

Performance Magazine

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Deloitte.



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FOREWORD



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Summer has finally arrived and with it, the latest edition of *Performance*. Our contributors consider what lies ahead, forecasting the trends in technology, talent, and transparency which have been and will continue to impact the Investment Fund industry. From changes in regulatory environments to the needs of the stakeholders who must implement them, the sector is as dynamic as ever.

In this issue, Deloitte Luxembourg's Nicolas Hennebert, Yann Mérillou, and Dario Zambotti take us through the seachange in investment fund audits over the last decade. This vast transformation, driven by digital technologies for data management analytics and recent ETL solutions, enriches the information available to investors in real time and amplifies the possibilities for future, real-time fund analysis. Simultaneously, the early investments in these solutions by audit firms, like Deloitte, are now providing returns through automation, data standardization, and efficiency.

We've witnessed tremendous growth of the Private Equity industry across Luxembourg, Europe – and more broadly across the world – in recent years as supportive and agile regulatory frameworks have

risen to meet persistent investor interest. As CEO of the Luxembourg Private Equity and Venture Capital Association, Stephane Pesch has had a front-row seat to observe this "golden age of private equity." Here, too, we see the benefits of digitalization, though challenges still lie ahead as firms seek expert talents who can wield data to keep up with market demand and demonstrate value for investors.

The challenge of attracting and retaining the "right" talent now denotes much more than the hard skills individuals bring to their workplace but also encompasses human capital. Human capital – the skills, knowledge, and experience in an individual and group – is emerging as an important aspect of any firm's thriving ESG framework. Contributors Matt Lanstone, Head of ESG

Research and Investing, and Emma Doner, ESG Analyst, at Capital Group, provide readers with five essential indicators to measure human capital and share how disclosing these results can set their firms apart.

Societal shifts including the global pandemic and the ever-looming global climate crisis have increased pressure on investment management companies to embed ESG into their everyday decision-making process. A conversation between Deloitte Caymans' Lawrence Usher and Waystone Governance's Rebecca Palmer attests to how the rising expectations of regulators and other stakeholders are supporting a more permanent change in the ESG landscape.

But will the environmental, social, and governance concerns of today resemble

the ESG considerations of the future? Amid a global pandemic, climate pressures, and even political upheaval, is the concept of ESG unshakeable, or must it shift to meet the ethos of the time in which it set? Against the backdrop of the current conflict in Ukraine, Mikkel Bates, Regulatory Manager at FE fundinfo, ponders this very concept.

From EFT to ESG, and around the world from the Cayman Islands to Switzerland, this issue of *Performance* presents opportunities for digitalization, data, and disclosure to drive the Investment Management sector toward innovation and growth, grounded in corporate responsibility concepts.

With all of these weighty topics and more, there's plenty to dig into. We hope you enjoy this 38th edition of *Performance*.



EDITORIAL

While performance and growth are constant priorities within the financial services industry, for the first time, we are seeing a different narrative overtaking the boardroom. Top priority has turned to navigating an impending talent crisis and tempering effects of The Great Resignation.

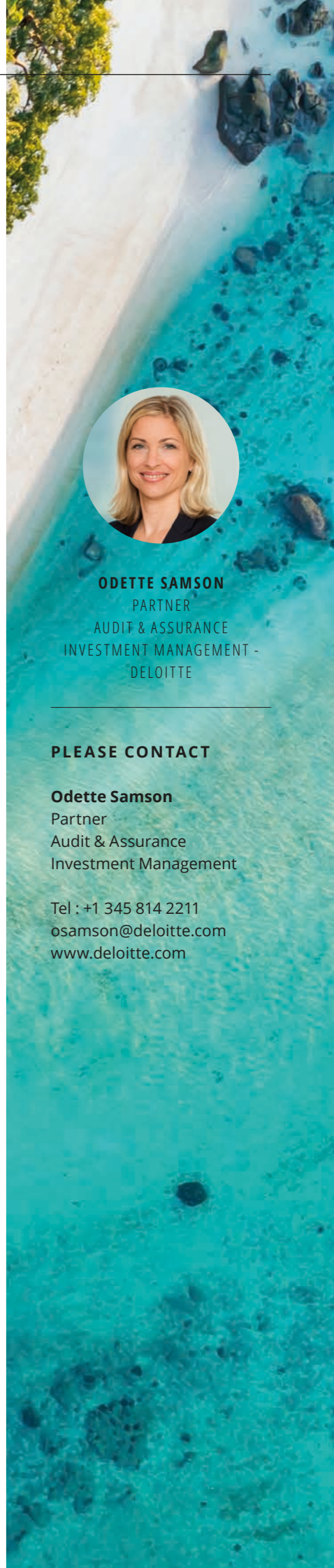
Redefining culture, embracing hybrid working models and developing innovative strategies to attract and retain top talent are critical factors to best position a firm to compete in the current environment. A variety of tools to navigate the new landscape is being deployed by management, such as embedding automation and technologies in operations, outsourcing operations, adjusting to a hybrid work model consisting of on-site and work-from-home policies, and reducing the office footprint to offset rising talent costs. Firms that resist change altogether remain the outliers, and risk further disruption as competing firms eagerly flex their novel approaches to recruitment and retention.

The move to redefine culture is partly explained by people's search for belonging and a sense of purpose in their work. The change is no longer the unique desire of the Millennial and Gen Z generations. Rather, it represents a societal shift across all levels within the workforce, largely as a consequence of growing environmental, social and governance (ESG) concerns and fueled by the COVID-19 pandemic. ESG concerns have had both internal and external implications on firms, and stakeholder engagement remains a key component in achieving the desired outcomes.

The concept of engagement between stakeholders, most notably between industry and government, underpins the success of the Cayman Islands. It is widely recognized within global financial services centers that facilitating the global flows of capital efficiently and responsibly requires regulation that is fit for purpose. While this issue is common across all jurisdictions, the Cayman Islands plays a leading role in securing the integrity of global financial services systems due to its prevalence for hedge and private equity fund structuring and has strengthened this role by introducing a series of regulatory enhancements in accordance with leading international standards.

Within this edition of Performance Magazine, we explore how the investment management industry is navigating the opportunities and challenges resulting from these current societal and regulatory pressures. As the pace of change impacting our industry accelerates, it is incumbent upon all participants, from board members, c-suite, service providers, investors and regulators to collaborate and adapt to the industry's needs in securing an efficient, effective, and thriving financial ecosystem for many generations to come.

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The digital revolution is also here

HOW ETL AND DATA ANALYTICS HAVE TRANSFORMED THE AUDITING OF FUNDS



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INTRODUCTION

The investment management industry is data-driven and the amount of data managed by the industry has increased exponentially in recent decades, in particularly over the last 10 years. Many publications have already discussed this evolution and its impact on the industry. For instance, in its article “Advanced analytics in asset management: Beyond the buzz”, McKinsey & Company illustrated the evolution brought about by the use of advanced analytics across the full asset management value chain, and explained how applying leading analytics technology to the different components of the value chain has helped to increase the effectiveness of decisions and the efficiency of the business. From data-driven client prospection to unbiased investment decisions; administrative and reporting process automation to automated controls, the digital revolution has made a significant mark on the industry.

In addition, data management and analytics evolutions are also transforming another segment of the value chain: the external audit. The external auditor has a critical role to play in the value chain as the fourth line of defense not only in providing assurance on the published annual accounts, but also bringing fresh and valuable perspectives and insight to asset managers reinforcing the trust of any stakeholders. This article analyzes how technology and data management have already transformed the external audit service, and highlight the positive impacts of this transformation on audit efficiency and quality and how it continuously strives to meet investor’s increasing expectations.

Exchange, transform and load: The ETL solution

Every audit starts with a strong data collection process which must be efficient and ensure reliable information ready for audit processes. Ten years ago, this collection process was based on e-mail exchange of Excel files and implied numerous manual interventions from all stakeholders involved in funds audits: the service providers, the management companies, the directors, and the auditors. On top of this, there was a lack of standardization of the accounting data format that led to manual and time-consuming retreatments. Every counterparty was spending a significant amount of time extracting data from their systems, only to, in many circumstances, manually amend and re-format before finally sharing it with auditors. These auditors then often had to manually retreat the data again before feeding it into

their audit software. All of this only added to an increasing risk of errors, mistakes, and un-due amendments.

Reducing such risks, together with the aim of improving efficiency, has been one of the main objectives behind the automation of the data gathering and audit transformation process.

One of the first steps in this automation journey was the set-up of secure exchange platforms and FTP channels between auditors and service providers. The creation of such a secured data exchange platform replaced the use of e-mails, USB sticks, mail etc. in the data collection process. The uploads/downloads were still manual, but the flow was automated.

A few years ago, robotics (RPAs), APIs, and other automated solutions adopted by central administrators’ platforms and/or by auditors

themselves, represented another important milestone in the automation journey. It made possible the automated transfer of information on a more regular basis and with limited human inputs at the entry and exit of the data flow. This positively affected risk management and the efficiency of the process.

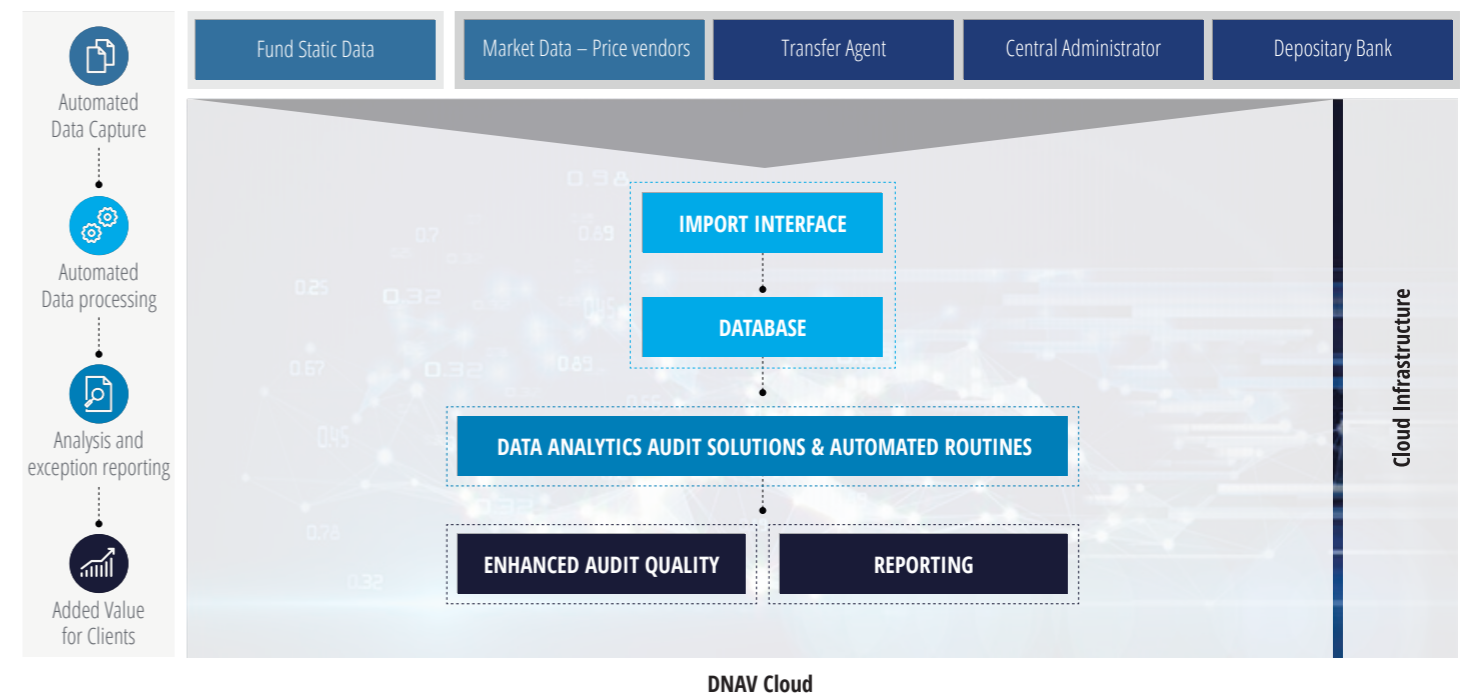
The creation of such a secured data exchange platform replaced the use of e-mails, USB sticks, mail etc.

