unearthed in close proximity to when they occurred are more easily addressed than those that are only revealed later down the line – potentially by a regulator.
3. Traditional surveillance programmes and their stewards may tend to review the outputs from these exercises in a siloed manner – as disparate and distinct pieces of information spread out across different systems. Perhaps in a vacuum, the content of an email appears benign. Perhaps the execution of a trade suggests business as usual. Perhaps a review of the interaction with public company management reveals nothing noteworthy. However, viewed holistically, with the aid of technology these pieces may come together as a mosaic to reveal patterns that would otherwise be impossible for the human eye to detect - our cognitive abilities to see patterns in large amounts of unstructured data are inherently limited.



A holistic view of surveillance – one aided by technology – can resolve these drawbacks and empower the compliance officer to execute his or her surveillance with greater efficiency, efficacy, and clarity – especially as firms continue to rely more heavily on electronic communications platforms in light of remote or hybrid work structures.

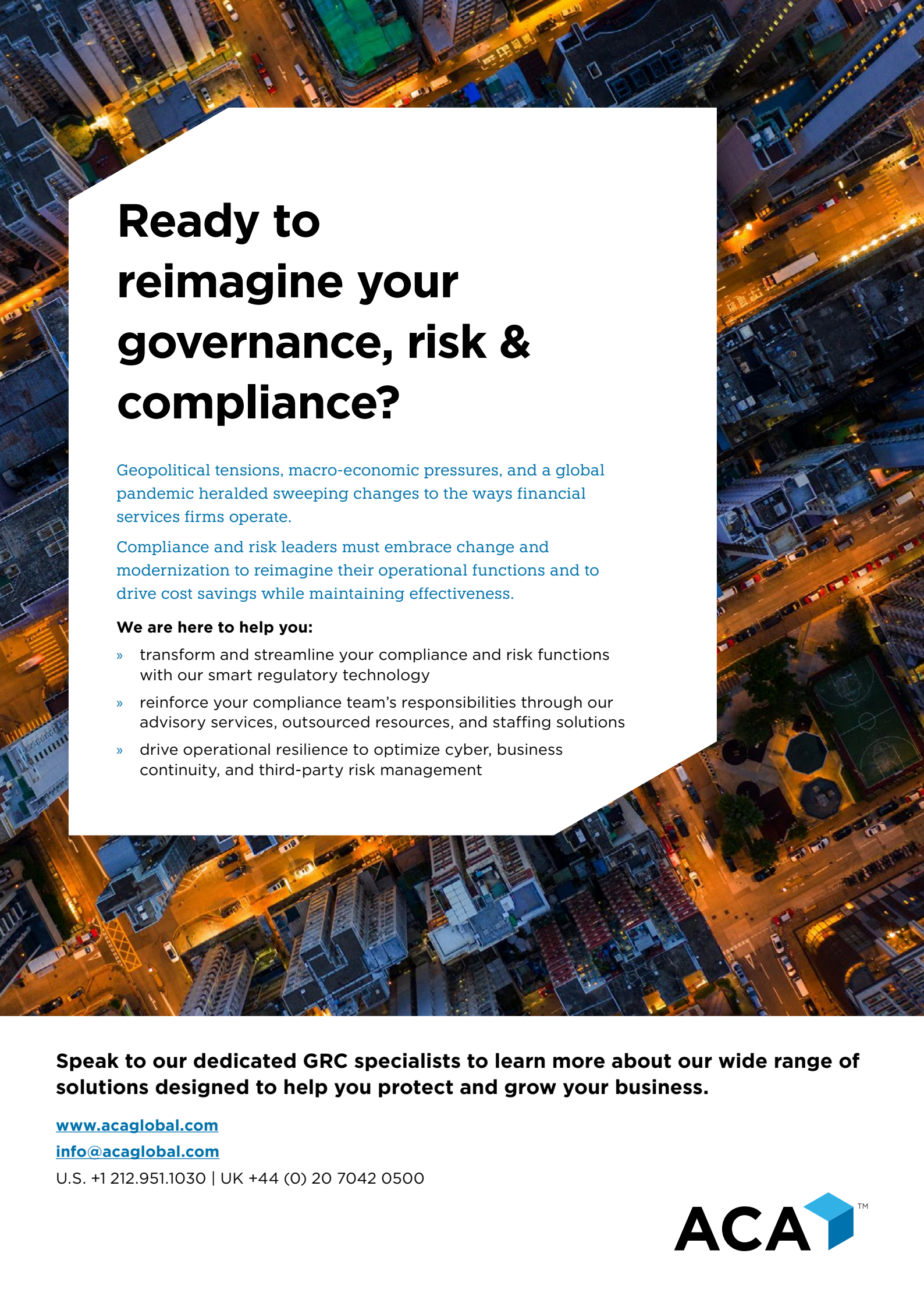
### **Finding clarity, focus, and accuracy through technology**

Now more than ever, firms are adopting technological solutions that leverage a combination of sciences to triangulate understanding of risk associated with people, their communications, and their behaviour. For a prime example, machine learning algorithms are being deployed to integrate trade or investment events with communications' meta-data to uncover behavioural signatures indicative of actions such as fraud. Finely-tuned behavioural algorithms can understand and map how people connect, uncovering the networks that underpin business, highlighting unhealthy relationships and in many cases predicting risk.

Developed and implemented in a number of ways, these algorithms are vastly superior to a manual surveillance approach. False positives are reduced or eliminated with increased resource efficiency. Issues are identified in near-real time, allowing the compliance officer to react to problems well before they are flagged by a regulator. Hidden but noteworthy patterns across large quantities of unstructured data, housed in disparate systems, are clearly revealed through the sophistication of technology.

While regulatory expectations continue to drive managers' interest in these tools, firms should also consider the commercial case for their adoption. It is not uncommon for sophisticated institutional prospective investors (for example, allocators, outsourced chief investment officers (OCIOs), family offices, pension funds, etc.) to review a managers' compliance programme with rigor that matches or exceeds that of a regulatory body. The perception by these investors that a manager's compliance programme is deficient in light of market practices and/or regulatory expectations may compromise the relationship. Consequently, the incentives for managers to adopt a strong, holistic approach to compliance surveillance rest somewhere between the public and private domains.

There are many reasons to support the adoption of a holistic surveillance programme. It is more effective and efficient compared to traditional methods of oversight. Regulators expect it as an expedient for preventing fraud, revealing it quickly, and otherwise adhering to regulations. Similarly, institutional investors may be more comfortable selecting a manager who leans into this philosophy.



