



Opalesque Roundtable Series '19

CAYMAN

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Editor's Note

Many of the most successful businesses in the world operate on a highly outsourced model. After some initial skepticism, outsourcing has now also fully arrived in active fund management, with core management, IT and compliance functions outsourced to knowledgeable service providers. Hedge funds were early adopters of outsourcing (which can be charged back to investors) which is becoming more prevalent in private equity as well. While right now we may still hear conversations like, "As now you are at XXX million, so you should have your full-time CFO or your full-time IT or compliance people in place," over time those thresholds will further shift from where they used to be to a situation where outsourced people in certain roles will become the norm.

Artificial Intelligence to test the limits of outsourcing

When it comes to artificial intelligence, the questions around outsourcing are reaching a new dimension and tend to confound every current practice and legal considerations. We know that some managers have invested enormously in this technology. From a legal perspective, are those managers now outsourcing responsibility to a robot? A robot has no legal personality itself and therefore cannot be sued (as well as presumably not having assets). Presumably any claim or investigation would be against the manager, perhaps on the basis of negligence. And where two robots interact with each other on each side of a transaction there will be other interesting questions (page 25).

"Cayman Model" still hugely successful despite increase in regulation, CIMA now empowered to fine

In 2018 the number of Cayman registered funds grew from 10,559 to 10,992, and also in 2019 there are further increases in new registrations. CIMA has also to date registered around 80 mutual funds whose strategies include investing in cryptocurrency, blockchain technology, Fintech, outperforming or replicating the performance of cryptocurrencies and indices related to crypto assets. This 4% uptick in Cayman funds is very positive in light of other surveys which revealed that the number of total funds is declining globally with the maturity of the industry and continued consolidation.

Industry players also say that CIMA's empowerment to impose a range of administrative fines is to be welcomed, in that it allows CIMA to apply a more nuanced and proportionate approach than had previously been the case. Stakeholders in other jurisdictions have long since taken regulators' ability to fine for granted as a basic element of the regulatory toolbox. Find out in this Roundtable how and when CIMA expects to impose fines.

The Opalesque 2019 Cayman Islands Roundtable took place in George Town with:

1. Juliette Maynard, Deputy Head Investments Supervision Division, Cayman Islands Monetary Authority (CIMA)
2. Caroline Heal, Partner, Investment Funds Attorney, Walkers
3. Lucy Frew, Partner, Head of Regulatory & Risk Advisory, Walkers
4. Craig Smith, Partner, PwC Cayman Islands
5. Ronan Guilfoyle, Co-Founder, Calderwood

The group also discussed:

- CIMA's Statement of Guidance on Outsourcing (page 11-12)
- Criteria for outsourcing anti money laundering compliance (page 16). What does a "risk-based" regulatory approach really mean? (page 13-14)
- **Applying the AML framework to private equity vehicles** (page 16-17)
- The challenge of auditing valuation and ownership of digital assets (page 19-20). **Digital AML certifications** (page 18)
- Which types of hedge funds and managers dealt best with the challenging markets of 2018 (page 21-22)
- How managed accounts can save a fund manager's business (page 22)

- Why Brexit is harder for banks to deal with than for managers. Why for UK managers with Cayman Islands funds Brexit could be advantageous (page 23)
- Artificial intelligence, robots advisors and digital upskilling (page 23-25)

Enjoy!

Matthias Knab
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Participant Profiles



(LEFT TO RIGHT):

Matthias Knab, Ronan Guilfoyle, Craig Smith

Caroline Heal, Ingrid Pierce, Lucy Frew, Juliette Maynard

Cover photo: Cayman Islands, © Matthias Knab

Introduction

Caroline Heal

Walkers

My name is Caroline Heal and I am a Partner in the Investment Funds Group at Walkers. I have been at Walkers in the Cayman Islands for 13 years. Prior to that, I worked in London specialising in corporate work and spent time on secondment at Henderson Global Investors. My practice is split between hedge funds, private equity funds and general corporate work.

Walkers is a leading international law firm and one of the largest law firms in the Cayman Islands. Walkers has 10 offices globally and practices six different laws. The firm also has an affiliated professional services business, Walkers Professional Services, which provides an integrated offering of fiduciary, corporate and compliance services.

Lucy Frew

Walkers

My name is Lucy Frew. I am a partner at Walkers, where I head the global Regulatory and Risk Advisory practice group. All the lawyers in the practice group, which extends across our international offices, are dedicated specialist financial regulatory lawyers. Each of us has many years' track record as financial regulatory lawyers, not only in private practice but also at the Cayman Islands Monetary Authority and other financial regulators and as senior and global head roles at international financial institutions.

I started my legal career as a barrister in London over 20 years ago, before going into private practice, and have specialised in financial regulation ever since. This has included both regulatory litigation and investigations and also non-contentious advisory and practical compliance. Although most of my career has been in private practice, I have worked at the UK financial regulator and as legal counsel at an international financial institution prior to joining Walkers.

Juliette Maynard

Cayman Islands Monetary Authority

My name is Juliette Maynard. I am the Deputy Head of the Investments Supervision Division of the Cayman Islands Monetary Authority (CIMA), the primary financial services regulator of the Cayman Islands. CIMA's role is to supervise the financial services industry. CIMA remains committed to the promotion and enhancement of market confidence, consumer protection and the reputation of the Cayman Islands. I've been with CIMA for the past six years, but I have over 20 years of experience in the financial services industry. My role is to supervise the investment funds, the mutual fund administrators, as well as the directors who are registered or licensed under the Directors Registration and Licensing Law.

Craig Smith

PricewaterhouseCoopers

My name is Craig Smith. I'm an assurance partner at PricewaterhouseCoopers in Cayman, which is a member of the global professional services firm, PwC. My 20 years in the industry had been spent between Cayman and New York.

The majority of our business, around 85%, is asset management and mostly assurance, we are seeing lately a lot of growth in other areas as well, especially in professional services, tax compliance, regulatory and other assurance services, and then some technology related items such as the crypto space which is just starting to grow. Having said that, we are mainly asset management dominated; hedge funds, private equity, venture capital funds; and mainly driven in the assurance areas.