In recent years, the emergence of ETL solutions developed by audit firms has been a final significant improvement in not only gathering the data, but also transforming it to

create data lakes and analytic solutions. As an example, one of the current ETL solutions used by Deloitte Audit offers the possibility to:

01. Directly pull, on a daily basis, all static and accounting data needed for the audit procedures from administrators’ systems without any manual intervention with a clear benefit in terms of security and efficiency;
02. Automate the transformation of data in an auditable format which remains consistent whatever the source is;
03. Run automated sanity checks and controls on the quality of the data provided and therefore increase assurance on the completeness and accuracy of the data received; and
04. To finally load these into our audit analytics solutions.

Figure 1. Workflow DNav



DNAV Cloud

To create such a solution, audit firms have worked in collaboration with major central administrators and custodian banks. Today, the data factory environment contributes to the consistency of information, the standardization of data, and the automation of the fund industry's needs to remain super-efficient and of the utmost quality. Finally, the last trend we have observed is the emergence of ETL solutions across countries. Most of the service providers are international players leveraging the same accounting and/or custodian systems over several countries, therefore the audit firms have started to deploy the same ETL solutions across jurisdictions. As an example, the aforementioned ETL is used for all major service providers active in France and in Luxembourg... and further afield!

of data are critical in ensuring efficiency and security. The subsequent ability to properly analyze the data and to visualize the information in a smart and meaningful way to support controls and business decisions, allows us to exploit the benefit of the technological evolution.

Well-structured exchange, automated transformation, and the loading of data are critical in ensuring efficiency and security.

In recent years, we have observed the emergence of digital solutions for smart fund audit analytics. "DNAV Luxembourg / DNAV Cloud" illustrates this evolution with a

development which began at the beginning of the 2010's. Today, as with the earlier described ETL, there are clear trends within fund audit analytic tools to converge across geographies and to move such solutions to a cloud-based environment.

Let's explore the purposes of such analytic solutions and which added-value they bring to the funds and their investors. Fund audit analytic solutions, such as DNAV Cloud, combines automation, data management, automated audit routines, and visualization of data. It enables a secure, efficient, and high quality audit process that adds value and ensures that the auditor and those charged with governance can focus on what matters.

01. It is expected that such fund audit analytic solutions incorporates advanced algorithms to test an entire population of data and to identify outliers and anomalies that require specific audit

attention. This enables auditors to focus on what matters and to perform a high quality and effective audit. As tangible benefits, the auditor provides the fund management with perspectives on an entire population and findings that, if cumulating in time, might become significant. Such a tool opens the door to the most efficient solutions and the quality of a full population audit focused on outliers, versus a sample-based audit.

02. It is expected that such fund audit analytic solutions focuses on specific features of the fund market such as multi-compartments funds, multi-currency classes hedged or not, swing pricing (full, partial, tiering), performance benchmark, investments and derivatives valuation, or different fee models (proportional, capped, fixed TER, etc.). This enables not only the ability to investigate

specific, relevant financial sections of the financial statements and to increase the overall quality of the audit itself, but, most importantly, to share with asset managers and other fund's stakeholders relevant perspectives and insights on the fund and the fund industry.

03. It is also expected that such fund audit analytic solutions offer smart visualizations of complex data and analysis. These visualizations help auditors to identify outliers and anomalies before they become material audit findings. The visualization of data enables fast identification and communication of (potential) issues. With such capabilities, the auditor can offer management a timely and transparent view into matters impacting the fund and related audit process. It enables management to access real-time audit status visualization.

The visualization of data enables fast identification and communication of (potential) issues.



As an example, DNAV Cloud offers these possibilities, but also gives auditors the ability to enforce data security, share insights, utilize autonomous data transfer with service providers, and employ advanced analytics that enable clients and the audit of their funds to move faster, safer, and smarter. The audit of funds has become as much about bits and bytes, as it is about adopting a secure and efficient process that adds value.

CONCLUSION

Over the last 10 to 15 years, the audit of investment funds have been transformed by the emergence of ETL and data analytics capabilities. This evolution has had an impact on all fund stakeholders, including investors, offering a higher efficiency in the fund's audit process without any compromise on the quality. Audit firms have developed and customized IT solutions to meet these expectations, and one can now observe a clear trend in a convergence of these solutions, consolidating local experiences and solutions within a unique, global cloud analytic purpose.

So, what's next? The investor of tomorrow, digital native, will be used to accessing real-time information—and tech innovations are making it feasible for all financial transactions. Customers are already comfortable making transactions with their mobile phones, to make purchases with their watches, and accumulating regular savings by setting up

automated rules on wealth planning platforms. The future investor will be able to invest in a fund via their mobile whilst receiving a real-time assurance from an external auditor on the NAV they are investing in. The digital revolution is here and these capabilities are within our reach.

Audit analytic solutions for funds
Well-structured exchange, automated transformation, and the loading

TO THE POINT

External auditing of investment funds has been transformed over the last 10 years through the quick evolution of data management and analytics solutions:

- 01. The ability to automatically capture, transfer, transform, elaborate, analyze, and present data is producing significant efficiency gains for investors.commodity, analyzing data will be the main asset in the future. Building the necessary infrastructure is key.
- 02. Data sanity, accuracy, completeness, and, more broadly, management have become the new oil for the analytics technology factory.
- 03. Data analytic solutions and algorithms enhance the quality of audits. For example, a move from a sample-based audit to a full population audit allows the identification of outliers and anomalies that require specific audit attention.
- 04. Smart analysis and visualizations of complex data help to provide the right insights to the governance and management of the fund.



Switzerland's fund distribution rules

RULES AND REGULATIONS FOR FOREIGN FUNDS AIMED AT QUALIFIED INVESTORS



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INTRODUCTION

Two years have passed since the Financial Services Act (FinSA) entered into force in Switzerland, with 31 December 2021 marking the end of the agreed transition period offered to foreign funds and their managers to adapt to the new rules. Now that some of these rules have been clarified by various texts of application and self-regulations, and that some observable practice exists, the time has come to review the rules on fund distribution in Switzerland.

This article focuses on funds aimed at Swiss-based professional and institutional clients (qualified investors) whether UCITS or alternative funds. It does not cover distribution rules for funds aimed at retail investors for which a stricter regime applies (including an approval from FINMA, the Swiss Financial Market Supervisory Authority).

Since the attractiveness of Switzerland is essentially linked to the significant size of the market of high-net worth individuals (HNWIs), a specific focus is given to the rules fund promoters must follow to approach such individuals by following a simplified process which avoids the tedious registration of a fund with FINMA.

The scope of FinSA

01. Activities covered by FinSA

are defined as financial services and include portfolio management, investment advice, receipt and transmission of orders, granting of loans to finance transactions, and acquisition or disposal of financial instruments. The activity of fund distribution falls under the scope of "acquisition or disposal of financial instruments".

02. Financial instruments

within the scope of FinSA are not only funds, but also include equity securities, debt instruments, structured products, derivatives, deposits, and bonds.

03. FinSA applies to financial services providers

Companies (fund managers or third-party fund promoters) can be considered financial services providers, but their employees or independent individuals (placement agents, distributors, etc.), who come under the definition of client advisers, can also be classed as such.

04. The territorial scope

of FinSA application is limited to financial services provided "in Switzerland or for clients in Switzerland". Distribution activity of a foreign fund manager promoting its fund in Switzerland from abroad is considered to take place in Switzerland and the

manager must therefore respect FinSA rules. For example, a foreign private equity fund manager who fully delegates the marketing of its fund in Switzerland to a placement agent is not submitted to FinSA obligations itself, but these obligations fall on the placement agent considered a financial services provider.

Main exemptions and out-of-scope activities

Under FinSA, only interactions with end-investors are qualified as financial services. For instance, FinSA obligations do not apply to a foreign promoter who distributes a fund to a Swiss bank (the bank is a professional intermediary and not the end-investor). Nevertheless, if the bank then invests in the funds for its clients in the frame of a discretionary portfolio or advisory investment mandate,

FinSA will apply to the bank for the financial service it performs for its clients.

Under FinSA, only interactions with end-investors are qualified as financial services.

Reverse solicitation is another exception. FinSA stipulates that a financial service is not deemed to be provided in Switzerland if requested at the express initiative of clients.

However, fund promoters should consider reverse solicitation as an exception and, to avoid future concerns or disputes, should keep evidence that the solicitation was truly initiated by the client.

FinSA and distribution of foreign funds

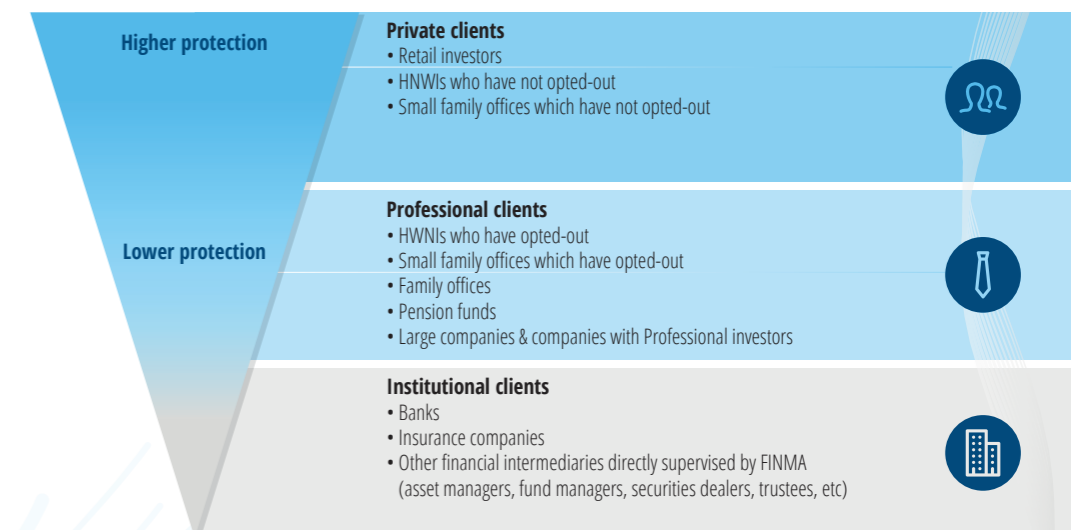
The first obligation of a financial services provider is to classify its clients in one of three categories as different FinSA rules apply to each one. The categories defined by FinSA are:

- Private;
- Professional; or
- Institutional.