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# The investment manager regimes in the Cayman Islands and BVI



**Alastair King**  
Senior Associate,  
Singapore  
**Carey Olsen**  
[Email Alastair King](#)



**Anthony McKenzie**  
Managing Partner,  
Singapore  
**Carey Olsen**  
[Email Anthony McKenzie](#)

*This article is written by Alastair King*

Asia-based sponsors working with multi-jurisdictional fund structures have long been familiar with the use of an offshore entity acting as either the investment manager or advisor. Over the last couple of years there has been increasing clarity of the options available, with both the maturation and increased prevalence of fund managers registered in the British Virgin Islands (BVI) pursuant to the Investment Business (approved managers) Regulations (AMR) and the BVI Securities and Investment Business Act (BVI SIBA), and the enhancement of the Cayman Islands' regulatory framework following the introduction of the International Tax Co-operation (Economic Substance) Act and its related Regulations (ES Law) and welcome updates to the Securities Investment Business Act (Cayman SIBA). This article discusses some of the key features of the investment manager regimes that have a lighter regulatory touch in the two jurisdictions; namely entities registered with the Cayman Islands Monetary Authority (CIMA) as a 'Registered Person' pursuant to Cayman SIBA (which has replaced the previous 'Excluded Person' regime), and those registered with the BVI Financial Services Commission (FSC) as an approved manager pursuant to AMR.

Fund managers established outside of BVI and the Cayman Islands will not normally require registration or licensing in such jurisdiction, provided that they, and the funds they manage, have no physical presence within that jurisdiction (save for the funds' registered agents and offices). There are no specific qualifications or other requirements on such overseas managers imposed by BVI or the Cayman Islands.

## Applicability and eligibility

Most Cayman Islands managers and advisors will fall under the Cayman SIBA requirements by virtue of carrying out 'securities investment business', which captures managing, dealing in, arranging deals in, and advising on deals in, securities, and acting as an 'EU Connected Manager'.

An entity may apply for registration as a Registered Person rather than full licensing under Cayman SIBA if it is:

1. A company within a group of companies carrying on securities investment business exclusively for one or more companies within the same group.
2. An entity with a registered office in the Cayman Islands and carries on securities investment business exclusively for 'sophisticated persons', 'high net worth persons', or companies, partnerships or trusts whose shareholders, limited partners or unit holders are all sophisticated persons and/or high net worth persons.

3. An entity regulated in respect of securities investment business by a recognised overseas regulatory authority in the country or territory (other than the Cayman Islands) in which the securities investment business is being conducted (e.g., the Monetary Authority of Singapore, the China Securities Regulatory Commission, the Financial Services Agency of Japan and the Securities and Futures Commission of Hong Kong).

BVI managers and advisors are eligible to apply to become Approved Managers if they will be (a) managing aggregate assets worth no more than US\$400 million if managing open-ended funds and/or aggregate capital commitments of no more than US\$1 billion if managing closed-ended funds; and (b) providing advice only to the following categories of clients:

1. Private or professional funds registered in BVI or in a recognised jurisdiction under BVI SIBA
2. Closed-ended funds, registered under the laws of BVI with the characteristics of a private or professional fund
3. Persons affiliated with a fund structure under 1 and 2 above.
4. Any fund domiciled in a recognised jurisdiction with the characteristics of a private or a professional fund (eg the Cayman Islands, China, Singapore, Australia, Japan and Hong Kong)
5. Foreign funds registered in a non-recognised jurisdiction with the characteristics of a private, professional or closed-ended fund which invest all or a substantial part of their assets in a fund structure under 1 or 2 above
6. Such other person(s) as the FSC may approve on a case-by case basis.

### Registration process

Both registrations involve a relatively straightforward application form setting out certain details about, and declarations/CVs from, the directors, significant shareholders and clients of the prospective Registered Person or Approved Manager.

Consistent with international practice, Registered Persons must also include in their application details of their Anti-Money Laundering Compliance Officer, Money Laundering Reporting Officer and Deputy MLRO. Approved Managers only need to appoint a Money Laundering Reporting Officer, but they do need to submit a copy of the written policies and procedures they have in place to combat money laundering, terrorism financing and proliferation financing (CIMA is not currently asking for these to be filed in respect of Registered Persons, but they do need to have been adopted).

In addition, the Approved Manager application requires both a copy of the investment management or advisory agreement between the applicant and each fund (or person) that it intends to act for upon commencement of 'relevant business', and written confirmation of the agreement to act from its BVI legal practitioner.

Provided CIMA or the FSC is satisfied that the application is complete and that the applicant's shareholders and the directors or senior officers are 'fit and proper persons' it will then proceed to register the Registered Person or Approved Manager. An Approved Manager may commence business if the FSC does not raise any questions in the seven days following submission of a completed application. CIMA has not provided any such timeline but generally acknowledges registrations of Registered Persons within two weeks.

### Costs

The application/annual renewal fees for a Registered Person and Approved Manager are US\$6,100/US\$6,100 and US\$1,000/US\$1,500 respectively. Note however that Approved Managers need to appoint an 'Authorised Representative' to liaise with the FSC, which creates an additional cost. There will be legal costs with either application and all Cayman Islands and BVI entities (regulated or unregulated) are required to appoint a licensed registered office provider/registered agent in the respective jurisdiction.



## On-going requirements

As regulated entities, both Registered Persons and Approved Managers have several on-going requirements in addition to those of unregulated entities in the Cayman Islands and BVI.

Similar to CIMA-registered funds, Registered Persons must appoint at least two individual directors/managers or one corporate director/manager, each registered with CIMA under the Directors Registration and Licensing Act 2014. Unlike entities holding a full CIMA licence under Cayman SIBA, Registered Persons are (a) not required to submit annual financial statements or business plans, (b) not subject to pre-approval of any change of directors, shareholders or beneficial owners, and (c) not subject to Cayman SIBA's Conduct of Business and Financial Requirements. An annual declaration needs to be filed and CIMA must be notified within 21 days of any change to the information set out in the Registered Person's application form or annual declaration.

Approved Managers also need to have two directors appointed at all times (one of whom must be an individual) although there are no additional registration requirements for the directors in BVI. In addition to an annual return to be filed each January, unaudited financial statements need to be filed within six months after the end of the financial year. The FSC must be notified within 14 days of any change to the information set out in the Approved Manager's application form or of any matter which has, or is likely to have, a material impact or significant regulatory impact on the Approved Manager or its 'relevant business'.

## Economic substance analysis

The other key regulatory consideration for fund sponsors is that of meeting the requirements of the applicable economic substance regime.

In the Cayman Islands, 'relevant entities' carrying out 'relevant activities' are required to meet an economic substance test (Cayman ES Test) in respect of gross income deriving from that activity. Helpfully 'investment funds' (including entities through which they invest) are not 'relevant entities' and therefore not subject to a Cayman ES Test. Conversely, Registered Persons will likely be a 'relevant entity', but 'fund management business' is the only management limb of Cayman SIBA caught within the 'relevant activities'. A Registered Person only acting as an advisor offering non-discretionary advice will therefore likely have no Cayman ES Test to satisfy.

In BVI the corresponding definition of 'fund management business' is restricted to "the conduct of an activity that requires the legal entity to hold an investment business license pursuant to section 4 and category 3 of Schedule 3 of the Securities and Investment Business Act, 2010". 'Approved Managers' do not currently need to hold an investment business license so fall outside the definition and therefore have no economic substance test to meet in BVI (other than the engagement of its registered office and authorised representative).