Ronan Guilfoyle
Calderwood

My name is Ronan Guilfoyle, I am a Co-founder of Calderwood which is a governance and compliance firm based here in the Cayman Islands with an office in Asia also. I started my career 21 years ago with EY in Ireland before moving to Cayman in 2002, so I have been here 17 years now. I spent my first four years here doing fund administration with a firm called Admiral which is now a part of Maitland. I then joined DMS Governance at the start of 2006 and spent 10 years there, 5 years as a partner, before leaving to start Calderwood with my Co-founder, Wade Kenny.

I've been sitting on boards for 13 years in Cayman, during which time I have served on the boards of some of the largest funds in the world. That's what we continue to do today at Calderwood. Our core services are independent governance services to investment funds and related vehicles. We also offer board support and compliance services to a number of our clients.

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Matthias Knab

As a start, let's maybe review some of the latest statistics from CIMA to give us a good indication of where the industry has progressed and maybe give us some insight to maybe where we are heading in 2019?

Juliette Maynard: CIMA has recently issued the 2017 Investments Statistical Digest, which is based on the filing of audited financial statements for all regulated funds registered with CIMA in 2017. While the data is a little dated simply because of the process and time lag associated with the information filed, it still provides some very useful trends.

According to the data, there was an increase of 12% in the Net Assets of Cayman funds, moving from \$3.6 trillion in 2016 to \$4 trillion in 2017. Total gross assets increased from \$6.1 trillion to \$6.9 trillion, representing an increase of 13%.

For 2018, there was growth in the total number of funds, moving from 10,559 to 10,992, about a 4% increase. In terms of quarterly statistics, CIMA approved around 109 funds per month compared to 97 funds in 2017. Also for January 2019, there were further increases in new registrations, and these are positive numbers for Cayman and the financial industry.

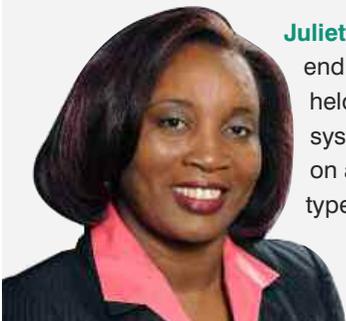
However, because of the M&A activities with mutual fund administrators, the number of licensed mutual fund administrators has declined from 97 in December 2017 to 88 in December 2018. There have been a number of acquisitions by global players, who want to be able to service clients across various jurisdictions and to maximize on economies of scale.

One other statistic is the number of funds that are investing into crypto assets or blockchain technology where CIMA has to date registered around 80 mutual funds whose strategies include investing in cryptocurrency, blockchain technology, Fintech, outperforming or replicating the performance of cryptocurrencies and indices related to crypto assets. CIMA will be undertaking in-depth reviews of the audited financial statements filed for those funds, examining the disclosures and the valuations determined for these investments.



Craig Smith:

I wonder, Juliette, have you seen any audited financial statements yet for crypto funds?



Juliette Maynard: CIMA has received about one or two, as most of these funds have a financial year end of 31 December 2018. As such there is more information to come in that regard. CIMA has also held several conversations with auditors and administrations to further understand from them what systems or mechanism they are utilizing in relation to the **valuations**, for unless the assets are traded on a recognized exchange, the valuation issue is going to be related to the level two or level three types of assets.

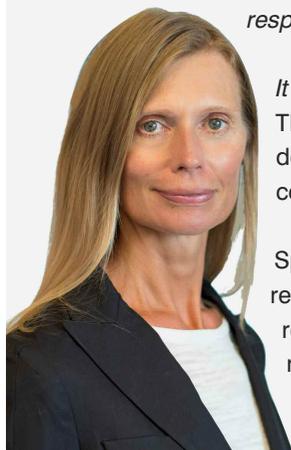
Craig Smith: *I thought that the 4% uptick in the fund population in Cayman was actually very positive in light of other global surveys which revealed that the number of total funds is declining with the maturity of the industry and continued consolidation. Given that decrease, for Cayman to register a 4% growth in the number of fund shows the remarkable strength of the jurisdiction and the comfort that the players in the industry have with Cayman and with the participants on the island here. As subjective as industry rankings might be, The Banker has named us the top specialized financial center and we are also regularly ranked as the best hedge fund services jurisdiction. My point there is that we are a premier jurisdiction and also a leading financial center, and this is of course something that we are conscious about and we intend to maintain.*

We very closely observe and comply with the global regulatory trends, so our position is to pro-actively engage with global regulators rather than to be reactive and do the minimum.



Lucy Frew: In recent years the pace of regulatory development has increased in the Cayman Islands to remain in step with international developments. Indeed, every significant Cayman Islands development has had its source in one international initiative or another, whether US FATCA, the OECD's Common Reporting Standard (CRS), the beneficial ownership regime implemented by the UK's other crown dependencies and overseas territories, updates to the Financial Action Task Force global standards for prevention of money-laundering and terrorist financing and the OECD's BEPS initiative, including country-by-country reporting and, most recently, economic substance legislation.

In the past it had been questioned in certain quarters whether the implementation of these initiatives would be detrimental to the Cayman Islands, especially when the tax transparency regimes FATCA and CRS went live in 2015 and 2017 respectively.



It has been satisfying to see that rather than diminishing, the number of investment funds has increased. The fact is that the Cayman Islands implements international standards rightly in recognition of investor demand, with the largely institutional investor base only willing to commit to international financial centers that have implemented international standards.

Speaking from day-to-day experience as a regulatory lawyer, clients have not been concerned about the regulatory requirements in principle but, rather, see it as an administrative burden. It is important that regulation is implemented appropriately, and recognizes the predominantly institutional rather than retail nature of the Cayman Islands investor and client base.

Caroline Heal: The investment managers and onshore counsel that we work with globally continue to see Cayman as the preferred destination for offshore funds. All of the regulation that Lucy mentioned – FATCA, CRS, beneficial ownership and the developments in AML regulation – has been introduced over a relatively short period, but the Cayman funds industry has taken it in its stride. The jurisdiction has managed to respond very effectively to the changing requirements of international standards.