Under certain circumstances, clients can ask to change category and opt-in (get more protection) or opt-out (get less protection).

Beside these main requirements, fund promoters (fund managers, third-party marketing companies, but also client advisers) must respect FinSA rules of conduct and organization.

Figure 1. Client segmentation obligation



Code of conduct

FinSA defines rules of conduct which apply to financial services providers. However, some rules do not apply to fund distribution activities (but only to portfolio management or advisory activities for instance). Exemptions are also based on client segmentation:

document containing all disclosures required by FinSA are often used as efficient practical solutions.

Organization rules

FinSA organization rules apply to fund promoters irrespective of the segment of clients to whom the fund is distributed.

demonstrate their knowledge and experience in fund distribution, but also their knowledge of the FinSA rules. More specifically, a client adviser who applies to enter a Client Adviser Register must provide evidence they have completed a training on FinSA rules.

must disclose the conflict of interest in an appropriate manner.

In the context of fund distribution, a potential conflict of interest may arise if a fund manager uses the services of a placement agent or third-party marketer. FinSA rules on conflicts of interest and retrocessions will impose specific obligations to the third-party marketer.

Figure 2. Code of Conduct rules

Rules of Conduct (Art. 7-19 FINSA) the obligation depends on Client Segmentation ▶▶	Private clients	Professional clients (including HNWIs who opted-out)	Institutional clients
Obligation of Information on the financial service provider, the fund, costs, conflict of interest, mediation rights, opting rights...	Yes	Yes, but obligation can be waived with express client consent	No
Obligation of Documentation: Communication and information with investors on the fund	Yes	Yes, but obligation can be waived with express client consent	No
Obligation of Rendering of Account: fund documentation is sent periodically to the client or at its request	Yes	Yes, but obligation can be waived with express client consent	No

For professional clients, rules of conduct can be waived with their express written consent. In practice though, to obtain the consent of each client may be complex and not well received. It may therefore be easier to apply FinSA rules of conduct to this whole category of clients.

However, a principle of proportionality exists depending on the size, complexity, legal form, and financial service provided. In addition, these obligations are limited to fund distribution activities of fund promoters. They do not apply to fund management activities if they are performed outside Switzerland.

FinSA's organization rules:

01. Adequate internal organization structure

Financial services providers must ensure that they fulfil their FinSA duties through internal regulations and appropriate organization of operations.

02. Knowledge, capabilities, and experience of employees

FinSA requires fund managers, third-party marketing companies, and client advisers to be able to

03. Adequate measures to prevent conflicts of interest

Specific attention should be given to Swiss rules on conflicts of interest and especially on retrocessions which may differ from other jurisdictions (e.g. EU rules on retrocessions). FinSA provides for an extensive definition of conflict of interests and implores financial services providers to prevent them via: organizational precautions and measures, disclosures rules, documentation of conflicts of interest, rules on compensation from third parties, and rules on staff transactions.

As a general principle, if organizational measures cannot be taken to prevent disadvantages to clients (or only with a disproportionate amount of effort), the financial services provider

04. Information and consent from clients on remuneration coming from third-parties

A third-party marketer may accept compensation from a fund manager only if they have expressly informed the investors in advance of such compensation—its scope and its type—and the investor has given express consent to such compensation. Without this consent, the compensation must be fully passed on to the investors. If the amount cannot be determined in advance, the financial services provider must inform its clients of the calculation parameters and the ranges (e.g. a percentage of the amount that the client will acquire). Upon the investor's request, the amounts effectively received must be disclosed.

Specific rules to market a foreign fund to HNWIs

By default, HNWIs are considered private clients and belong to the same category as retail investors.

However, HNWIs can 'opt-out' and instead be considered as professional clients. This opting-out allows fund

For professional clients, rules of conduct can be waived with their express written consent.

To fulfil some of the obligations of information, the insertion of Swiss disclosures in the fund offering and marketing documents or the provision of a separate 'FinSA information'



TO THE POINT

01. From client segmentation, to rules of conduct, internal organization, conflict of interest and retrocessions, as well as specific rules to distribute a fund to HNWIs, FinSA provides for several obligations which apply to the distribution of foreign funds to Swiss-based qualified investors.
02. Two years after Switzerland's enforcement of FinSA, fund distribution rules are becoming clearer for foreign fund managers and their marketers.
03. To limit the costs and administrative burden related to their marketing campaigns in Switzerland, fund promoters should perform a proper analysis of their objectives to assess which rules will apply to them and which measures and actions should be taken to comply with Swiss regulations.

promoters to distribute foreign funds not registered with FINMA to these HNWIs.

- Before advertising or offering a fund to HNWIs, a **Swiss representative** must be appointed by the fund: a local point of contact for Swiss investors and FINMA. This requirement stems from the Swiss Collective Investment Scheme Act (CISA).

and its employees—in charge of marketing for Switzerland—must **enter a Swiss Client Adviser register**.

CONCLUSION

After two years of interpretation, self-regulations, and practice, FinSA rules on fund distribution are getting clearer.

For foreign funds and their managers who plan to target Swiss-qualified investors, proper preparation is recommended to ensure compliance with Swiss regulations. The organizations must carry out an analysis of their marketing strategy, research the type of client

they will target, and review the measures and actions which must be taken (e.g. affiliation, registration, and appointment of fund representative and paying agent etc.). This effort is especially relevant when working with professional clients and HNWIs who have opted-out.

An appropriate preparation and analysis of their needs should help fund promoters entering the Swiss market to limit their costs and administrative workload.

Endnotes

¹ FinSA Art.3 let. c. cipher 1., and FinSO (Financial Services Ordinance) Art. 3.2.

² FinSA Art. 3 let. d., and FinSO Art.2.1.

FinSA organization rules apply to fund promoters irrespective of the segment of clients to whom the fund is distributed.

To distribute funds to HNWIs having opted-out, the foreign fund promoter must take a few additional steps:

- Similarly, a **Swiss paying agent** must be appointed: a Swiss bank that a Swiss investor could use as intermediary to invest or receive proceeds from the fund.
- Additionally, the company promoting the fund (fund manager and/or third-party marketer) must **affiliate with a Swiss Ombudsman**,



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The golden age of Private Equity Observations from an insider

Why has private equity proved so popular in recent years and how did it become the rising star of the alternative investments funds industry and private capital?

 **The agile regulatory landscape: A guarantor of growth**


The implementation in Europe of the Alternative Investment Fund Managers Directive (AIFMD) in 2013 was certainly one of the triggers of such success. First considered as a threat and a costly upgrade to operational processes, it finally paved the way for tremendous expansion. It helped to define and clarify some common standards, which although not entirely perfect still provided enough options and benefits to professional and specialized Private Equity fund managers, the famous GPs (General Partners).

Some countries, like Luxembourg for instance, went the extra-mile and used this occasion to supplement some special features which also became accelerators of this growth. These included the refurbishment of the Limited Partnership law (SCS) and the creation of the Special Limited Partnership (SCSp),

which currently represents the most used legal form, at least in our industry, and is a true bestseller with more than 6,400 active SCSPs. This crucial addition to the Luxembourg toolbox was also accompanied by two emerging business models, which grafted themselves into the ecosystem. It allowed specialized fund administrators (PSFs) to emerge under certain conditions as depositaries of “assets other than financial ones” (i.e. non-listed assets and so englobing the PE funds) and the rise of the third party AIFM model. Instead of instantly creating an in-house AIFM, such robust providers proposed the required services, substance, and manpower—a real starter pack—in order to accelerate the launch of such activities, which also became another local specialty.

In 2016, Luxembourg continued its innovative pathway with the implementation of another winner: the Reserved Alternative Investment

Fund (RAIF). This offered an interesting structuring model, which included add-ons such as the possibility to use sub-funds, the pan-European ‘passporting’, and a fast time-to-market as supervision is handled at AIFM-level and not at product level. It proved so successful that there are currently more than 1,680 such vehicles in the marketplace. And it isn’t only Luxembourg that showed its creative chops: other EU countries also took the opportunity to innovate and refurbish their existing vehicles. Together, the EU has become a busy hub for Private Equity structures, targeting EU capital and doing local and international investments.

 **The performance, trust, and expertise**

The flexible toolbox, the recognition of the track record by institutional, professional investors, and the profound experience of the different asset servicers are surely guarantors of the success of the Private Equity

asset class, but the main reasons are its core values and intrinsic strengths.

Together, the EU has become a busy hub for Private Equity structures, targeting EU capital and doing local and international investments.

Globally, the long-term goal of PE is to invest into unlisted small, medium, or larger companies in order to make them better, stronger, and more profitable before selling these firms on (or exiting) after a successful transformational process. In the past, this was heavily centered around financial restructuring—the use of leverage, cost reduction/



savings and, in some cases, even consolidation. This model evolved over time and today the emphasis is placed upon concrete contributions to the real economy and the ecosystem of enterprises, which require capital, external expertise, and succession planning solutions in order to leverage and pursue their growth. These target companies, once aligned with the GP's interests, are now able to embrace a new age of evolution with one of the following:

- A complete digitalization of their operations;
- The launch of new products;
- The expansion to new markets; and/or
- A fully-fledged buy and build strategy (buying up competitors and becoming a national, EU, or worldwide champion).

The same applies to venture capital (VC) which allows start-up companies to be backed, quite often, by former successful entrepreneurs in order to get their companies off the ground and grow. VC, in its noblest sense, is injecting money (in a way, 'passing on' money to new founders) and helping innovation, research and development, and a new generation of giants to emerge. These investments do have a capitalistic goal of improving the value of the companies themselves, which also triggers further positive outcomes for the society via new jobs, career opportunities, and the creation of an agile workforce capable of handling multi-dimensional skills and fast-paced industries.

PE is the perfect combination of finance and entrepreneurship and is meant to create value

and deliver performance. In this industry, everybody has or should integrate this entrepreneurial spirit, try to improve their performance, and remain curious and eager to learn. Hard work and very robust studies are surely part of the 'must-have' package, but it's worth the effort because of the brilliant professionals and entrepreneurs you will meet, because of the diversity of the profiles that will be found in PE teams or investment committees.