## Conclusion

The Registered Person and Approved Manager regimes provide helpful, light regulatory touch options for sponsors looking to set up an offshore fund manager or investment advisor. By highlighting the nuances between the two regimes sponsors should have a clearer insight as to which is more suitable for their needs.

[A Chinese version of this piece can also be read on the AIMA website.](#)



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To find out more, please contact one of the lawyers listed.



**Anthony McKenzie**  
Managing Partner, Singapore

D +65 6911 8311  
E [anthony.mckenzie@careyolsen.com](mailto:anthony.mckenzie@careyolsen.com)



**James Noble**  
Partner, Singapore

D +65 6911 8322  
E [james.noble@careyolsen.com](mailto:james.noble@careyolsen.com)

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# Cayman Islands economic substance requirements for discretionary investment managers



**Ann Ng**

Head of Asia Funds & Investment  
Management Practice  
**Maples Group (Hong Kong)**  
[Email Ann Ng](#)



**Dan Won**

Associate, Asia Funds & investment  
Management Practice  
**Maples Group (Hong Kong)**  
[Email Dan Won](#)

31 December 2021 is the deadline by which the first annual Economic Substance Returns together with supporting documents are required to be submitted by Cayman Islands 'relevant entities' conducting a 'relevant activity' under the 'fund management business' category to confirm their compliance with the economic substance test under the Cayman Islands economic substance regime. This article aims to serve as a reminder for such relevant entities of their obligations under this regime.

## Cayman Islands economic substance regime

On 1 January 2019, the Cayman Islands enacted the International Tax Co-operation (Economic Substance) Act (as revised) (ES Act) in response to global Organisation for Economic Co-operation and Development (OECD) base erosion and profit shifting (BEPS) standards regarding geographically mobile activities. Since its initial enactment, the ES Act has been amended by several regulations to reflect certain practical aspects of the economic substance requirements, and is supplemented by the Guidance on Economic Substance for Geographically Mobile Activities (as amended) (Guidance) issued by the Cayman Islands Tax Information Authority (TIA), a function of the Department for International Tax Cooperation (DITC) within the Cayman Islands government.

The ES Act introduces certain economic substance and reporting requirements for Cayman Islands 'relevant entities' conducting 'relevant activities'. A relevant entity conducting a relevant activity is required to satisfy the economic substance test under the ES Act (ES Test) for any part of its 'relevant income' from the relevant activity that is not subject to tax imposed by a jurisdiction outside the Cayman Islands.

## What is 'fund management business'?

Fund management business is one of the nine prescribed relevant activities under the ES Act and is defined as "the business of managing securities as set out in paragraph 3 of Schedule 2 to the Securities Investment Business Act (2020 Revision) carried on by a relevant entity licensed or otherwise authorised to conduct business under that Act for an investment fund."

As the relevant definition of “managing securities” in the Securities Investment Business Act (As Revised) (SIB Act) is “managing securities belonging to another person in circumstances involving the exercise of discretion”, a relevant entity that is registered under the SIB Act as a ‘registered person’ (or is a licensee with the Cayman Islands Monetary Authority (CIMA) under the SIB Act) and conducts discretionary investment management services for its clients with respect to securities would be regarded as conducting fund management business under the ES Act.

### **Economic substance requirements for Cayman Islands discretionary investment managers**

A relevant entity carrying on fund management business is subject to the ES Test in relation to the fund management business conducted, unless it has no relevant income from the fund management business.

The ES Test is satisfied if the relevant entity, in relation to the fund management business: (i) conducts core income general activities (CIGA) in the Cayman Islands; (ii) is directed and managed in an appropriate manner in the Cayman Islands; and (iii) has adequate operating expenditure, physical presence and personnel in the Cayman Islands.

CIGA in the context of the fund management business include: (i) taking decisions on the holding and selling of investments; (ii) calculating risk and reserves; (iii) taking decisions on currency or interest fluctuations and hedging positions; and (iv) preparing reports or returns, or both, to investors or CIMA, or both. The Guidance contains a sector specific section on fund management business, which elaborates on each limb of CIGA, and provides indications of measures likely or unlikely to satisfy each limb. For example, for the preparing reports or returns CIGA, the Guidance notes that “A fund manager can satisfy this head of CIGA by ensuring that there are systems and processes in place so that the fund manager is able to provide its client investment fund with accurate information on the investment fund’s financial position on a timely basis.”, whereas for the decisions on currency or interest fluctuations and hedging positions CIGA, “A fund manager is unlikely to satisfy this CIGA by taking isolated decisions involving specific investments of its client investment fund.”.

The Guidance further states that the term ‘adequate’ for the purposes of the ES Test shall mean “as much or as good as necessary for the relevant requirement or purpose”, and what is adequate or appropriate for each relevant entity will be dependent on the relevant entity’s particular facts and business activity.







The TIA has the power to determine whether a relevant entity has satisfied the ES Test for any financial year for which a report is required under the ES Act.

If the TIA determines that a relevant entity has failed the ES Test for a financial year, it shall issue a notice to the relevant entity of such failure and impose an initial penalty of US\$12,195 (or US\$121,951 in the subsequent financial year if the relevant entity has not remedied such failure). Continued failure by a relevant entity to comply with the ES Test may result in the TIA submitting an application to the relevant Cayman Islands Registrar to strike off the relevant entity.

### **What do Cayman Islands discretionary investment managers have to do?**

In addition to the annual economic substance notification to the relevant Cayman Registrar to confirm its status as a relevant entity and the relevant activity conducted, a relevant entity conducting fund management business is required to submit an annual Economic Substance Return (ES Return) together with requisite supporting documents on the online economic substance portal (Portal) established by the DITC in respect of the fund management business conducted during its previous financial year (whether or not it has received relevant income from such business).

In light of the revised registration regime under the SIB Act, a relevant entity conducting fund management business may regard 2020 as the first year of conducting fund management business. This means that if for example a relevant entity conducting fund management business has a financial year ending 31 December, the first ES Return for the fund management business must be submitted on behalf of the relevant entity on the Portal on or before 31 December 2021.

In completing the ES Return, careful consideration of the relevant entity's individual circumstances is required as relevant in determining the 'adequacy' or 'appropriateness' of certain limbs of the ES Test. The relevant entity must also ensure to maintain appropriate records to demonstrate the adequacy and appropriateness of the resources utilised and expenditures incurred.

### Further points of consideration

The application of the ES Act needs to be monitored on an ongoing basis as any change in the relevant entity's business activities may impact on the relevant entity's economic substance and/or reporting requirements under the ES Act.

If it is not practical for a relevant entity conducting fund management business to continue satisfying the ES Test for one or more heads of CIGA by itself, the relevant entity may, subject to certain conditions, outsource the conduct of its Cayman Islands CIGA to another person in the Cayman Islands. The relevant entity outsourcing Cayman Islands CIGA must be able to demonstrate that it has adequate supervision of the outsourced activities and, to satisfy the ES Test, that both the supervision and the outsourced CIGA are undertaken in the Cayman Islands. If Cayman Islands CIGA is outsourced to a non-Cayman Islands service provider, then the relevant entity should not receive the relevant income for such outsourced activity.