Ronan Guilfoyle: *Cayman is still the jurisdiction of choice for most US and Asian based managers, and the new fund launch numbers speak to that. We started our firm less than three years ago and have gone from two people with zero clients to now seven people come April with over 150 manager relationships.*

During this time there has been a number of regulatory changes which we have assisted our clients implement, but there are still a number of new challenges ahead of us like economic substance requirements. Also, the forum for harmful tax practices and the OECD are both involved in looking at Cayman's efforts on tax transparency, and we've also got CFATF (Caribbean Financial Action Task Force) report to come out soon, so it's literally been one thing after another. But what's interesting is that while in the past, a lot of these new regulatory changes and reviews may have been seen as threats to Cayman's success, the fact is now that all of our competitors, especially the Caribbean jurisdictions, are all signing up to and complying with the exact same regulations that Cayman has.



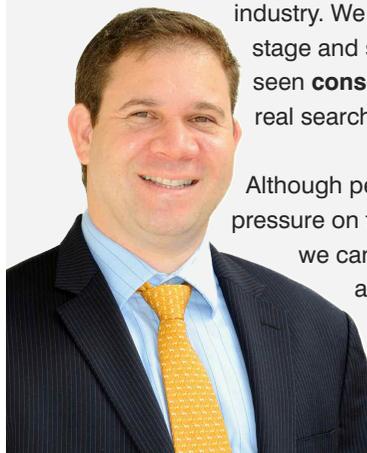
What we in Cayman have, to our advantage, is that over the last 15 to 20 years Cayman has been the go-to place because of our regulatory regime, service providers and investment product offerings. **Our offering is tried, tested and trusted**, and the global fund industry sees us as best in class.

Juliette Maynard: Just to add one other statistic from the 2017 Investments Statistical Digest. In addition to the asset value of funds, revenue has increased as well. Funds are earning greater profits – for example, total return on gross assets increased from 2% in 2016 to 5.52% in 2017, and the return on net assets increased from 3.56% to 9.5%.

The statistics for 2017 demonstrated good performance from the funds, and of course CIMA is looking forward to analyzing the 2018 results. And certainly, to Ronan's point, with the strengthening of regulations, the objective as a regulator is to find the right regulatory balance. For example, corporate governance is important to CIMA, and I'm sure we'll talk more about that as well. As Operators take responsibility for sound governance and oversight of the funds, understand their operations, including the risks and ensuring that appropriate controls are implemented; it is testament to why the Cayman Islands financial industry is such a strong one.



Craig Smith: The media along with the hedge fund databases have of course already reported that from a performance perspective, 2018 was a challenging year for many funds, and as a result there's likely going to be a bit more fallout in the industry. We have seen this trend for a while. The alternative investment industry is a mature sector at this stage and so it's a little tougher for the smaller players seeing the larger managers get larger. We have seen **consolidations** and, on the other side also some struggles from the smaller managers. There is a real search for efficiency and for innovation as a result of that.



Although performance in 2017 was positive as mentioned, there continues to be a general downward pressure on fees, not just manager fees and incentive fees, but fees of service providers as well, I am sure we can all relate to that. Managers along with their investors are coming up with new fee models such as 0% management fee and a higher incentive fee instead of the traditional 2 and 20, so you might have 0 and 30 on some classes. As in any industry, not all operators will survive. In spite of this, we do think that assets will grow in alternatives but that there will be smaller number of players eventually.

Caroline Heal:

We have also witnessed pressure on fees, but we have seen managers be resilient to these challenges. For some managers 2018 didn't end well in terms of performance, but there were still success stories where some managers were able to take advantage of the volatility.

Matthias Knab

That is correct, the 2018 performance wasn't that good with the average hedge fund down to 4% to 5%. Yet, [as we have reported on Opalesque](#), 21% of the hedge funds in one particular fund database were up 5% and more in 2018.

Caroline Heal: It is good to see managers being creative, such as offering tiered management fees to incentivise investors, or restructuring existing products to make it more attractive for investors to make additional investments. It is interesting to see managers adapting to the changing market place and we have continued to see new products with different terms being launched.



Matthias Knab

Caroline, could you maybe try to specify what sort of new products or changes you have been noticing lately?

Caroline Heal: Yes absolutely. We have seen start-ups with founders classes with special liquidity rights and fee terms as well as tiered management and performance fees linked to AUM.

We are also seeing more funds with less frequent redemptions and differing capital commitment structures, including rolling commitments which is quite new to the market and a hybrid between a traditional hedge fund and a private equity committed capital structure.



Ronan Guilfoyle: I think not only do investment managers have to be creative regarding fee changes, I think all service providers have to be as well. The service providers represented here today have probably tiered their fees at some point for emerging managers with some sort of increase kicking in when the AUM goes up, and we at Calderwood have done the same. Administrators have had that model for a long time. Sometimes there may be a really good lift out new client coming out of one of our clients and so you might do something in terms of fees for them because you want them to be successful. People want to give the managers they work with a chance to be successful.

As we know, the barriers to entry now for the industry are very high. Having an institutional infrastructure in place is seen as the minimum requirement. Back in the days when I was administering funds and then serving on funds initially, we regularly saw the proverbial two people with a Bloomberg machine starting with some friends and family money. If they built a decent track record they could easily go from ten million to a hundred million to a billion within two to three years. That just doesn't really happen anymore unless you are a very long-established manager with a great track record.

We, as service providers in this industry, are really engaged in giving the managers, who really are the engine to all investment products, the best opportunity we can, to be successful. But, because the costs of entry are so high, it's just a different game now, and ever-increasing regulation doesn't make it any easier. It may make the investors feel safer and maybe they are safer as a result of that, but it comes with an added cost associated with it. And so, I think we are all looking for ways to help the managers cut costs as much as they can to get up and running.



Craig Smith: The demand for institutional quality has also driven a bit more innovation. What we have also seen is the rise of consultants and **more outsourcing** which is actually seen as a positive nowadays with respect to operational functions, whether it be the CFO role or the CCO role and so on, more is being outsourced to knowledgeable service providers.



I think when we first saw this happening seven to ten years ago, initially it was met with a certain degree of skepticism. But with the strength and professionalization of the whole eco system outsourcing certain functions to established, strong players is a helpful, and often cost efficient move, especially for emerging managers and a reassuring development for investors when they are doing their due diligence to see that the manager has got quality, even if it's not in-house. Seeing quality around things such as operations and back office can give investors a bit more security in terms of applying capital to that manager given that about 50% of fund failures in the past have been due to operational issues, as opposed to portfolio or asset management issues. This outsourcing trend continues to evolve, including a growth in product offerings.