PE is the perfect combination of finance and entrepreneurship and is meant to create value and deliver performance.

There is no 'one size fits all' mentality and you can work with engineers, industrialists, PhDs, merger and acquisition specialists, genius financiers, visionaries, smart marketers, and pragmatic back, middle, and front office specialists who are attracted by this mind-set and business attitude. The goal of PE is not to simply analyze markets and indicators or mechanically review firms while trying to do short-term bets or transactions. Rather it is to successfully transform (value creation) the portfolio companies into the winners of the next generation— thanks to these specialists with an intimate knowledge of launching, running, and selling companies.



The challenges and opportunities of the industry

Since the PE sector is growing in strength and size (Preqin PE forecast 2020-2026 from US\$4.52 trillion to US\$ 11.12 trillion with a CAGR of 15.6%), is it therefore exempt of any flaws? The realistic and pragmatic answer is no.

For example, the industry itself is and usually remains labor-intensive, heavily under-automated (especially the AML/KYC processes), and still embeds many manual processes despite emerging applications and digital platforms from FinTechs or legacy IT firms. It is also complex to value new assets or businesses which do not yet exist, especially when a comparison with current indexes, market data, or previous transactions is not feasible nor available. This hinders the use of classical valuation models and therefore requires a robust methodology, powerful tools, and sophisticated internal resources. This need for high-level experts and talent represents an interesting but also serious challenge, since these specialized profiles require well-trained candidates with the right level of technical, theoretical knowledge (as provided by recognized, but selective University programs) and, most importantly, direct exposure to the sector. This is a long process which calls for time, continued efforts, a good corporate culture (to extend the retention rate), and a degree of flexibility since energetic talents can sometimes be rather impatient, expect early and 'tasty' packages, need strong mentorship/leadership, claim

direct access to executives, and require hands-on experiences with responsibilities.

Data is another rather difficult fish to catch and to consolidate. This should not come as a surprise since it is naturally embedded in the industry's DNA and usually composed of private capital injected into private markets through non-public transactions and dedicated to selected categories of investors (e.g. institutional, professional investors, family offices, private high-net worth individuals). Thanks to industry efforts such as those by Invest Europe and the different national European PE/VC associations, some statistics have been collected and treated in order to provide a more holistic overview, next to some specialized financial information providers which also have invested a great deal of time in order to be work on global reports, estimates, and trends, in collaboration with the industry and the inevitable use of manual surveys.

Data is another rather difficult fish to catch and to consolidate.

Nevertheless and despite some of those characteristics, the industry's success, performance, and resilience have been validated in recent years by the tremendous and continued investors' appetite which has fully empowered its growth. It is important to underline that the value creation process, as described above, has softened the

discussion around the limited liquidity of PE funds (classical PE structures being for a majority closed-ended with an expected lifetime of a decade). This was unfortunately and wrongfully perceived as a risk, while missing the exact rationale of patiently boosting companies and increasing their intrinsic value without any quarterly pressures as experienced in the publicly listed space.

The industry is also receiving many optimistic signals from tech innovators which have the ambition to digitalize the sector and accelerate its evolution.

Finally the opening up of practitioners to more transparency, increased reporting (financial and non-financial including the important ESG criteria), and prevalent success stories have also led to more interest from smaller investors who would like to access the PE asset class and benefit from its returns and strengths. This opens a new paradigm: the democratization of PE. This could represent a tremendous injection of additional capital, but only with the right set-ups and the availability of adequate solutions which could deliver strong returns and a great portion of diversification to many portfolios.

We have truly entered the golden age for the private equity industry.



Measuring the value of human capital

HUMAN CAPITAL IS ONE OF THE LARGEST DRIVERS OF VALUE

INTRODUCTION

Human capital refers to skills, knowledge and experience possessed by an individual or population, viewed in terms of their value or cost to an organization or country. Within our Environmental, Social and Governance frameworks at Capital Group, human capital is identified as one of the largest drivers of value.



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The importance of human capital

In our analysis of companies, we see several clear areas where human capital can have a material effect on financial results:

- Attracting, developing and retaining the right people
- Supplying sufficient training for workers to take on new skills and technologies
- Building diverse, innovative, purpose-driven cultures
- Maintaining positive labor relations and preventing strikes and stoppages

companies to effectively measure and report on human capital management. We consider these to be the most valuable to investors and most reasonable to report across all industries and countries.

Quantitative data is critical to helping us differentiate companies, understand risk and opportunity and ask evidence-based questions to management. From that foundation, qualitative data, either disclosed in company reporting or shared through dialogue with management, can provide context.

Five essential indicators to measure human capital

We believe there are five indicators that enable

Figure 1. Five essential indicators to measure human capital

Indicator	Description
Total cost of the workforce	Salaries, wages, bonuses and pension benefits of all employees
Employee turnover	Voluntary involuntary exiting and incoming employee data points
Demographic data	Gender, race, ethnicity and other measures of diverse representation across various levels within the firm
Skills and training	Total training days, types and costs
Culture and engagement	Surveys exploring employees' attitudes to work and their firms, e.g., purpose, well-being and empowerment

High importance, low disclosure

Despite the importance of human capital, very little information is currently disclosed by companies. We measured the level and consistency of human capital disclosure within sectors and regions and found gaps that are largely driven by regulation. Poor, inconsistent disclosure could mean that human capital is undervalued by the market.

Without this disclosure, it is more difficult to understand elements like minimum wage, median wage and productivity, and to determine the impacts from upward wage pressure or increased competition for talent. Other major reporting gaps are around areas such as

diversity, employee turnover and investment in skills and training.

Poor, inconsistent disclosure could mean that human capital is undervalued by the market.

Three major trends underscore the investment implications

Three secular trends are making the need to accurately

measure and value human capital increasingly clear:

01. Persistent inequality could increase employee activism and work stoppages

Low wages, pay gaps and inequality are persistent across many industries and regions. In the U.S., workers' compensation is a declining share of GDP, hourly compensation isn't keeping pace with productivity, and significant gender and racial pay inequity remain (and has potentially widened throughout the pandemic).

Employees across almost all industries are coming together more frequently to push for change.

Demands include anything from increasing wages and benefits to halting potentially unethical defense contracts to ending racial and gender discrimination. For example, in January 2021, more than 200 Google and Alphabet workers formed the Alphabet Workers Union. Members of the union contribute 1% of their yearly compensation toward union dues, which would be used to help compensate individuals for lost wages during a strike.

General Motors' six-week worker strike in 2019 resulted in US\$3.6 billion in lost production (44% of the company's earnings before

interest and taxes in 2019). It's reasonable to predict that the number and length of work stoppages will continue to increase given the economic strain on low- and medium-wage workers compared to high-wage workers throughout the pandemic.

Employees across almost all industries are coming together more frequently to push for change.

02. Changing workplace preferences

Before the coronavirus pandemic, U.S. unemployment was at record-low levels and employees had record-high confidence in finding new jobs. This led to an increased rate of changing jobs. As economies recover and reopen, many employers report difficulty finding hourly workers.

Employees have started looking for benefits beyond basic wages (after reaching a minimum level), including work-life balance, health benefits, financial planning benefits, training opportunities and a purpose-driven culture.

Employees and job seekers report valuing work environment, training and development higher than financial compensation.

Figure 2. 2021 most wanted job characteristics



Source: Mercer Global Talent Trends 2021

In 2021, while compensation is still the highest priority for employees, benefits related to health and financial well-being are increasingly important. Employees also report being more motivated by the opportunity to do purposeful work versus the opportunity to get promoted. In contrast, the same study released in 2017 reported that employees' most wanted job characteristics were: (1) fair and competitive compensation, (2) opportunity to get promoted and (3) leaders who set clear direction¹.

Company culture may be intangible, but it is essential to attracting, retaining and motivating people. One notable academic study found a link between employee satisfaction and long-term value over a 25-year period. The research concluded that the "100 Best Companies to Work for in America" earned an annual four-factor alpha of 3.5% from 1984 to 2009, 2.1% above industry benchmarks².

03. The need for innovation and new skills

As trends such as digitalization, automation and energy transition take hold, workforces will start to look dramatically different. There could be more competition for hiring and retaining employees with highly sought-after skills — such as those supporting cloud computing, big data and e-commerce.

Several forward-looking companies have taken steps to retrain their current workers rather than hiring new ones. Amazon is one of those with US\$700 million investment³ in worker training.

Corporate balance sheets have already transformed from tangible to intangible assets, including things like patents, software, brands and data, all of which are driven and sustained by human innovation. In 2020, approximately 90% of S&P 500 value was in intangible assets, which is in sharp contrast to 32% in 1985. This shows the pace of digitalization within firms,

which is often faster than workers can develop new skills.

Amazon is one of those with US\$700 million investment³ in worker training.

CONCLUSION

Most industries will be materially affected by ongoing human capital trends, if not experiencing the impacts already. Increased systematic human capital disclosures are an opportunity to understand how companies manage people, differentiate leaders and laggards, and identify those that can create a competitive advantage.

Endnotes

- ¹ Mercer, "Talent Trends: 2017 Global Study," (Mercer LLC, 2017).
- ² Alex Edmans, "Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices." *Journal of Financial Economics*, September 2011.
- ³ Amazon, "Amazon Pledges to Upskill 100,000 U.S. Employees for In-Demand Jobs by 2025," press release, July 11, 2019.

TO THE POINT

Most industries will be materially affected by ongoing human capital trends, if not experiencing the impacts already. Increased systematic human capital disclosures are an opportunity to understand how companies manage people, differentiate leaders and laggards, and identify those that can create a competitive advantage.



Navigating the ever-evolving ESG landscape

THE VIEW FROM THE CAYMAN ISLANDS



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INTRODUCTION

Skepticism surrounding ESG and responsible investing persists, but this sentiment has abated as a growing body of academic research supports that the integration of ESG factors into investment analysis can drive alpha. Even the most ardent of skeptics can usually concede that integrating ESG aspects into their day-to-day decision-making process is a very important risk mitigation tool. In fact, many investment management companies have been applying social and governance factors for years, just not necessarily labelling them as “S” or “G.” For example, analysts considering a target company’s workers relations or managers shorting companies where the CEO is also the chairman are both indicators of poor corporate governance.

The “E” component is relatively new but has gained considerable momentum in the drive to achieve net-zero goals. The issue of energy security has resurfaced because of Russia’s invasion of Ukraine and led to accusations that the green agenda has been abandoned. On the contrary, while the fallout from the war has increased oil and gas prices in the short term, the crisis has the potential to be the catalyst for a full-scale change as to how Europe (and the world) sources its energy and will potentially accelerate the move from carbon-intensive energy sources, as renewables resemble a cheaper and more secure alternative.

In this interview, Lawrence Usher of Deloitte and Rebecca Palmer of Waystone Governance, examine ESG trends and discuss recent developments in associated regulations to assist in navigating this ever-evolving landscape.

Lawrence Usher (LU): Is ESG a choice or a necessity?