A fund looking to establish, maintain or outsource economic substance in the Cayman Islands for its Cayman Islands discretionary investment manager is therefore encouraged to seek legal advice with respect to its existing or proposed transactional structure and compliance with the ES Test.

It is worth noting that the activities of a British Virgin Islands (BVI) 'approved manager' do not ordinarily fall within the definition of 'fund management business' in the BVI and, as such, an 'approved manager' does not require substance in the BVI. The approved manager regime in the BVI is subject to certain eligibility requirements so will not be available for all types of fund managers.

*The Maples Group, through its international law firm, Maples and Calder, advises on the laws of the Cayman Islands and the BVI and can assist with queries relating to the economic substance regime, including compliance and reporting regimes in both jurisdictions.*





# The regulatory hosting model in the UK: Current challenges and potential developments



James Tinworth

Partner

Fieldfisher

[Email James Tinworth](mailto:James.Tinworth@fieldfisher.com)

There are a few versions of the regulatory hosting/umbrella model for fund management in the UK, but the basic arrangements are the same. An individual (or individuals) (PM) wants to manage a fund without having its own entity authorised by the Financial Conduct Authority (FCA). PM can set up a UK entity (PM Ltd). PM Ltd and PM then enter into arrangements with an FCA authorised manager (the host). Under these arrangements, the host is appointed as the fund's manager and PM is seconded from PM Ltd to the host with the intention of PM acting as the individual portfolio manager(s) of the fund. The fund usually has PM Ltd's branding. Usually, PM Ltd is appointed as the host's appointed representative (AR). As an AR, PM Ltd can provide non-discretionary investment advice and arrange deals in regulated investments in its name without requiring its own FCA authorisation.

This model has been around in the UK for at least 15 years. It originally gained traction because applications for FCA authorisation were taking nine-12 months and sponsors wanted to launch their funds much sooner (it was a matter of weeks to get the model in place). In the beginning, the model was mainly used as an interim measure until the manager had received its FCA authorisation. The model also provides several other advantages. In particular, the host should provide infrastructure, risk management and compliance support. The model can also provide managers with a good understanding of what it means to be regulated before the manager decides to become regulated in its own right.

You do still see managers who use the model as an interim arrangement, although the environment has shifted in two fundamental ways: (i) managers and hosts are generally happy for the arrangements to be longer-term and (ii) there are much higher barriers to becoming authorised and much greater uncertainty of capital raising and success. The hosting model is now the default option for smaller first-time managers in the UK.

The model is generally understood by managers and investors, although certain aspects sometimes cause difficulties. For example (i) PM Ltd is not the fund's manager: the host is (ii) as an AR, PM Ltd can only advise and arrange deals: it cannot manage, (iii) the relationship between the fund and the host (its manager) is not the same as the relationship (bond?) would be between the fund and PM Ltd (if PM Ltd were the manager), (iv) the agreements between PM, PM Ltd and the host should be a material part of investor due diligence, and (v) the interests of PM and PM Ltd may not always be aligned to the host's interests. The model is under pressure from political unpopularity, the FCA's continuing discomfort with the industry and continuing regulatory change.

## In the political spotlight

Greensill was a finance business, not a fund management business. The Greensill debacle, however, involved a part of the model (Greensill Capital was an AR (but there were no secondments)) and, crucially, the regulatory host involved is very well known in the fund management space.

In some ways, Greensill is a bit of a red herring. Indeed, the FCA said “[Greensill] is not the trigger for our focus on the AR regime: we have been considering it ... however, the issues raised by recent events highlight some of the potential harm and challenges associated with the AR model”.<sup>1</sup> In other ways, with the political spotlight being on the AR regime and, by extension, the regulatory hosting model, Greensill has most likely encouraged and accelerated FCA action.

## The FCA

The FCA has mainly dealt with its concerns behind the scenes. Periodically, we hear about the FCA giving hosts (one, some or all) a hard time over a particular regulatory topic. Sometimes, providers just vanish. The FCA has made its concerns public on at least two occasions in the past few years: the FCA’s review of principal firms in the investment management sector and subsequent “Dear CEO” letter in May 2019 (“We have significant concerns about this hosting model and will continue to assess the risks associated with it”) and the FCA’s review of host authorised fund management firms in June 2021. The regulatory hosting model was not the subject of the latter review (authorised fund management firms act as managers of UK authorised funds and delegate to a suitably authorised investment management firm) but the implications are clear.

The FCA’s main concerns about the model in May 2019 included:

- Conflicts of interest
- Hosts having appropriate control and risk management frameworks, including experienced people, to oversee the funds and the activities of the seconded portfolio managers

The FCA grouped its key observations from the 2021 review into four main areas:

- Due diligence over delegated third-party investment managers and funds
- Oversight of delegated third-party investment managers and funds
- Governance and oversight
- Financial resources

In its letter to the Greensill Parliamentary Committee referred to above, the FCA stated:

“We have also concluded that we need to do further work [in the context of the AR regime] at our gateway for authorisations, and on our supervisory and policy approaches.”

The work programme will include:

- Greater engagement with, and scrutiny of, firms as they appoint ARs ... the FCA will “assess whether the firm has appropriate systems and controls to oversee the AR”
- “... [the FCA] will undertake proactive supervision of principal firms that may pose a higher risk of harm ...”
- “Carrying out a range of targeted supervision activity in sectors, or portfolios, where [the FCA considers] that the AR regime is a particular driver of harm”.
- “Undertaking analysis ... to determine whether policy interventions are required...This could also include making recommendations to the Treasury for changes in the legislative regime.”

1 See FCA letter to Rt Hon Mel Stride MP dated 4 May 2021



The FCA has introduced a periodic fee of £250 payable on each of a firm's ARs. Of more concern, we understand that the FCA is sometimes taking between three and six months (and sometimes up to nine months) to approve new ARs or individuals at ARs. It used to take a few weeks to get the model in place. Hopefully, these longer timeframes will not become the norm. Such a delay is not reasonable to start-ups and/or their investors.

### Continuing regulatory change

We understand that the FCA is already challenging the financial resources of certain regulatory host providers. There has always been a regulatory capital cost to managing a new fund under the AIFMD. The Investment Firms Prudential Regime (IFPR) (implementation date of 1 January 2022) will only increase this cost. The IFPR will have the combined effect of putting more regulatory capital pressure on the host providers themselves (and potentially driving some providers out of the market) but also increasing the attractiveness of the hosting model to a new manager.

### What next?

Could the FCA propose a variation to the model where more regulation applies directly to the AR? This could be attractive to both the industry and the FCA. Could the FCA possibly propose a lighter regulatory regime in the UK for small managers? Unfortunately, both seem unlikely.

Hosts will continue to be challenged by the FCA (and investors) with the result that (i) the number of firms offering hosting arrangements will be reduced as players choose, or are compelled, to leave; (ii) the remaining providers will need to focus on their infrastructure and enhance where required; and, (iii) it is going to get more expensive.