Lucy Frew: On the face of it, larger managers and funds have a competitive advantage resulting from a global increase in regulation because they are better resourced to respond. However, while the danger is that a high regulatory barrier to entry or survival results in reduced competition and reduced diversity of business models, we have seen how managers and funds of all sizes are often responding to increased regulation through outsourcing.

Investor demand for independence and institutional level infrastructure are also motivating factors. Institutional investors are more focussed on regulatory compliance as part of their operational due diligence.

Hedge funds were early adopters of outsourcing but now private equity managers are also increasingly outsourcing a variety of functions. Increased regulatory requirements makes in-house compliance increasingly expensive, as regulatory processes can be very manual. Also, outsourcing to a third party can be charged back to investors. On the other hand, some players prefer to not to outsource to third parties, citing concerns around control, flexibility and security or skepticism as to whether outsourcing will result in cost saving.



A variation on outsourcing which has assisted emerging managers are hosted platforms, which allow a fund to be launched using an existing regulated infrastructure.

With that, segregated portfolio companies (SPCs) are playing a role and I wondered whether when collecting data on fund launches CIMA also captures any of the individual segregated portfolios of SPCs, which may be managed by different managers. There could be a greater increase in numbers of new funds than is revealed on an aggregate SPC basis.

Juliette Maynard: The funds are generally counted at the legal structure level, which means that the SPC is only counted and not the underlying segregated portfolios (SPs). CIMA however continues to see an increase in those structures, and will be enhancing its reporting to enable the extraction of more detailed information for the underlying SPs. This will enable further reporting on the individual portfolios. Last year CIMA undertook an exercise to reach out to industry to obtain updated information on the SPs, with the aim of increasing the accuracy of its records and the reporting of these structures.

Through the Regulatory Enhanced Electronic Forms Submission (“REEFS”) system, anytime an SP is added or terminated, there is now a mechanism for industry to promptly notify CIMA which will enable more timely updates of its records.



Going back to the outsourcing theme for a moment, as a result of the M&A activities with mutual fund administrators and further to the issuance of the AML Regulations and Guidance Notes and the requirements for the appointment of AML officers, there is an increased use of the outsourcing model. With CIMA having issued a **Statement of Guidance on Outsourcing**, this provides industry with a framework to understand CIMA’s expectations relating for example to the responsibilities of the parties involved and what can be outsourced. That guidance was timely in outlining the structure for what’s happening globally.

Craig Smith: I have to echo that, the question of reliance versus delegation was received from our clients, and it was gratifying to be able to pass that on. We received a lot of questions in the past few months regarding AML and regulations. We are always happy to help our clients with the requirements wherever possible.

Ronan Guilfoyle: Outsourcing is actually something we do with our own business. We have outsourced our entire back office at Calderwood and it’s very cost effective. We’ve had a CIMA regulatory audit in 2018, and we have our internal policies and procedures on outsourcing. CIMA has a statement of guidance on outsourcing which was very helpful for getting our policy in place. Also, we’ve seen a lot of our clients used outsourced services and it can also be very cost effective for a startup. As Craig said, whether it’s AML, CFO, CTO or some other function, it makes sense to outsource for startups. Why do you need to have full-time staff doing the work when you don’t have enough work to fill the day for them? In that scenario, I think outsourcing makes perfect sense.

We outsource our finance and IT departments locally, also our software and systems, marketing and design as well as the maintenance of our website. It's great to be able to have people that you know and trust doing the work locally. In today's modern world you just email them and it's like they are sitting in the office next to you except the cost is significantly lower. And of course, for smaller firms and smaller managers, it's the same.

What I'm going to be interested to see going forward is whether that just becomes the norm. Right now, there may still be a conversation like, "Now, you are at XXX million, you should have your full-time CFO or your full-time IT or compliance people in place." I think what we will see over time is those thresholds further shifting from where they used to be to a situation where outsourced people in those roles will just become the norm. For a multibillion-dollar fund, that's slightly different, because we all know that the vast majority of funds aren't multibillion-dollar funds. I think the average fund size is somewhere between \$100m to \$250m, right? And also, just looking outside of finance, outsourcing has become part of today's business because of the way we all interact these days.



Lucy Frew: *Many of the most successful businesses in the world now operate based on a highly outsourced model. Although still nascent in the Cayman Islands, regulated outsourcing can be a large part of a financial regulatory lawyers' practice as indeed it has been for me. This is an area where regulatory requirement and commercial drivers are generally well-aligned. However, it is important to use a lawyer who is very experienced with reviewing outsourcing contracts, especially in relation to technology outsourcing, as there are many pitfalls which can be avoided if properly addressed at the outset. We expect to see more outsourcing related contractual and advisory work.*

Ronan Guilfoyle:

This relates to the substance requirements as well. For our clients that are in need of those services, I think the quality service providers here are very well-positioned to assist them with that. For the most part, funds aren't profit-shifting entities, so most of them aren't really impacted by these substance requirements anyway, but for the types of clients that are impacted, we can address that and assist them to fulfill those requirements.

Caroline Heal: *When we were working with clients to appoint AML officers, it was really interesting to see how different managers dealt with the same requirements. You could have two managers who from our perspective looked very similar in terms of business type, AUM and structures and yet they dealt with the AML requirements in a completely different way. One of them might have appointed individuals from the manager, prepared policies and procedures and conducted necessary training. The other might have concluded that they didn't have the capacity or experience and so outsourced to another service provider. It was good that managers were able to choose from the different options available to best suit their business.*



Ronan Guilfoyle:

But then also, the number of services a client demands as he grows can also increase, right? It's like, "Well, can you do this for us as well?" On our side it's like, "Can you provide compliance services?" "Sure we can. We have someone who is an expert in that. We can help with that." "Can you provide governance services? Can you provide board support services?" – whatever it may be. And so, attending to a client requests allows you to think about how you grow your own business as well.

Juliette Maynard: One of the messages relating to the update to the AML Guidance Notes is that it is essential to follow a **risk-based approach**. For the industry and also for CIMA, we wanted to ensure that the focus is on where the critical risks exist. For example, consider who is high-risk, low-risk, or medium-risk, and therefore what appropriate action should be taken.



And in discussing the concept of outsourcing and who the services are being outsourced to, it is important to remember that consideration must also be given to where the entities and the outsourcing agents are located, who they are operating with, and how their systems are structured. Entities have to take a number of risks into consideration, in being clear and transparent, as they make decisions about the processes and the entities that will be relied on.