Rebecca Palmer (RP): ESG is no longer a choice; it is a necessity for long-term success among managers looking to capture a greater share of the growing allocation to ESG as estimates suggest that such mandated assets could make up half of all managed assets in the United States by 2025. Taking into account the institutionalization of investors and the collective pressures they have exerted on investment managers, considering ESG aspects in your day-to-day decision-making process, is now more often a prerequisite for attracting inflows, managing risks, and creating long-term value. The consideration of ESG factors will become increasingly critical to the success of businesses across all sectors and is not just limited to investment funds.

The profile of ESG will continue to rise and become more relevant over the next few years as the next generation take control of companies and are left to deal with societal challenges (from gender and race equity, to pay equality and social mobility) and the consequences of climate change on businesses and society as a whole. Millennials and Generation Z are more concerned with a well-run company that is mindful of the social environment they are operating in and are often more concerned with putting social responsibility over profits.

LU: How is Cayman approaching ESG?

RP: As one of the world's leading international financial centers, the Cayman Islands regulates an estimated 12,046 mutual funds and 14,679 private funds sponsored by investment

managers across the globe. Thus, Cayman has a key role to play in promoting responsible investing. With that in mind, the Cayman Islands Government is currently working on a legislative framework for the implementation of ESG criteria for Cayman's financial services industry.

Mutual funds and private funds with more than one investor are regulated by the Cayman Islands Monetary Authority (CIMA). As these funds are typically sponsored by investment managers located overseas, the regulatory nexus is to the funds, rather than the investment managers, which differs from other jurisdictions such as the UK, where it is the investment managers that are regulated.

While it is not yet known how the new legislative framework will look, it seems likely that any regulation will be directed at regulated funds, given both their significance and the regulatory nexus.

The consideration of ESG factors will become increasingly critical to the success of businesses across all sectors and is not just limited to investment funds.

On 13 April 2022, CIMA released a circular on ESG and sustainable investing, which noted:

"Sustainable investing is a complex and developing subject and the expectations and practices around ESG-related risks are also quickly evolving. As such, there is a growing need for regulated funds to better understand the impact of ESG-related risks in their implementation of this investment strategy. At a minimum, those charged with governance of regulated funds should have clear roles and responsibilities in managing and mitigating the risks from climate change and other ESG-related risks in line with the fund's set investment objectives and should start establishing reliable approaches for identifying, measuring, monitoring, and managing material ESG-related risks. Additionally, funds are required to ensure clear and ongoing disclosures in the context of their reporting requirements."

The circular also noted that, as part of its supervisory mandate, CIMA will continue to undertake reviews and assess available information, such as best practices undertaken in other key financial jurisdictions, with the aim of developing a suitable regulatory and supervisory approach for climate-related and other ESG-centric risks.

As a fiduciary, I wholeheartedly endorse the stance taken by CIMA as it relates to those charged with governance. It is imperative that both fund directors and investment managers have a clear understanding of ESG and that the associated policies are fit for purpose and are in place with an appropriate level of oversight.

LU: The United Nations Principles for Responsible Investment (UNPRI) recently released a piece



on tax transparency outlining the concepts of tax fairness and encouraging investors to adopt and embed fair tax principles as part of their responsible investing mandates. How do you see Cayman responding to this?

RP: The outcome of the Cayman Islands' tax neutrality, as it relates to the financial services industry, is to allow for a single layer of taxes to be paid in the onshore jurisdiction where the investor is tax resident. A retiree withdrawing their pension may pay taxes in their country of residence on that income, however, it is widely accepted that it would

be unfair and inefficient for the investment fund in which they are invested to also pay taxes and potentially reduce their pension even further. The system of double tax treaties aims to prevent the double taxation of an individual's savings. However, it can be cumbersome and overly bureaucratic. In the case of the Cayman Islands, an additional layer of taxation is considered unnecessary. If we think about the purpose of taxation, it is principally to generate revenue for the provision of services and to support community needs. The Cayman Islands

is fortunate to have a highly educated population, high employment rates, and a small population such that it can support its local community, without the additional tax revenue sources necessary in other jurisdictions.

The Cayman Islands has a robust regulatory environment that combats tax evasion. The Cayman Islands enacted The International Tax Co-Operation (Economic Substance) Act on 1 January 2019, as part of Cayman's obligations as a member of the OECD to address Base Erosion and Profit Shifting (BEPS). The Cayman Islands is one of more than 90 countries that agreed to implement the Common Reporting Standard (CRS). The Cayman Islands Tax Information Authority (TIA) is responsible for ensuring CRS compliance and enforcement and has extensive powers to levy hefty penalties for noncompliance.

The Cayman Islands is one of more than 90 countries that agreed to implement the Common Reporting Standard (CRS).

As a jurisdiction, the Cayman Islands promotes tax transparency and has a robust regulatory environment to prevent tax evasion. As part of responsible investing practices, a company should review its tax practices and ensure that it is operating

in jurisdictions that are complying with global norms such as CRS.

Aggressive tax practices do not align with responsible investing, and companies pursuing overly aggressive tax practices will continue to attract negative press, which will ultimately and adversely impact their share price.

LU: How important is the regulatory environment to the implementation of responsible investing?

RP: A robust regulatory and legal environment is essential to the effectiveness of financial markets, a sentiment that is echoed by our regulator, the CIMA's mission statement: "To protect and enhance the integrity of the financial services industry of the Cayman Islands."

On most ESG due-diligence questionnaires, there will be sections that ask about anti-bribery and corruption policies. Such questions should also be asked of the jurisdictions in which investment funds operate. There is a renewed focus on anti-money laundering (AML) following the Russian invasion of Ukraine and the resulting significant increase and jurisdictional divergence in the sanctioning of individuals.

As a jurisdiction, Cayman takes AML very seriously and has enacted stricter AML regulations than many of its competitive jurisdictions. For example, some jurisdictions only require the identification of ultimate beneficial owners with at least a 25% stake, while in Cayman that threshold is significantly lower at 10%. Cayman is, however held to a higher threshold than other jurisdictions, being deemed a

major financial center by the Financial Action Task Force (FATF).

On 25 February 2021, the FATF reported that Cayman is compliant or largely compliant with 39 of the 40 areas of technical compliance; this was further upgraded in October 2021 to be compliant or largely compliant with all 40 FATF recommendations – a significant achievement as some larger jurisdictions have areas that are deemed non-compliant or only partially compliant.

Cayman has a strong regulatory environment that goes hand-in-hand with responsible investing mandates and remains the world's leading domicile for alternative investment funds.

LU: What challenges in implementing ESG do managers of Cayman funds face?

RP: Managers face different pressures dependent upon the needs of their investors, their investment strategies, and their regulators. As a result, investment managers face different challenges and are at different stages of their ESG journey.

ESG is not a one-size-fits-all and it's important for an investment manager to consider their own investing philosophy and firm values, prior to developing their ESG policy. This should not be an off-the-shelf product, whilst it can be very helpful to work with ESG advisors or compliance consultants on developing an ESG policy, this should be bespoke to the firm. Investment managers need to be able to clearly articulate their vision and how they are applying ESG to their portfolios, be that exclusionary or full integration.

Investment managers also need to clearly understand their investors' evolving needs and ESG reporting should be geared to meeting those needs.

ESG data quality continues to improve, but I would be remiss not to note that coverage is still frequently limited to larger Western companies. There are currently no global norms on disclosures, and information that is used by ESG-ratings services is often self-reported and unaudited.

For private equity and debt managers, there is no global consensus as to what information should be collected from portfolio companies and SMEs may struggle to meet the demands around collecting data on carbon emissions. There are, however, some great tools out there to assist with this.

A lack of ESG expertise is still a significant barrier to ESG investing, and it is often necessary to rely on external expertise to develop the necessary frameworks and policies.

LU: How are you seeing investors' ESG demands evolve?

RP: It is now very common to see ESG forming part of the due diligence investors are performing on prospective investment managers. The extensiveness of this process can catch some investment managers off guard with a common reaction being, "We're not an ESG fund. Why are we being asked this?"

As investors need to report back to their own stakeholders (e.g., university-endowment funds are coming under increasing pressure from their student bodies to ensure they

are investing responsibly), they are seeking to collate the data they need from their investment managers.

A lack of ESG expertise is still a significant barrier to ESG investing, and it is often necessary to rely on external expertise to develop the necessary frameworks and policies.

ESG due-diligence questionnaires can number many pages, and it is helpful for investment managers, including those who are not running ESG mandates, to spend some time considering how they will address these questions. Even where ESG is not applied at the product level, investment managers should expect to be asked whether they have an ESG or responsible investing policy and be prepared to answer why there is not one in place.

Where there is an established responsible investing policy, investors are looking beneath the hood to understand how it is applied in practice. Appropriate oversight and senior level engagement is expected.

Side letters are another area where investors are increasingly including specific ESG criteria and requesting specific ESG metric reporting.

LU: Inclusion and diversity is a central component of ESG. What best practices are you seeing?

RP: Many leading investment managers have become signatories to the Institution of Limited Partners Association's (ILPA) Diversity in Action pledge. The ILPA has also updated its due-diligence questionnaire to enhance the questions asked around diversity, equity, and inclusion together with a useful diversity metrics template to assist investment managers in collating data. Investment managers should expect to answer questions on their own diversity statistics and what they are doing to promote an inclusive culture. Investors increasingly expect to see family leave policies and a code of ethics that covers discrimination and to understand how recruitment process addresses diversity in the workplace.

If we take gender diversity, women still have a long way to go to come even close to the number of investment or finance executive roles that men currently hold. Deloitte counts itself among 100 Women in Finance's (100WF) Leadership Council, and Odette Samson from Deloitte Cayman sits on the Global Advisory Council of 100WF. So it is great to see Deloitte's commitment to the diversity agenda. 100WF's guiding principle is Vision 30/40, with a goal for women to occupy 30% of senior investment roles and executive committee positions by 2040. A common industry complaint is that they cannot attract female candidates. Looking at the way in which job advertisements are written, evaluating internship programs, and using nontraditional methods

of recruiting could address this. For example, those investment managers seeking to address gender diversity within their own firms can also look to advertise positions via 100 Women in Finance, a job board that is available to the organization's 20,000 plus global members.

LU: Waystone has been operating as an institutional governance provider for over 20 years, as a fiduciary how do you see the G in ESG?