The model's arrangements may adapt and evolve. In theory, at least, the AR element of the model (which has historically borne the brunt of FCA and political concern) is in some respects redundant. The PM can manage its fund with only the secondment arrangements with the host being in place.

Will hosts impose a cap on the number of secondees that they can host or will the FCA impose a cap? Will a time limit be placed on hosting arrangements?

Will the AR regime be divided into sectors and risk levels (e.g. IFAs, distribution of insurance products, fund management etc.) with differing regimes? If so, what risk level will be given to the regulatory hosting model?

I think that the model is here to stay. Without it, new manager start-ups in the UK below a certain level of anticipated assets under management will simply not happen and non-UK managers who wanted to establish a UK presence may reconsider. It should be noted that the Temporary Permissions Regime will be ending in the next couple of years and the UK's hosting model may be a vital way for EU firms to choose to continue to operate in the UK.

The UK is promoting its position as an asset management hub and, as the UK finds its place outside the EU, it would be yet another act of self-harm to make the UK's regulatory hosting model unworkable.

Many thanks to the hosts and due diligence specialists who generously contributed their time and thoughts for this article.



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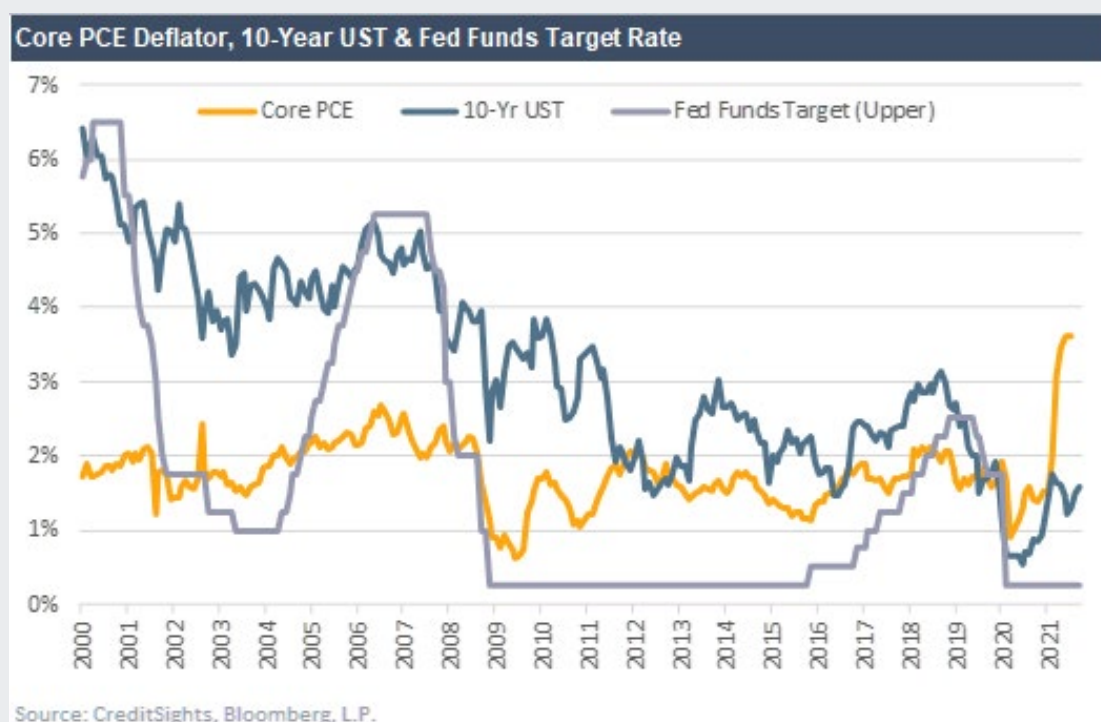
# Price Take/Price Maker: 3Q21 Inflation Playbook



**Winnie Cisar**  
Global Head of Strategy  
CreditSights

## Persistently transitory

Most market participants view the Federal Reserve as 'in play' to make a taper announcement at its early November meeting, and the 29 October release of September's personal consumption expenditures (PCE) deflator data may prove a key focus for investors leading into the meeting. The Fed uses core PCE as its preferred measure in its policy of 'average inflation targeting' and, in the April 2021 reading, core PCE jumped to 3.1% (year-over-year (YoY) % change). In the subsequent months, core PCE has climbed above 3.5% and consensus estimates point to another heady gain of 3.7% (YoY) for the September data. Looking further out, many, including the Fed, believe inflation will moderate as core PCE is expected to end 2021 at 3.2% before declining further in 2022 and 2023 (to 2.8% and 2.2%, respectively). With other central banks implementing rate hikes and inflation proving stickier than expected, market participants have pulled forward expectations of one (or more) Fed funds rate hike(s) into late 2022. The Fed funds futures market currently shows a 40% chance of a hike at the September 2022 Federal Open Market Committee (FOMC) meeting and an almost 60% chance of a December rate hike, a significant change in expectations from just a few months ago. At the end of June, the futures market was pricing in a 24% chance of a September 2022 hike and 32% of a December hike.



In the two rate hiking cycles since 2000, the Fed started to raise the Fed funds target prior to, or in tandem with core PCE hitting the 2% target level. For many investors, the recent extended period of Fed accommodation, both in the form of quantitative easing and zero interest rate policy (ZIRP), is a point of concern given the risk of a policy error as the Fed navigates its exit strategy. These fears recently came to a head as the jump in core PCE has proven persistent and has generally been met with patience from the Fed, keeping a lid on rates.

For corporate credit investors, the pace of changes in the monetary policy and rates landscapes have the potential to drive significant total return losses across both investment grade (IG) and high yield (HY), which trade at the low end of the historic range in yields.

The September readings for consumer price index (CPI) and producer price index (PPI) added more pressure to the Fed and rates. Both metrics hit lofty levels and showed persistently acute pressure in autos, energy, and overall core goods. Increases in housing prices added to investor concerns as the shelter category of the CPI data jumped 3.2% YoY. Taken together, these factors leave the US consumer on somewhat less stable ground as housing and energy prices account for a significant portion of household budgets. We also note that recent data show glimmers that inflationary pressures may abate over the next 12 months, as some categories have demonstrated modest price stabilisation (medical services and apparel).