Lucy Frew: *The Cayman Islands' emphasis on a risk-based approach is positive and should be welcomed by industry. The alternative is a more granular rule-based regime, which while providing certainty can result in a more box ticking approach. International experience as a regulatory lawyer suggests that the pendulum may swing between risk or principles-based to rules-based.*

Risk-based is preferable because it is more about having policies and procedures in place that are tailored to address the actual risks relating to a particular entity but it does involve a more bespoke and nuanced thought process. This requires an entity conducting relevant financial businesses to identify and assess money laundering and terrorist financing risks in relation to investors or clients and beneficial owners and their jurisdictions, other jurisdictions in which the entity itself operates, the entity's products, services and transactions and its delivery channels (that is, the means by which the entity conducts business with investors or clients).

The entity must design and implement policies and procedures to manage and mitigate the risks that it has identified and assessed and document its risk based approach. The entity may rely on another entity (for example a manager, administrator or other service provider) for the performance of its anti-money laundering and counter-terrorist financing functions, which is typically the case for a fund, given it has no staff. In this case it must review the policies and procedures of the person prior to entering into the reliance agreement and test them, from time to time, subsequent to entering into the relationship to ensure that the policies and procedures are adequate to perform the function and satisfy the relevant obligations in the Cayman Islands. A risk-based approach requires a different approach to supervisory inspections as well as industry implementation.



Ronan Guilfoyle: I think fund managers, in essence, have always had a quality approach when they are setting up a new firm and new funds. They would look carefully and select their service providers, make sure they have a CIMA registered fund, the right directors too, and that they are active in strategies and asset classes they specialize in, *so there was always that thought process. The only difference now is that we are actually documenting it so that there is a transparency and a trail people can point to.*



What Cayman has been so great at doing through the last 20, 30, 40 years is thinking about how we can serve our clients with new services and products. There is a lot of effort that goes into putting these new services and products in place and typically most of the local top-quality firms are involved.

Juliette Maynard: **One cannot underestimate the need for documentation of the process.** From a regulator's perspective, CIMA wants to see that evidence, and how it is demonstrated.

This was augmented when the Cayman Islands went through the CFATF inspection, where as an industry we were required to demonstrate the effectiveness of the AML regime. Yes, the technical compliance was deemed sound, but equally the industry has to step back and ensure that processes are being examined, procedures and systems are in place to ensure that when someone says, "Show me," it can be demonstrated.



Ronan Guilfoyle: I would think that everyone at CIMA must have been incredibly busy with all the new regulation that has come through and then dealing with many different industry bodies locally and externally. Now we have a fines regime that's in place also. I was wondering where you envisage the focus being after the CFATF report is released, and also what sort of questions are you getting from industry in terms of clarity around some of these items?



There is always a lot of interaction and communication between the different bodies such as AIMA, CIFA, CIDA and Cayman Finance, but I was wondering if you find that everything is coming through those industry associations or are there still individuals, managers or service providers individually reaching out for clarity on, just to pick an example, how the fines regime might work?

Juliette Maynard: To my knowledge, CIMA has to date received some questions around the fines regime. *The implementation of the fines regime is ongoing. It was communicated that at the moment the focus will be on the **AML element** of the regime. As such, entities must ensure that if AML issues arise, they have a mechanism for promptly addressing those issues, to avoid the possibility of being fined under that regime.*

Regarding AML, entities must make sure that they are complying with the respective regulations. CIMA continues to have conversations with industry groups, meeting with different industry associations, where collective issues are discussed. These meetings also provide an avenue for CIMA to remain aware of any current and emerging issue.



Craig Smith:

I think the AML requirements were initially a bit of a concern to some clients and they weren't quite sure how to address the requirements. I'm not sure if any fines have been levied yet, but people did ask about that and essentially understood very quickly the need to implement something there.

Of course, as we all know, we are still awaiting the report from the CFATF on the effectiveness of these laws.



Lucy Frew: CIMA's empowerment to impose a range of administrative fines is to be welcomed, in that it allows CIMA to apply a more nuanced and proportionate approach than had previously been the case. Stakeholders in other jurisdictions have long since taken regulators' ability to fine for granted as a basic element of the regulatory toolbox. To the extent that clients have commented at all, it is to ensure they understand what CIMA's expectations are. There is an appetite for information about enforcement actions, even on a no-names basis.

Caroline Heal:

I agree. I think the ability for CIMA to impose fines enhances the reputation of the jurisdiction and sometimes makes our job as legal advisers more straightforward as there is certainty about the consequences of failing to comply.

Lucy Frew: *At the same time, while CIMA's ability to fine is positive, it should not be necessary to fine in the same way as, say, the SEC or the FCA. We have seen extremely high fines being imposed in the US and UK and it is important to recognize that the Cayman Islands is entirely different from those jurisdictions.*

The Cayman Islands' business model is predominantly institutional and does not, unlike the US, UK and other onshore jurisdictions, have any significant retail market. Also, the population of regulated entities in the Cayman Islands is relatively small - CIMA is able to know and communicate with its licensees directly and individually, rather than by fine. Having said that, we would anticipate up upturn in enforcement action, given the CFATF's focus on effective enforcement. We are prepared for this and a number of the lawyers in my practice group have significant contentious regulatory experience.





Ronan Guilfoyle: As you say, most managers that we deal with are regulated somewhere else already, and they are used to having those requirements and regulations. Personally, I would be more comfortable outsourcing to parties which are actually on the ground or close to the respective regulator to ensure that you are adequately and properly meeting all requirements. For example, I don't generally mind who becomes the AMLCO once I know it's someone who is qualified to perform the role.

*But for managers who run Cayman funds, I also need to be sure that someone really knows the Cayman regulations and has read them inside-out, because as director of those entities, I am responsible to ensure that the fund complies with the regulations. And therefore I would rather have someone, whether from a law firm, or an administrator or a governance firm, with that distinct experience of **local compliance obligations**, because that's where I will feel more comfortable.*

Caroline Heal:

Indeed, some of the managers that we worked with were initially very keen to put the AML framework in place themselves and appointed individuals from their organization, but later changed their minds and arranged to outsource. They realised that there is a little bit more to the AML compliance officer role than they had anticipated and acknowledged that they were perhaps not sufficiently familiar with the Cayman AML law and regulations to perform the role.