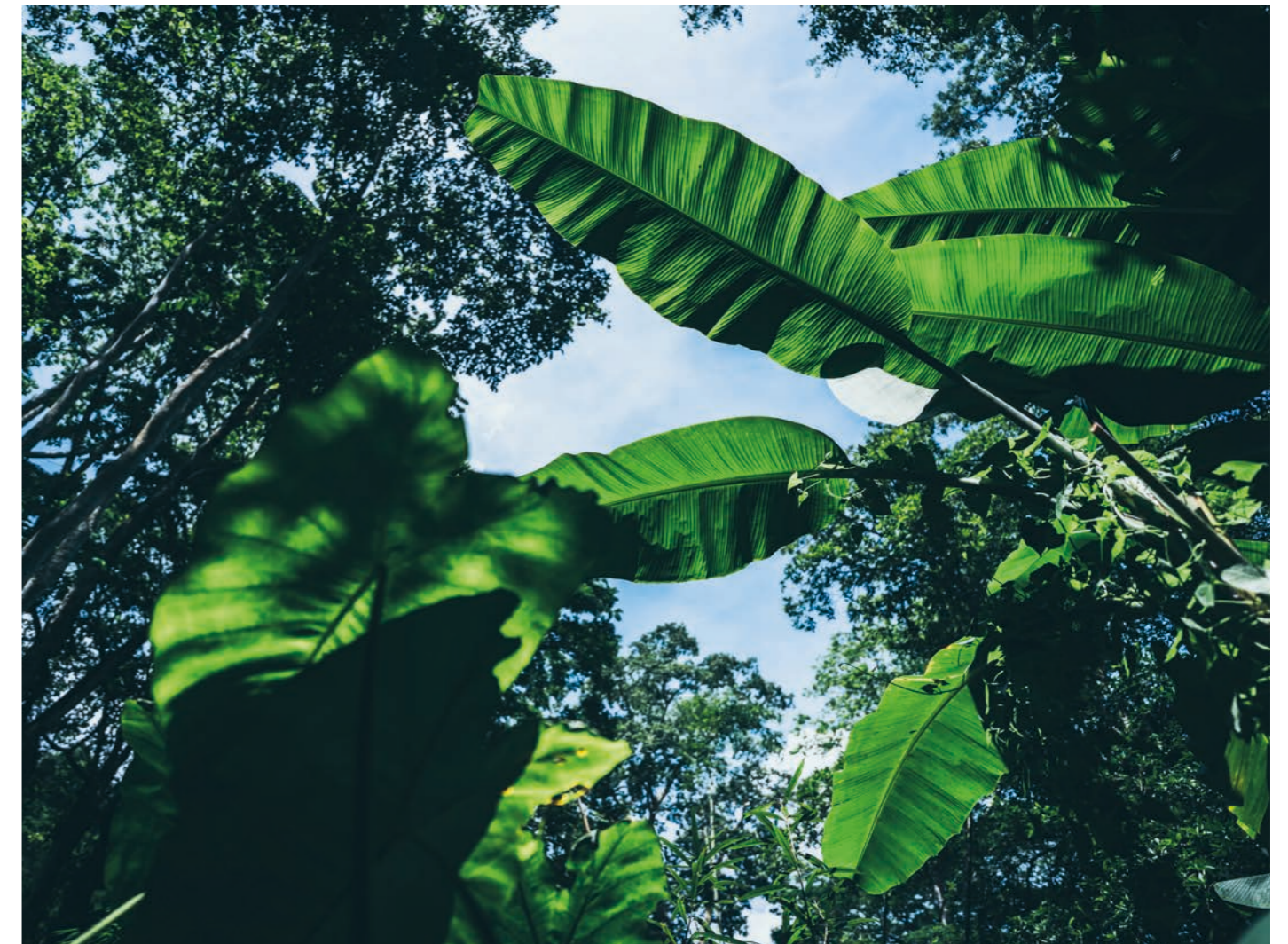
RP: Governance, perhaps unsurprisingly, is the most critical pillar within ESG. If the governance piece isn't right, it will be almost impossible to gain traction on the E and the S.

Corporate governance provides a framework for achieving objectives and a system of policies and procedures that dictate corporate behavior. Governance provides the oversight to ensure compliance with laws and regulation, in addition to internal policies and procedures, and protects the interests of all stakeholders.

Governance, perhaps unsurprisingly, is the most critical pillar within ESG.

Bad corporate governance can lead to loss of trust, which can have a material impact of profitability as seen in among high-profile corporate failures.

Governance is not only a factor to examine as part of investment analysis, it is also a core component in any responsible investing



framework; having those with the right expertise and knowledge at the table can make all the difference. The SEC's risk alert issued in April 2021 highlighted observations of deficiencies and internal control weaknesses from examinations of investment advisers and funds regarding ESG investing. During examinations of investment advisers, registered investment companies, and private funds engaged in ESG investing, instances of potentially misleading statements regarding ESG investing processes were observed.

However, the SEC also found that where compliance

personnel were integrated into ESG-related processes and were knowledgeable about ESG approaches and practices, these firms were more likely to avoid materially misleading claims in their ESG-related marketing materials and other client/investor-facing documents. For those investment managers struggling to navigate ESG, working with an external advisor or compliance specialist can really make a difference. Having independent board directors with specialist knowledge on advisory or responsible investing committees, can be a powerful way to stay on course and avoid greenwashing.

The SEC's risk alert issued in April 2021 highlighted observations of deficiencies and internal control weaknesses from examinations of investment advisers and funds regarding ESG investing.

LU: What are key developments that will benefit managers of Cayman funds?

RP: On 21 March 2022, the SEC released details of its much-anticipated proposal for climate disclosures. The proposal would require domestic and foreign registrants to report on climate-related risks and the impact of their businesses, plans to address those risks, and greenhouse gas emissions.

The SEC proposed rule amendments that would require a domestic or foreign registrant to include certain climate-related information in its registration statements and periodic reports, such as on Form 10-K, including:



Climate-related risks and their actual or likely material **impacts** on the registrant's business, strategy, and outlook;



The registrant's **governance** of climate-related risks and relevant **risk management processes**;



The registrant's **greenhouse gas (GHG) emissions**, which, for accelerated and large accelerated filers and with respect to certain emissions, would be subject to assurance;



Certain climate-related **financial statement metrics and related disclosures** in a note to its audited financial statements; and



Information about **climate-related targets** and goals, and **transition plan**, if any.

The proposed disclosures are similar to those that many companies already provide based on broadly accepted disclosure frameworks, such as the Task Force on Climate-Related Financial Disclosures and the Greenhouse Gas Protocols.

Asset managers listed in the US will need to comply with the new rules once finalized, but the impact of the new rules on the wider industry is substantial, as it will significantly improve the quality of available data. Investment managers integrating ESG risks into their portfolios will have reliable carbon data upon which to make informed decisions about risks and opportunities.

The SEC's announcement was followed only a few days later by the IFRS Foundation and Global Reporting Initiative (GRI) announcing a collaboration agreement under which their respective standard-setting boards, the International Sustainability Standards Board (ISSB) and the Global Sustainability Standards Board (GSSB), will coordinate their standard-setting activities.

This collaboration has the potential to significantly address one of the key challenges around inconsistencies in terminology and lack of convergence in sustainability reporting.

I'm personally excited to see the progress being made in the space and given the strategic priority now being given to disclosure consistency and assurance over key ESG metrics, I believe this further elevates the critical role that the audit profession plays – not only in keeping our financial markets safe but also the broader responsible investing agenda.

TO THE POINT

01. In the wake of societal shifts as we emerge from the COVID-19 pandemic and confront the ever-looming global climate crisis, there is increased pressure on investment management companies to include environmental, social, and governance (ESG) aspects into their everyday decision-making process.
02. Investors, stakeholders, employees, suppliers, lenders, regulators, and other stakeholders are demanding companies consider how their business impacts the world, their contribution to society, and how they conduct themselves on a day-to-day basis.



Modernization through regulation

TWO YEARS ON, WHAT HAVE WE LEARNED FROM THE CAYMAN ISLANDS' PRIVATE CAPITAL FUNDS REGULATORY REGIME?



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INTRODUCTION

In February 2020, the Cayman Islands introduced the Private Funds Act, regulating closed-end private funds for the first time. Expanding on its established mutual funds regime for open-end funds, the new regulation's purpose was to improve access and quality of information available to its regulator, enhance confidence in the jurisdiction across stakeholders, and set the stage for continued growth in the private capital sector. This article examines the global regulatory trends that led to an enhanced regulatory framework, implementation of key provisions to comply with the Private Funds Act, including registration statistics, and an analysis of registration and operating requirements of the modernized regulatory measures.

Regulation of investment funds has been an established practice in the Cayman Islands and other jurisdictions globally for decades. Open-end investment funds have been regulated by the Cayman Islands Monetary Authority (CIMA) since the introduction of the Mutual Funds Act in 1997. The regime was further enhanced in 2003 when CIMA gained operational independence from Government giving it full rein to exercise its powers in meeting international standards of supervision and regulation. Led by a vision of creating a thriving, innovative, and well-regulated financial services system¹, CIMA sought a balanced approach to meet applicable international standards while providing value to stakeholders—and it worked.

Regulation of investment funds has been an established practice in the Cayman Islands and other jurisdictions globally for decades.

The Cayman Islands quickly became a leading international financial center known for its stable political environment and top tier legal, accounting, and fiduciary experts, offering unequaled expertise and stability to stakeholders. While CIMA's oversight of mutual funds was long established, the complex population of Cayman Islands-domiciled private funds remained largely unregulated.

The changing landscape

The acceleration of globalization in recent years has led the Organization for Economic Co-Operation and Development (OECD) to revisit cross-border transactions in the spirit of fairness. In 2015, the OECD introduced the Base Erosion and Profit Shifting (BEPS) Initiative which seeks to reform international tax rules and ensure that multinational enterprises pay a fair share of tax wherever they operate². The Cayman Islands counted itself among the initiative's early adopters, alongside 137 countries signed up to implement BEPS' 15 Actions. The first Action under³ review was Action 5 on harmful tax practices, focusing on transparency, and substance. Action 5 seeks to ensure that where a company is domiciled and tax resident, it also maintains a physical presence and discharges key operating activities that support its revenues being taxed in that jurisdiction and not elsewhere.

Applying the concept to an investment fund, however, was not so clear-cut. The OECD understood that an investment fund, being a structure that pools capital but outsources all aspects of its management, did not fit within the concept of economic substance. Given a fund cannot reasonably demonstrate physical presence due to its very nature, an acceptable remedy for this issue was to subject unregistered investment funds to an appropriate level of regulatory oversight. Similar to other member jurisdictions, the Cayman Islands quickly set about enhancing its regime and enacted the Private Funds Act in February 2020.

The Private Funds Act is intended to regulate Cayman-domiciled closed-end private funds and AIVs that are pooling capital and offering interests to investors.

Key stakeholders impacted by the Private Funds Act

The 'operator' of a closed-end fund is responsible for registration, compliance with ongoing operating requirements, and the fund's regulatory reporting obligations. Given the importance of this role, the operator must be a natural person from the applicable governing body (e.g., board of directors, general partner, or trustee). Failure to register or other instances of non-compliance may carry substantial monetary penalties for the operator personally, and CIMA has communicated that fines will be issued for non-compliance. The basis for such actions is expected to be proportionate to the infraction and within the range of prescribed dollar amounts.

The 'four-eyes' principle applies to operators of a closed-end fund, whereby a minimum of two directors for companies, or two natural persons for general partners and corporate directors, must be named for each registered fund.