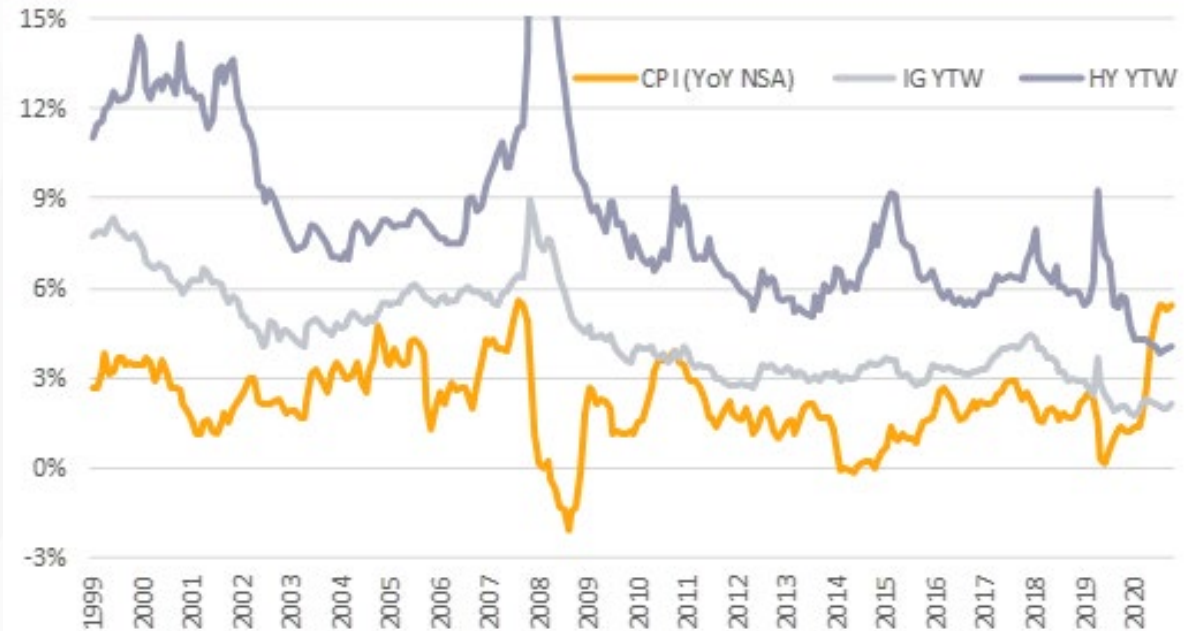
	Weight	Sep '20	Oct '20	Nov '20	Dec '21	Jan '21	Feb '21	Mar '21	Apr '21	May '21	Jun '21	Jul '21	Aug '21	Sep 21
Headline CPI	100%	1.4%	1.2%	1.2%	1.4%	1.4%	1.7%	2.6%	4.2%	5.0%	5.4%	5.4%	5.3%	5.4%
Shelter	33%	2.0%	2.0%	1.9%	1.8%	1.6%	1.5%	1.7%	2.1%	2.2%	2.6%	2.8%	2.8%	3.2%
Food	14%	3.9%	3.9%	3.7%	3.9%	3.8%	3.6%	3.5%	2.4%	2.2%	2.4%	3.4%	3.7%	4.6%
Medical Services	7%	4.9%	3.7%	3.2%	2.8%	2.9%	3.0%	2.7%	2.2%	1.5%	1.0%	0.8%	1.0%	0.9%
Vehicles & Parts	8%	4.5%	5.3%	5.1%	5.0%	4.6%	4.2%	4.5%	9.2%	13.3%	20.3%	19.8%	17.2%	14.9%
Educ./Comm. Svcs	5%	2.8%	2.7%	2.4%	2.3%	2.0%	2.1%	2.0%	2.0%	2.2%	2.4%	1.2%	1.3%	1.7%
Energy	7%	-7.7%	-9.2%	-9.4%	-7.0%	-3.6%	2.4%	13.2%	25.1%	28.5%	24.5%	23.8%	25.0%	24.8%
Transportation Svcs	5%	-5.1%	-5.1%	-3.4%	-3.5%	-4.1%	-4.4%	-1.6%	5.6%	11.2%	10.4%	6.4%	4.6%	4.4%
Recreation Services	4%	2.7%	2.6%	2.6%	1.6%	0.3%	1.1%	1.2%	1.8%	0.6%	1.9%	3.7%	3.5%	3.5%
HH Furnishings/Supplies	4%	2.1%	1.9%	2.9%	2.9%	2.4%	2.3%	2.8%	3.2%	3.7%	3.4%	3.0%	3.3%	4.8%
Apparel	3%	-6.0%	-5.5%	-5.2%	-3.9%	-2.5%	-3.6%	-2.5%	1.9%	5.6%	4.9%	4.2%	4.2%	3.4%
Recreation Goods	2%	-0.8%	-1.3%	-1.0%	-0.2%	-0.2%	0.3%	0.8%	2.9%	3.5%	3.2%	3.2%	3.3%	3.5%
Medical Goods	1%	0.9%	-0.8%	-1.1%	-2.5%	-2.3%	-2.5%	-2.4%	-1.7%	-1.9%	-2.2%	-2.1%	-2.5%	-1.6%
Core (Ex Food & Energy)	79%	1.7%	1.6%	1.6%	1.6%	1.4%	1.3%	1.6%	3.0%	3.8%	4.5%	4.3%	4.0%	4.0%
Core Services	58%	1.9%	1.7%	1.7%	1.6%	1.3%	1.3%	1.6%	2.5%	2.9%	3.1%	2.9%	2.7%	2.9%
Core Goods	21%	1.0%	1.2%	1.4%	1.7%	1.7%	1.3%	1.7%	4.4%	6.5%	8.7%	8.5%	7.7%	7.3%

Source: BLS, CreditSights. Note: Shows select YoY price change per CPI category, sorted by weight in the headline index. Category labels abbreviated from official titles. Not Seasonally Adjusted. Intra-category color scheme.

Compared with historic levels, US IG and HY are trading at the very low end of the range for yields and spreads, leaving little room for spread compression to offset a move higher in interest rates and mitigate total return losses. In fact, for the first time since 1999, the recent acceleration in CPI pushed the annual rate of inflation well above IG and HY yields. In prior cycles, credit spreads have proven resilient amid inflationary pressures with both IG and HY generally tightening during periods when inflation runs around 2% (or slightly higher). This makes sense intuitively as recent inflationary periods have also coincided with strong economic growth, supporting risk appetite and credit fundamentals. However, investors are now navigating a coordinated global economic reopening that is complicated by pandemic related disruptions to the supply chain and labour markets all while waiting for the Fed to make its exit from the market.



### US CPI and IG/HY Yield-to-Worst



Source: CreditSights, FactSet, ICE Data Indices, LLC

These factors leave us less inclined to expect broad-based spread compression across IG, though a modest amount of spread tightening through year-end is possible in HY (US IG & HY Q4 2021 Outlook: Freshly Squeezed provides our forecasts through year-end for both asset classes). With these factors in mind, we view inflation and its specific impact across sectors and single names as a key catalyst for valuations.

### Price takers/price makers in US investment grade and high yield

The CreditSights team of fundamental analysts identified three specific inflationary pressures: raw materials/commodity prices, labor costs and supply chain/transportation and assessed each sector's potential risk to cash flows from each of these categories. The analysts then provided an overall inflationary risk assessment for the sector. Overall market inflationary risk assessments for IG and HY are meant to reflect the aggregation of the sector recommendations on a fundamental, rather than technical, basis. For investors interested in sensitivity to interest rates at the sector level, see US Chart of the Day: Duration Adj Sector Yields.

### US investment grade

Ultra-low yields have broadly benefited the IG universe, allowing issuers to lock in historically cheap, long-term debt financing and supporting fundamentals. As of now, inflation plays only a moderate threat to IG fundamentals, with the most risk to cash flows for autos and consumer goods. Sectors that require seasonal labor, including leisure and retail, both of which are already facing labor shortages, are also at risk of margin compression from higher labor costs. In general, IG financials and energy, two sectors where we have overweight recommendations, are well-positioned in an inflationary environment.