Craig Smith:

I did have a question. We know that the AML laws apply to not just the CIMA-registered hedge funds, and it brings up to mind private equity which we are also seeing a lot more of. *I was wondering if CIMA has any thoughts as to how the AML framework is being applied to private equity vehicles?*

Juliette Maynard: *CIMA's expectation has always been that for any entity that is engaging with the flow of funds with any party, it needs to know the parties and therefore conduct relevant due diligence. Whether regulated or not regulated, there is an expectation that funds are undertaking the necessary due diligence. For private equity funds, and the level of discussion that initially ensued on the changes to the guidance notes, CIMA was of the understanding that entities were already undertaking the necessary level of due diligence. Given the degree of conversation that has taken place, it brought to bear that fact that all parties have a part to play in protecting the jurisdiction.*

CIMA understands its role as a financial regulator to seek to regulate what needs to be regulated. Regarding private equity, there has always been a conversation about what is or should be the oversight. CIMA's obligations include meeting international requirements, whether it relates to economic substance or AML/CFT, but the main message is that if we all play a part in ensuring that we are protecting the jurisdiction and having systems in place to know clients and investors, then that puts the Cayman Islands in a better position.





Lucy Frew: Our view at Walkers had also been that unregulated as well as regulated funds have been required to undertake due diligence on investors, so for our clients generally the requirement were not regarded as new. However, has been much focus on developments to the anti-money laundering and counter-terrorist financing regime over the last eighteen months or so because of the CFATF inspection. *It is important to recognize that the risks for private equity funds are different to those for hedge funds. Investments will typically be locked in for many years, which may not appeal to a prospective money launderer.*

Ronan Guilfoyle: Within the broader AML regulations, we are not only responsible for the AML on the investors, but also now on the investments, right? So probably for a few unique types of PE strategies, let's say investing in art or wine or something like that, that part becomes a very difficult role to play. And while managers self-administering their own funds is less of a thing on the PE side but still happens for a decent chunk or percentage of PE funds, questions that need to be addressed is if they were performing due diligence on these investors or were they all personally known to them? This is an example of the topical discussion that's going on, and I am sure we will certainly hear and see more about it over the next twelve months and beyond. *There are a lot of managers on the PE side who are watching these developments, and I personally do think that their industry is most likely the one which is going to change the most in the future.*



Juliette Maynard: Just to add one last point to Lucy's comment, the AML Guidance Notes clearly states that *to the extent someone does not undertake any client due diligence then one must clearly document the rationale.*

CIMA has taken the approach to expect some level of due diligence being performed, but where an exception is taken; there must be clear documentation and justifiable explanations.

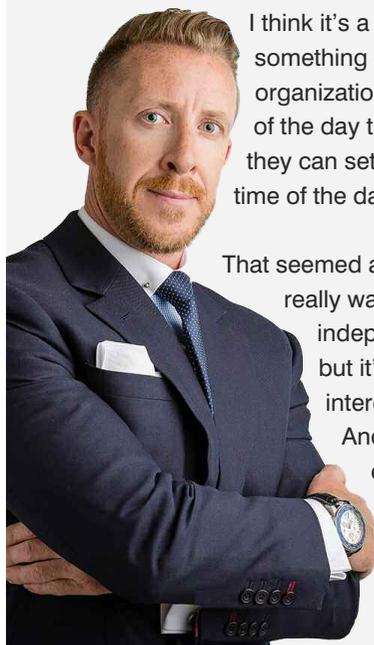


Lucy Frew: In this context, we also need to remember that the Cayman Islands' AML/CFT regime is very much based on FATF principles, which are also implemented in numerous other jurisdictions. While there may always be exceptional cases, the vast majority of managers will find Cayman Islands AML/CFT concepts as very familiar because they have to comply with very similar requirements in their own jurisdictions. Generally speaking, the AML/CFT requirements should be broadly aligned across all FATF jurisdictions.

Ronan, you mentioned due diligence on the investments held by the fund, **where funds investing in crypto assets** is an area of particular interest. We are familiar with how regulations apply to the traditional financial sector, so what is really interesting for regulatory lawyers is considering the application of traditional regulations to investment in crypto assets and FinTechs. This also throws up challenges for service providers such as administrators, custodians and auditors, where it is not straight forward to verify ownership and provenance of fund assets.



Ronan Guilfoyle: Well, based on a discussion I had recently, I believe that Cayman Finance are actively looking at solutions in this space and are possibly building software where someone can submit their AML\KYC to Cayman Finance, who will review it and be able to provide a digital AML certification, which could then be used as way of directly investing in real time into Cayman Funds which are in the Crypto space.



I think it's a really great idea, because one of my clients which is in this Crypto space has tried to do something similar though proprietary software, but it wouldn't be as effective as a certification from an organization like Cayman Finance. My client's initial thinking was that anyone could subscribe at any hour of the day through such a system, and the minute their AML is approved, their subscription goes live, and they can set out to buy crypto-currency. So, in a day where the prices may fluctuate, it could depend on the time of the day that you subscribed at.

That seemed at the time, like a really risky sort of client to have. We eventually convinced them, "Hey, you really want to be taken seriously, and you want to be institutional, you are going to have to have an independent administrator, independent audit. This may work for some for friends and family money, but it's not going to work for a fund regulated by CIMA." I still thought that the concept was interesting. We have also had a couple of requests for compliance officers on those types of entities. And it is like, "Well, how do you get comfortable with the investors, with the assets, with the exchanges they are on?" I think these things will get figured out at some point, but it will take time. I also believe this asset class isn't going away, and therefore somebody will find a solution for those types of issues.

Craig Smith: I agree – technology is the answer there, we just haven't caught up to it yet. This is still a developing industry. I like to refer to the hype cycle where due to investor sentiment the price of a bitcoin was almost \$20,000 end of 2017 and a year later dropped to under \$3,000, and a lot of the late comers are now out of industry. I guess we all know people who personally invested and then have become disenfranchised and disillusioned and exited. But over time, I do see this new field reaching kind of a plateau of productivity, and for that to happen, technology has to catch up and enable service providers to provide institutional solutions.

As a firm, we have our own technology people working on the means to understand, test and verify ownership and get comfort with the fundamental questions that need to be answered in order to properly audit certain crypto assets. We think this is something which will occur in the next six to twelve months. We anticipate being there and able to provide those answers to investors, but there are still a few things we need to shake out.