Scope of the Private Funds Act: When is registration required?

Careful consideration of all elements of the definition of a private fund must be made in order to determine whether a

closed-end fund falls within the scope of the Private Funds Act, and would ultimately result in registration as a private fund with CIMA.

The Cayman Islands counted itself among the initiative's early adopters, alongside 137 countries signed up to implement BEPS' 15 Actions.

Closed-end fund managers should be mindful that registration must be accomplished within 21 days of accepting any capital commitments and in no circumstances prior to calling any capital. Most Cayman-based legal advisors have developed efficient processes for raising, launching, and registering funds that can easily meet client's timing needs.

The definition of “private funds” in the context of the Private Funds Act includes any closed-end funds whereby:

- The fund is established for more than one investor;
- It is established as a company, unit trust, or partnership;
- It offers, issues, or has issued investment interests to investors with the aim of enabling investors to receive profits or gains from such activities;
- The investors do not have day-to-day control over the fund’s investment activities; and
- The investments are managed as a whole by or on behalf of the fund operator, either directly or indirectly.

The Private Funds Act explicitly exempts certain “non-fund” arrangements. Some examples of non-fund arrangements include:

- Securitization special purpose vehicles;
- Joint ventures;
- Proprietary vehicles;
- Holding vehicles;
- Structured finance vehicles;
- Employee incentive schemes;
- Sovereign wealth funds;
- Single family offices; and
- Funds listed on a stock exchange.

Operating requirements

The Private Funds Act obligates registered funds to comply with several operating provisions. These provisions are modeled after the ESMA guidance for regulation of alternative investment funds. Operators continue to actively consult with compliance professionals, independent advisory board members, and their Cayman-based legal and accounting professionals.

Registration checklist

- REEFS Application Form (APP-101-77);
- Certificate of Incorporation/Registration (as applicable);
- Constitutive Documents (Memorandum and Articles of Association/Trust Deed/ Declaration of Partnership (as applicable);
- Offering Memorandum/Summary of Terms/Marketing Material (as applicable);
- Auditor’s letter of consent;
- Administrator’s letter of consent (if applicable);
- Structure chart; and
- Application Fee CI\$300 (US\$365).

More information on [CIMA’s gazette here](#), or their [Investment Funds FAQ section here](#).

CIMA’s framework for regulation recognizes that compliance regimes should be fit for purpose, and therefore a variety of approaches to satisfy the operating requirements may be acceptable as long as any inherent conflicts of interest are identified, managed, monitored, and disclosed to investors. In keeping with CIMA’s pragmatic and risk-based approach to oversight, the requirements have been discharged with minimal impact to fund managers’ existing operations and infrastructure.

The Private Funds Act obligates registered funds to comply with several operating provisions.

While certain operators have been exercising the necessary due care in upgrading their own compliance and reporting practices, our experience has

largely been that the prescribed operating requirements have essentially codified commonplace industry best practices.

Adoption of the operating requirements was also a positive outcome for managers who concurrently reviewed their compliance and regulatory reporting programs, which offered the opportunity to harmonize various global-reaching internal compliance programs, all while revisiting and mitigating any identified gaps.

Fund Annual Return

The Fund Annual Return is required to be completed by the operator and is subsequently submitted by the local auditor or other CIMA-approved third party. The Fund Annual Return includes select information related to the closed-end fund, its investors, portfolio, service providers, and related entities of the fund (co-invest funds, parallel funds, and AIVs). A signed declaration from the operator attesting to the fund’s compliance with certain operating requirements is also required. These items are to be submitted alongside

the audited financial statements within six months of financial year-end.

Audited financial statements

Annual financial statements are required to be audited by an approved local auditor and submitted to CIMA within six months following fiscal year-end.

The requirement to submit annual audited financial statements had a largely benign impact to fund managers as existing limited partners or other regulators generally required distribution of audited financial statements; and CIMA accommodated existing industry practices of combined financial reporting to suffice for their purposes.

The introduction of the locally approved auditor regime was new to some private capital managers, however, this approach mirrors the longstanding practice in place for hedge funds under CIMA’s purview. CIMA is able to establish a local point of contact for all funds subject to its oversight by leveraging local expertise and the global networks of the approved audit firms. Auditors are obligated to notify CIMA in writing upon becoming aware of a fund that:

- Is likely to be or currently insolvent;
- Is operating in a prejudicial manner to investors;
- Has insufficient books and records to prepare financial statements;
- Is attempting to carry on business in a fraudulent or criminal manner; and/or
- Is in non-compliance with the Private Funds Act and other AML/KYC requirements.



In practice, accounting firms auditing CIMA-regulated hedge funds have a history of notifying CIMA of any such irregular scenarios, which is largely viewed as enhancing the effectiveness of the regulatory regime while optimizing the footprint of CIMA’s internal team of trained analysts and supervisors.

Valuation

The Private Funds Act requires that a closed-end fund’s investment portfolio be fair-valued at least annually. Many fund managers employ third-party valuation agents to value their portfolios in part or whole. As a means of balancing the cost with the benefits of this requirement, the valuation function may also be performed in-house, by someone independent of the portfolio management

function. If it is not practical or proportionate to employ a third-party or delegate valuation to an independent individual, conflicts of interest must be disclosed.

The Private Funds Act requires that a closed-end fund’s investment portfolio be fair-valued at least annually.

Custody

The Private Funds Act requires that a closed-end fund appoints a custodian(s) to hold custodial assets in segregated accounts.

Custodial fund assets would generally include assets that are capable of being transferred and held in custody by a custodian, such as cash and listed securities. If not practical based on the nature of assets, a closed-end fund may notify CIMA and disclose any conflicts of interest.

Cash monitoring

The Private Funds Act requires that a closed-end fund appoint a person to monitor all cash and ensure payments made from investors for investment interest have been received by the fund. This function can be outsourced to an independent third-party such as an administrator. Conflicts must be disclosed if the function is performed by the fund manager.

The form of such conflict of interest disclosures related to the above operating requirements is not prescribed; however, industry norms for disclosure of conflicts of interest in LPAs largely sufficed. Any necessary revisions have been adopted by legal practitioners with minimal impact.

CIMA has also released various **rules, statements of guidance, policies, and procedures** over many of the operating requirements to assist registered funds in applying the general provisions of the Private Funds Act.

CONCLUSION

Two years later...

The Cayman Islands remains a leading jurisdiction for formation of investment funds. The introduction of closed-end funds to the Cayman regulatory regime has proven to increase transparency, investor protection, and confidence in the jurisdiction.

- In 2020, overall investment fund registrations increased more than two-fold to approximately 24,600 regulated funds on the back of 12,695 closed-end fund registrations;
- Further growth ensued in 2021, with:
 - Closed-end fund registrations increasing 16%; and
 - Open-end fund registrations increasing 7%.
- The 2021 year-end saw a record high of 27,398 regulated funds; and
- For funds sponsored by U.S. Securities and Exchange Commission-registered investment advisors, the Cayman Islands is leading the way on open-end funds and sits second only to the United States for closed-end funds.

The notable 16% increase in closed-end funds registrations in 2021 further demonstrates that investors and managers have adapted to the recently enacted global regulatory measures, and Cayman continues to be the domicile of choice for investment fund formations outside the United States.

Endnotes

¹ www.cima.ky/strategic-plan

² Base erosion and profit shifting - OECD BEPS

³ Action 5 - OECD BEPS

Figure 1. Hedge Funds - SEC Registered Advisers (Percentage of NAV)

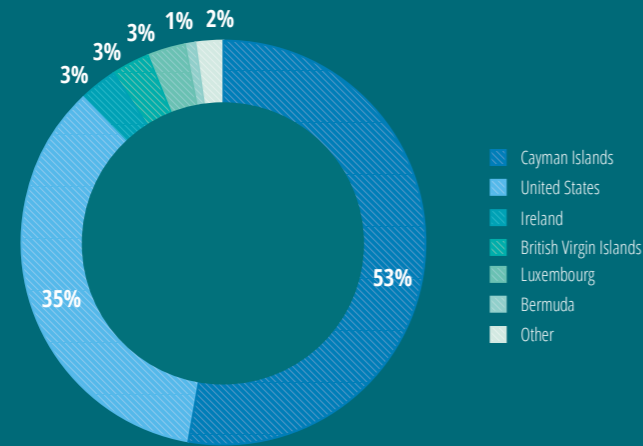


Figure 2. Private Equity Funds - SEC Registered Advisers (Percentage of NAV)

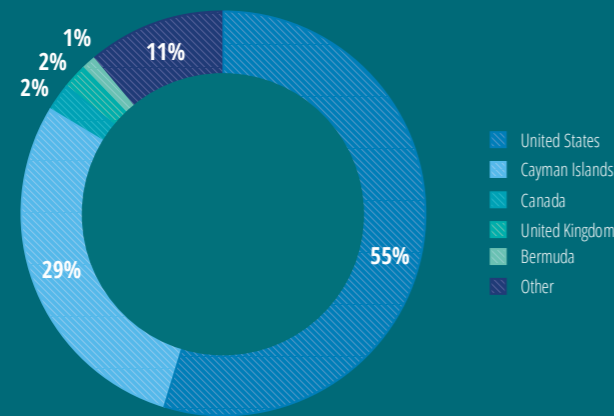
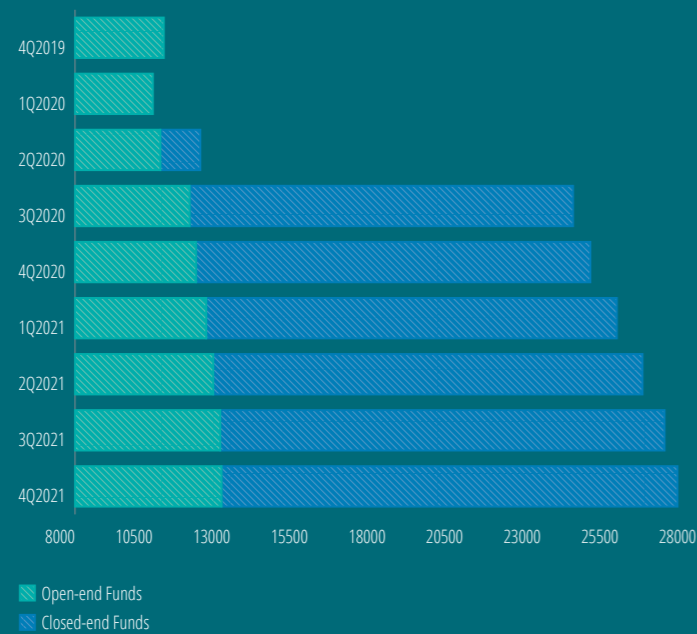


Figure 3: CIMA Registered Investment Funds



TO THE POINT

01. In February 2020, the Cayman Islands introduced the Private Funds Act, regulating closed-end private funds for the first time.
02. The introduction of closed-end funds to the Cayman regulatory regime has proven to increase transparency, investor protection, and confidence in the jurisdiction.
03. Our experience has largely been that the prescribed operating requirements have essentially codified commonplace industry best practices.
04. The notable 16% increase in closed-end funds registrations in 2021 further demonstrates that investors and managers have adapted to the recently enacted global regulatory measures, and Cayman continues to be the domicile of choice for private investment fund formations outside the United States.