Sector/Subsector	Rec	OAS	YTW	Duration	Cash Flow Risk From:			
					Raw Materials/ Commodity	Labor Costs	Supply Chain/ Transportation	Overall Inflationary Risk
<b>IG Aggregate</b>		<b>90 bps</b>	<b>2.23%</b>	<b>8.3 yrs</b>	<b>Low</b>	<b>Low</b>	<b>Low</b>	<b>Medium</b>
<b>Financials</b>	<b>MP</b>	<b>80 bps</b>	<b>1.95%</b>	<b>6.2 yrs</b>	Low	Low	None	Low
Banking (Large US) <sup>1</sup>	OP	76 bps	1.85%	5.6 yrs	None	Low	None	None
Banking (Regional US)	UP				None	Low	None	None
Financial Services <sup>2</sup>	OP	80 bps	1.94%	6.0 yrs	None	Low	None	None
Insurance	MP	97 bps	2.35%	8.8 yrs	Medium	Low	None	Low
<b>Non Financials &amp; Utilities</b>		<b>94 bps</b>	<b>2.35%</b>	<b>9.3 yrs</b>	Low	Low	Low	Low
<b>Industrials</b>		<b>93 bps</b>	<b>2.32%</b>	<b>9.1 yrs</b>	Low	Medium	Low	Low
Automotive	MP	68 bps	1.65%	4.4 yrs	Medium	Low	High	High
Basic Industry	MP	118 bps	2.57%	8.7 yrs	Medium	Low	Medium	Medium
Capital Goods		78 bps	2.13%	8.4 yrs	High	Low	Medium	Medium
Consumer Goods	MP	87 bps	2.29%	9.2 yrs	High	High	High	High
Energy	OP	113 bps	2.50%	8.6 yrs	Low	Low	Low	None
Environmental	MP	70 bps	2.12%	9.0 yrs	Low	Medium	Low	Low
Healthcare	UP	78 bps	2.23%	10.0 yrs	Low	Low	Low	Low
Leisure	OP	138 bps	2.54%	5.1 yrs	Low	High	Low	Medium
Media	MP	110 bps	2.61%	10.7 yrs	Low	Medium	Low	Low
REITs <sup>3</sup>	MP	92 bps	2.21%	6.8 yrs	Low	Low	None	None
Retail	UP	73 bps	2.15%	9.6 yrs	Medium	High	High	Medium
Technology & Electronics	UP	78 bps	2.14%	9.0 yrs	Low	Low	Medium	Low
Telecommunications	OP	115 bps	2.70%	11.1 yrs	Low	Medium	Low	Low
Transportation	MP	103 bps	2.49%	10.5 yrs	High	Medium	Low	Medium
<b>Utility</b>	<b>MP</b>	<b>105 bps</b>	<b>2.55%</b>	<b>10.2 yrs</b>	Medium	Low	Low	Low

Source: CreditSights, FactSet

Data as of November 10, 2021.

<sup>1</sup> Valuations based on the ICE Banking & Brokerage Index, which includes both US Large and Regional Banks.

<sup>2</sup> Recommendation applies to Aircraft Leasing, which is classified as Financial Services.

<sup>3</sup> Valuations based on the ICE Real Estate Index, which includes REITs.

## US high yield

In the US HY market, we expect inflationary pressures to play a moderate role in Q3 2021 earnings performance, and we have assigned the asset class a 'medium' rating for overall inflationary risk. The same two sectors are identified as inflation being a high risk to cash flows in the near-term: autos and consumer goods. Our analysts also identified pockets of potential challenges, specifically the effect of elevated raw materials/commodity prices on the capital goods sector, high labor costs for leisure issuers and continued supply chain/transportation-related pressures for retailers (especially heading into the holiday season). In the HY market, only energy is identified as having no risk to cash flow from inflationary pressures as commodity prices ultimately dictate what issuers in a range of other sectors must pay. Other HY sectors at overall low risk of an inflation-related hit to cash flows include healthcare, media, technology and telecom.

Sector/Subsector	Rec	OAS	YTW	Duration	Cash Flow Risk From:			
					Raw Materials/ Commodity	Labor Costs	Supply Chain/ Transportation	Overall Inflationary Risk
<b>HY Aggregate</b>		<b>306 bps</b>	<b>4.20%</b>	<b>4.2 yrs</b>	<b>Medium</b>	<b>Low</b>	<b>Medium</b>	<b>Medium</b>
Automotive	MP	226 bps	3.25%	4.1 yrs	Medium	Low	High	High
Basic Industry	MP	316 bps	4.30%	4.0 yrs	Medium	Low	Medium	Medium
Capital Goods		331 bps	4.28%	3.1 yrs	High	Low	Medium	Medium
Consumer Goods	OP	233 bps	3.61%	6.2 yrs	High	High	High	High
Energy	OP	348 bps	4.68%	5.0 yrs	Low	Low	Low	None
Healthcare	MP	303 bps	4.17%	3.9 yrs	Low	Medium	Low	Low
Homebuilders & Real Estat	MP	286 bps	3.99%	3.9 yrs	Medium	Medium	Medium	Medium
Leisure	OP	312 bps	4.04%	3.1 yrs	Medium	High	Medium	Medium
Media	OP	336 bps	4.59%	4.0 yrs	Low	Low	Low	Low
Retail	MP	295 bps	4.15%	4.5 yrs	Medium	Medium	High	Medium
Technology & Electronics	MP	270 bps	3.95%	4.1 yrs	Low	Low	Medium	Low
Telecommunications	MP	335 bps	4.54%	4.3 yrs	Low	Medium	Low	Low
Transportation	OP	267 bps	3.64%	3.7 yrs	High	Low	Low	Medium
<b>Utility</b>	<b>OP</b>	<b>271 bps</b>	<b>3.94%</b>	<b>5.0 yrs</b>	None	Low	Low	None

Source: CreditSights, FactSet

Data as of November 10, 2021.