Juliette Maynard:

Craig, we talked about the AML aspect of it, but my question is also around the valuation policy. As an auditor, what can you tell us in relation to addressing the hurdles around the valuation and other challenges?



Craig Smith: Sure, we think the valuation can actually be addressed depending on the guidelines in the documents and depending the level of trading that the currency might have. Those **valuation reference points** need to be specified by the fund documents, so there we want to see a clear delineation for a cut-off in terms of measurement. That's something that some of these currencies are offering now, but not by all. And so that might make a difference in our acceptance of such a client. Also, if the market value is undeterminable, the question is then how to set a price at which to deal the investors and to strike a NAV?

The more difficult question revolves around existence and custody, and that's something that we have been more focused on, to be honest.

Juliette Maynard:

From a regulatory perspective, CIMA is also concerned with those issues and have been working with the Government to find the appropriate legislative framework to address those questions around valuation, AML and custody of the keys or the custody of the assets. CIMA continues to engage with the industry to understand how these issues are evolving, as this space continues to rapidly evolve.

Craig Smith: *We are seeing our fair share of inquiries of "Will you audit our fund that invests in this space?" But the investors so far tend to be emerging managers, we haven't seen institutions diving in. Talking to institutional investors, they have exactly the same questions. They will only be jumping into this when the institutional quality is able to surround the third-party administrators and the custodians and so on. That has to happen before we see a wholesale shift.*

But I do think this is coming down the line. What I anticipate happening is that a lot of players will be shaken out and the ones that remain will be stronger.



Lucy Frew:

It is important to bear in mind that the Cayman Islands is predominantly an institutional jurisdiction, with an institutional and professional rather than retail investor and client base. The investor base is well equipped to conduct its own due diligence and risk assessment and does not require the same type of consumer protections as would be relevant for retail investors.

Ronan Guilfoyle: As we have all heard just recently, a Canadian CEO of a crypto exchange has supposedly died with US\$190 million worth of his client's money apparently lost as he held all the cold storage keys personally and they were lost when he died. This is why it's so important to also do a proper due diligence on these exchanges. As we have said, these are global issues. Can a regulator protect investors against such events? The whole idea is that these digital assets are not meant to be hackable, but now we are learning that there are a number of risks we didn't consider.

Crypto currencies are an emerging asset class, and I agree with Craig that it's probably not going away anytime soon, but there are a lot of lessons to be learned, but that's not different from any other asset class when it first started off. People even needed to get used to the stock market and learn their lessons there as well. So also with crypto currency, we are in the process of learning what the key risks are, trying to mitigate against them, and seeing whether this is a worthwhile asset class to have.



And just basing from some of the discussions I had with some friends about some less developed countries using these crypto currencies for payment means and that think it could be a solution to a number of problems because they can't get correspondent banking relationships and other such banking issues. They see digital currencies as a possible solution to some of these issues.

I do believe that here in Cayman we have an opportunity with some great minds solving problems we may be able to find solutions to investors, to the regulator, to the managers, and custodians. We mentioned some of the issues, and there's more of them. We have one right now which is restricting fee at redemptions which sort of changes the industry. And so we will be going through this, and this isn't a short-term cycle. Ten years from now we will certainly talk about some of these or different issues, but I do think in a decade we'll still be here talking about it.

Craig Smith: One I would like to point out is of all the many breaches which have occurred, none of them seem to be due to the underlying blockchain technology. It's unique things like the cold wallet that the Quadriga founder had to himself and then lost.

The maturation of this industry will occur when these types of issues can be resolved and redundancies can be built in. But at least the foundational technology so far has been proven sound, and I think that's a comforting fact for those investors that are considering entry.



Matthias Knab

After the crash of Bitcoin, for the last year or so, one of the new buzzwords is "stablecoin" where the value is pegged to something. What are your observations and thoughts regarding stablecoins?

Craig Smith: Well, I think stablecoin was a reaction to the question of what supported the value of Bitcoin? And it's funny, talking to the older people in the industry who say, "There's nothing supporting this." And so we would like to see some kind of backing. For years we also have the gold standard, gold bullion backing the US currency. As a result, some of the things we're seeing are tokenized capital whereby capital side is now using the blockchain technology and there's a traditional asset base supporting that. And they're using this underlying technology to then support the exchange of tokens in a different manner.



And so it's started to branch out, this crypto currency, and the blockchain is finding multiple uses. I think we'll see more ICOs and tokens that are related to traditional portfolio which then again goes back to the AML questions which we discussed. But I do see those proliferating as well.

Matthias Knab

Before, we talked about situation of emerging managers, that there are more barriers to entry. We also discussed the 2018 performance which wasn't that good for the average hedge fund (down to 4% to 5%) and yet **21% of the hedge funds in one particular fund database were up 5% and more** in 2018.

You from the service provider side also explained that you commit to a start up manager's success and help them make it and in that sense also trying to bet on the right horse. I was wondering, what type of managers did you from your perspective see succeed in the most recent past?

Ronan Guilfoyle: I would say that the experienced managers, the ones who have been through a number of different cycles and markets, tended to have done better during 2018 than others.

I mean, the whole idea behind a hedge fund is not just following an index. When there are downturns and your portfolio is hedged, you should not be down as much as the index might be down. I think a lot of the emerging managers were down quite significantly when the index was down in November and December, regardless of the markets you might have been focused on. A lot of the world markets were down and then also rebounded in January, but what I would expect from a hedge fund manager is that they outperform the market. In fact, a number of our managers performed very well in 2018, and *it was often the larger, more established managers who performed better than people with less experience.*



Caroline Heal: Granted, the markets have been challenging and some funds have experienced large redemptions, but we noticed that despite this *managers that have strong relationships with their investors have been successful in retaining assets.*



Obviously, if they continue to underperform investors will redeem, but regular communication and the provision of information on performance can assist in maintaining assets through a short period of poor performance.

Craig Smith: While I wouldn't be able to point to any one strategy that has outperformed or done better, but in terms of some of the characteristics of the managers who are still around is because they are finding innovative new ways to help clients and investors to stick with them. And so even if performance has been down, sticky capital is something they all seek.