ESG investing as the 'age of complacency' ends

HOW UNSHAKEABLE CAN THE DEFINITION OF ESG ACTUALLY BE WHEN SEISMIC GLOBAL EVENTS CHANGE THE LANDSCAPE?



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REGULATORY MANAGER
FE FUNDINFO

INTRODUCTION

01. The global political landscape has always affected ESG investing considerations.
02. We witnessed the volatility of global markets in reaction to the pandemic over the last two years.
03. But just as one epoch defining event perhaps nears an end, another one begins with Russia's invasion of Ukraine.
04. With war at the doorstep of Europe, how does the asset management world follow the wider economy in divesting from Russian exposure?
05. More importantly, how unshakeable can the definition of ESG actually be when seismic global events change the landscape?

Russia has seen huge economic sanctions across the world. For the asset management industry to follow suit and steer clear of Russian exposure as an ethical consideration, it must overcome complex challenges in a world now more globally connected than in a world now more globally connected than our forebears could have imagined.

Shifting ethics and exposure

One challenge is fully understanding the exact exposure of a fund's holdings, particularly regarding ESG. If complete visibility of a fund's holdings is unattainable, or there is only a partial view, it can be difficult to react to a rapidly changing and evolving situation like the one in Ukraine – where one asset or market is suddenly regarded as toxic.

Despite the challenge above, some major players in the investment industry responded quickly to the suspension of financial trading in Russia or have taken an unequivocally strong position. Liontrust suspended its Russia fund; Jupiter suspended its Emerging European fund, while abrdn and DWS have said they will not make any investments in Russia "for the foreseeable future." However, the speed at which different asset classes can respond to the sudden escalation of conflict varies, as many will be taken by surprise and forced to act quickly to adhere to their ESG commitments. For example, many companies announced their intention to withdraw from Russia such as BP, Shell, Apple, and Adidas.

But it is easier for an equity-based fund to divest itself from 'unethical' investments than it is for a property fund. Surges in

redemption requests can have serious implications for every fund, but it is felt particularly sharply among property funds at times of stress, as the gating of M&G's property portfolio showed toward the end of 2019. For every day the conflict goes on, liquidity across every fund facing redemptions will dwindle until the conflict resolves or the fund must gate.

But it is easier for an equity-based fund to divest itself from 'unethical' investments than it is for a property fund.

The conflict also shows how fluid the definition of ESG may be. Armaments and munitions, for instance, have long been considered an unethical investment. Yet the argument that armaments now constitute a "good" investment, in light of the changing security situation in Europe, holds some significance. Might the same apply to nuclear power if gas supplies are stretched (the director-general of the French Treasury said the war in Ukraine vindicates the inclusion of nuclear power in the EU's sustainable taxonomy) or to genetically modified foods if Ukraine's leading position as a wheat producer comes under strain?

This conflict, therefore, solidifies the opinion that investing in a "pure" ESG fund with no exposure to controversial industries, is practically

impossible. "It depends..." seems to be one of the few narratives that is consistent when it comes to ESG investing: armaments were once unethical, tobacco companies are promoting their "next-generation" products, and fossil fuel companies are transitioning to sustainable energy providers. Is alcohol still an unethical investment?

Investing in transparency

Another consistent principle that regulators strive toward is transparency. In a modern, global economy, where industries and services are interlinked, it can be very difficult for an investor to avoid every potentially "harmful" or "controversial" industry in their portfolios. Even the greenest of industries will have some exposure to fossil fuels in the supply chain. Wind power for instance requires turbines, which in turn require steel made by burning coal.

It is important, therefore, for investors to be fully aware of what their portfolios contain at the underlying holdings level. If they have a strong aversion to nuclear energy, gambling, or tobacco, they need to understand where their funds are investing. Greater transparency from investee companies, along with regulations such as the SFDR in the ESG space, are welcome regulations that enable ESG funds to react more quickly and exert their influence effectively in times of global crisis such as in Ukraine.

If, in times of conflict, ESG definitions are more fluid, then that will surely affect their long-term performance in relation to "traditional" funds. Throughout the pandemic, market conditions supported ESG funds' ability to generate

superior returns, but that was in an economy where technology stocks bolstered most ESG funds. Now as the "age of complacency" is potentially over, oil prices have soared past 2014 levels, and as no ESG fund is likely to have holdings in a major oil company, the ability to generate positive returns in this new global economy, excluding Russia, may prove challenging. Furthermore, if the "age of complacency" really is over, the difficult question must be asked: Can ESG as we know it perform as desired if a "new normal" befalls Europe and the zeitgeist reverts from prosperity and growth to defense and survival.

Wind power for instance requires turbines, which in turn require steel made by burning coal.

CONCLUSION

The peaceful and immediate resolution of the conflict in Ukraine should be the prime focus for every organization. The investment industry has a role to play, and it has been encouraging to see such a strong consensus by the industry to wield its power. Perhaps the increased awareness of ESG investing among asset managers and the pressure to emphasize social and ethical considerations at the heart of their operations has sharpened their thinking and quickened their action. If this is the case, then the argument for ESG investing is an even more powerful one.

From delivery mechanism to strategic lever: The future of funds



VARUN ATRE
HEAD OF PRODUCT
CALASTONE

INTRODUCTION

As fund managers consider how to evolve and enhance their distribution strategies, they are being confronted by two trends.

The first is demographic, with a growing body of evidence that the industry's client base is getting younger. In 2021, the median age of clients for the dominant UK fund platform Hargreaves Lansdown was 46, down significantly from 2007 when it stood at 58. The US story is similar, with Merrill Lynch reporting that a fifth of its new wealth management clients last year were under 45.

The second concerns the use of technology. Fund managers increasingly face competition from providers whose slick service is attuned to the needs of customers already well accustomed to seamless digital experiences. According to a 2021 Fenergo report titled *"Weathering the Crisis through Digital Transformation"*, most managers say that they have lost customers to "digital-first" competitors in 2020, rising from 78% in EMEA to 82% in North America and 93% in APAC.



The fund distribution of tomorrow

For managers, the implication of technology adoption and shifting customer demographics could not be clearer. It's a game of survival of the fittest: fail to overhaul distribution in a way that meets the needs of a more demanding customer base and risk losing them to competitors who will provide the speed, service, and tooling. These service details are increasingly the bottom line for many customers – and not just those in younger age groups.

This convergence of new technology and shifting

customer expectations represents a threat to managers, but it can also be an opportunity for those willing to grasp the digital imperative. Evidence suggests that many fund managers are beginning to adapt and seek a different kind of relationship with a new generation of customer. Following decades in which they have been comfortable with using fund platforms as their primary engine of growth, fund managers are now looking toward the benefits of direct relationships. A BNY Mellon study found that 80% expect to increase direct-to-consumer (D2C) as a distribution channel in the next three years.

Managers will not abandon the distribution channels that have served them well, but the D2C growth underlines a strategic imperative to move closer to the customer. As relatively anonymous entities to the many customers who invest in their products via platforms, fund managers have a desire to claw back brand recognition in a more competitive

landscape; according to a survey by Accenture, almost all managers (97%) consider brand to be a differentiator, but 25% fear their own does not stand out from the crowd.

For funds, the future of distribution is not just a question of channels and tools, but also one of strategy. Many are seeking not only to reach

Evidence suggests that many fund managers are beginning to adapt and seek a different kind of relationship with a new generation of customer.

a new category of customers, but to cater to them in different ways – with personalized recommendations, added-value services, and an experience closer to traditional wealth management than generic investment products. As distribution evolves, its role must be about more than efficiency of reach; in the emerging landscape of funds, it must also enable ambitious client service in an environment of ever-greater expectations.

Investing gets personal: the future of fund products

The question that follows is, *how can fund managers adjust the nature and structure of their*

investment products to retain customer loyalty and meet customer expectations?

For funds, the future of distribution is not just a question of channels and tools, but also one of strategy.

Foremost among these will be tokenization, or the use of distributed ledger technologies (DLT) that allow investors to hold assets as virtual entities

(tokens) stored on a ledger that provides a single, universally accessible record of ownership. Benefits of this approach include reduced costs and the ability to convey fractional ownership of assets that have typically been restricted to those with larger asset pools (infrastructure, some real estate and private equity).

Technologies such as DLT and artificial intelligence promise to change how fund managers can build products and provide services and widen the demographic to which these can then be offered. For the first time, it is becoming feasible that a customer with a relatively small asset base could now receive the kind of

investment service that would once have been reserved for high-net-worth or ultra-high-net-worth individuals. Once prohibitively expensive features such as separately managed accounts, direct indexing, and tax planning will likely become part of the mainstream offering as fund managers seek to expand their global reach – potentially bringing in a wider and deeper base of smaller accounts, all of whom can be served in more bespoke ways than before.

Industry research suggests that funds are looking to move quickly in this direction; 80% of asset managers surveyed by Accenture believe that “customization for the masses”

will be an important trend in the years ahead, while 61% are seeking to provide an “enhanced personalized client experience” according to BNY Mellon.

Such personalization will likely become increasingly important as funds target the rising numbers of Millennial and Gen Z investors, who are often more engaged with their portfolios and likely to have a strong opinion about which asset classes they do and do not wish to be invested in. A combination of tokenization, AI, and slick user experience (UX) means we are getting closer to a world in which an investor can self-select a portfolio personalized to their

interests and preferences, at the touch of few buttons.

Technologies such as DLT and artificial intelligence promise to change how fund managers can build products and provide services and widen the demographic to which these can then be offered.

That would be a dramatic departure for fund managers – bringing them into the territory of financial advisers and even threatening to make the traditional mutual fund obsolete. Yet it also carries the potential prize of making them indispensable to the investors whose decisions will shape the future of the industry.

The closer fund managers can become to these customers, and the more precisely they can meet their needs, the better placed they will be to navigate a challenging road ahead.

TO THE POINT

01. A convergence of new technology and growing customer expectations represents a threat to managers, but it can also be an opportunity for those willing to grasp the digital imperative.
02. As distribution evolves, its role must be about more than efficiency of reach; in the emerging landscape of funds, it must also enable ambitious client service in an environment of ever-greater expectations.
03. Technologies such as DLT and artificial intelligence promise to change how fund managers can build products and provide services and widen the demographic to which these can then be offered.
04. Personalization is going to be increasingly important as funds target the rising number of Millennial and Gen Z investors, who are often more engaged with their portfolios.
05. Tokenization, AI, and slick user experience (UX) mean we are getting closer to a world in which an investor can – at the touch of a few buttons – self-select a portfolio personalized to their interests and preferences.

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