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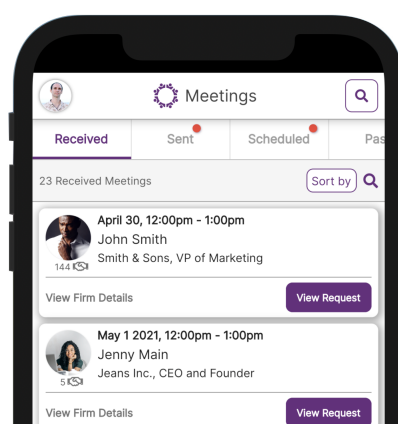
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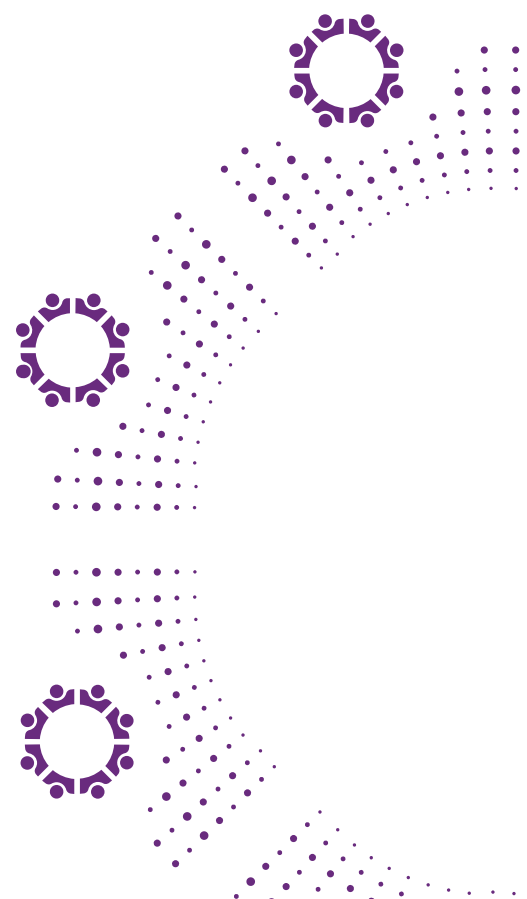
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Thank you for reading the Edition 128 of the AIMA Journal. If you would like to contribute to future editions, please email [Caterina Giordo](mailto:Caterina.Giordo@aima.org)

## PUBLICATION PLAN 2022

- **Q1 Edition 129**

Deadline for submission 5pm UK time Monday 14th February | Publication Monday 21st March

Please note the deadline for reserving a spot for the Q1 2022 edition of the AIMA Journal is 5pm UK time, Friday 28 January.

- **Q2 Edition 130**

Deadline for submission 5pm UK time Monday 23rd May | Publication Monday 27th June

Please note the deadline for reserving a spot for the Q2 edition of the AIMA Journal is 5pm UK time Friday 6th May.

- **Q3 Edition 131**

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Please note the deadline to reserve a spot for the Q3 edition of the AIMA Journal is 5pm UK time Friday 8th July.

- **Q4 Edition 132**

Deadline for submission 5pm UK time Monday 24th October | Publication Monday 28th November

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**Important:**

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# CONTACT US



## **Bermuda**

[usa@aima.org](mailto:usa@aima.org)

## **Brazil**

[info@aima.org](mailto:info@aima.org)

## **Brussels**

38/40 Square de Meeus, 1000  
Brussels, Belgium  
+32 2 401 61 46  
[info@aima.org](mailto:info@aima.org)

## **Cayman Islands**

[cayman@aima.org](mailto:cayman@aima.org)

## **Hong Kong**

Unit 1302, 13/F, 71-73 Wyndham  
Street, Central, Hong Kong  
+852 2523 0211  
[apac@aima.org](mailto:apac@aima.org)

## **London (Head Office)**

167 Fleet Street, London EC4A 2EA  
+44 20 7822 8380  
[info@aima.org](mailto:info@aima.org)

## **Middle East**

[info@aima.org](mailto:info@aima.org)

## **New York City**

12 East 49th Street, 11th Floor.  
New York, NY, 10017, USA  
+1 646 397 8411  
[usa@aima.org](mailto:usa@aima.org)

## **Singapore**

1 Wallich Street, #14-01 Guoco  
Tower, Singapore 078881  
+65 6535 5494  
[apac@aima.org](mailto:apac@aima.org)

## **Shanghai**

Suite A10, 28th Floor SWFC, No.  
100 Century Avenue, Pudong,  
Shanghai 200120, China  
+86 136 1191 9817  
[apac@aima.org](mailto:apac@aima.org)

## **Sydney**

+61 (0) 412 224 400  
[apac@aima.org](mailto:apac@aima.org)

## **Toronto**

500 - 30 Wellington Street West,  
Box 129, Commerce Court,  
Toronto, ON M5L 1E2, Canada  
+1 416 364 8420  
[canada@aima.org](mailto:canada@aima.org)

## **Tokyo**

+81 (0) 3 4520 5577  
[apac@aima.org](mailto:apac@aima.org)

## **Washington**

2001 L Street NW, Suite 500,  
Washington DC 20036, USA  
+1 202 919 4940  
[usa@aima.org](mailto:usa@aima.org)



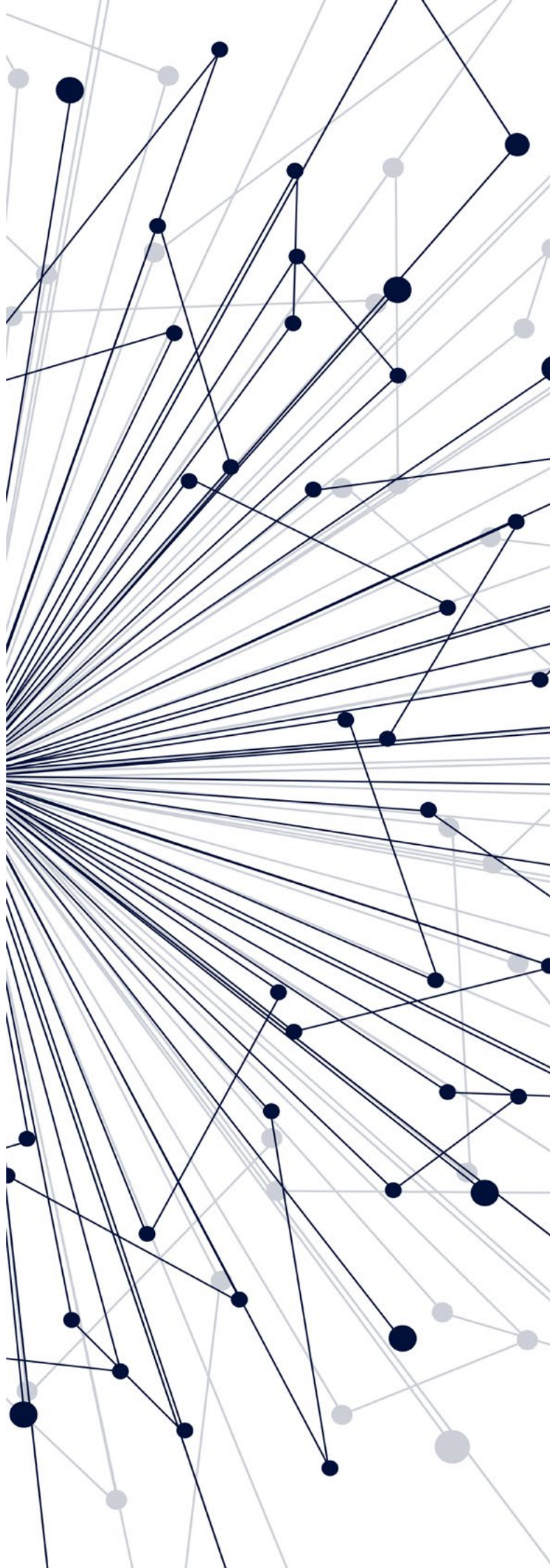


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