One of the things they have been doing for example is taking on more **managed accounts**. We don't get to see all the numbers and all the performance associated with those, but *increasingly we hear that the co-mingled vehicle isn't the only thing supporting managers when they are facing tough times. Although the main fund is the preferred location for capital, managed accounts can have more loyal investors and tend to offer the customization that they are seeking.*

It can offer different fees and also allow a differentiated access to strategies and managers. For example, it could take one sleeve of a multi-strategy manager focus on a certain area with the leverage and/or concentration they want.

In terms of longevity, the managed account wasn't initially favored by managers, but we have seen a continued proliferation.



Matthias Knab

We spoke initially about the growth of Cayman funds and AUM, which geographies are foremost driving this growth?

Juliette Maynard:

Referring to the 2017 Investments Statistical Digest again, Managers in the United States continue to be the top managers as measured by net assets held by managers, specifically Delaware, New York, United Kingdom, and California. Internationally, Hong Kong is the top locations for the investment managers with Cayman funds.

Craig Smith:

We are seeing **a lot of growth coming out of Asia**. Of course, the New York and US-based managers will always be the larger share, but lately it has been notable to see the continuing trend of growth from Asia compared to some of the more developed markets.

Juliette Maynard:

And I think that might be driven by some of the legislative changes that are occurring in Asia that are encouraging more local funds and local investment into those structures.

Craig Smith:

Just anecdotally it seems that the Singapore Variable Capital Company, or VCC was pretty much copied off Cayman legislation. So, kudos to the Cayman lawyers, I think imitation is a flattery.

We didn't really touch on Brexit, but I would be interested to know if Walkers are seeing that or are being asked on how managers might be impacted by a hard Brexit or whatever you want to call it at the end of March.



Lucy Frew: *Brexit is harder for banks to deal with than for managers. Especially for UK managers with Cayman Islands funds, there may be some advantages to the UK leaving the EU. We are not aware of many Cayman Islands funds being particularly targeted to the EU as opposed to, say, Switzerland which is not part of the EU, or the UK. Other markets are seen as more attractive.*

What is more interesting for the Cayman Islands is the potential for the UK to position itself as a fund domicile. Mid-shore jurisdictions such as Luxembourg, Dublin, Asia and potentially the UK are worth watching. However, the UK is currently very much a manager, rather than fund, jurisdiction so does not currently have the necessary expertise or service providers. Frankly, Brexit has probably been seen as less of a potential threat for UK managers than the spectre of a Corbyn government.

Craig Smith: I heard one manager say, if Corbyn gets into power he's moving to Cayman.

Ronan Guilfoyle: I've heard that a couple of times too.

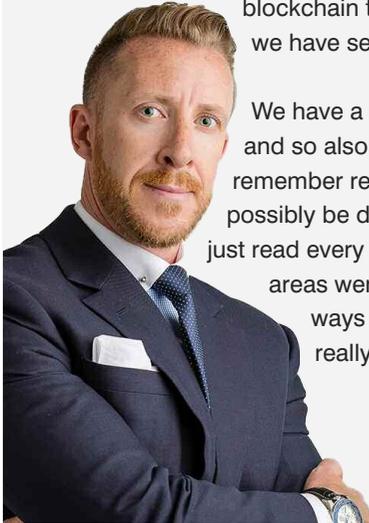
Juliette Maynard: On a related subject for a moment, a question for you Craig is, what are you seeing in terms of robotics/automation of tasks, the use of **artificial intelligence** in the manager's space and with service providers in general? For example in the legal profession or how the auditors are assisting their clients. How are you seeing the technology evolving and changing the industry?

Craig Smith: On the audit side, we actually haven't seen anything concrete and so there are still ideas being floated and discussions. I myself am not an expert in this area, but **digital upskilling** is something I think that's going to affect everybody. Applications will come into play whether it's coming from the custody side, whether it's trade execution, administration, information collection and NAV production – these are all areas which have been discussed on the audit side internally.

Some days when I go to our internal training sessions I wonder if my job will become defunct because of a robotic auditor. While I don't think it will go that far, it is certain that the tools and methods we use to conduct audits will evolve. We continue to develop tools to assist us and trying to increase our efficiency as we have over the last five to ten years, but there is always the ability to increase this.



Ronan Guilfoyle: I think the whole AI sector is a very interesting space, and as Craig said, there are lots of uses that can be applied across our industry. From a manager perspective, I haven't seen that much use of AI although we do have some clients who are active in the space. Of course, a number of managers are telling you they are using AI, things have moved on since the early systematic trading days. From what I have observed, I'm not sure there's been that great amount of innovation in what the managers do or how they do it but maybe I just haven't had enough exposure to it personally. When it comes to blockchain technology and other FinTech, there will be practical uses that will streamline the industry just as we have seen other advancements already over the last 10 years.



We have a number of managers on the PE side who invest in companies that use blockchain technology, and so also there it will be very interesting to see the current and future applications of that technology. I remember reading articles a couple of years ago that the work performed by auditors and lawyers could possibly be done by AI using blockchain technology. That, with this new technology, there will be ways to just read every single document and have all information in massive databases and knowing what all the risk areas were, etc. However, I don't think you can remove the human part of that. There may certainly be ways technology can enhance and speed up processes, but from a manager perspective, I haven't really seen anything truly groundbreaking so far.

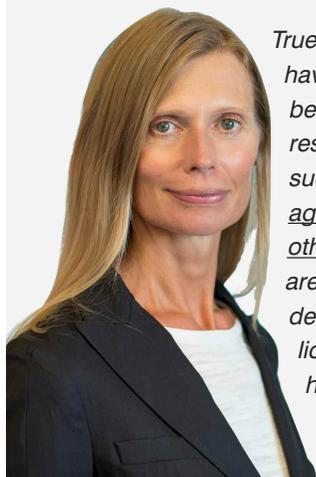
Craig Smith: AI is a buzzword, and of course we hope you are right about the human side being maintained.

PwC actually produced an app called "**Digital IQ**" which is about measuring your digital intelligence. *This is as much about attitude as it is about knowledge*, and so openness to adopting new things and considering new areas is a big part of it, and not just knowing how to use the latest and greatest tools out there. So if a veteran like me can adapt my attitude, then hopefully I'll be around the next few years when new things are developed.



Caroline Heal: I agree with Ronan, I don't think technology will ever completely remove the human element. In legal services I haven't seen that much use of AI, but it is evolving and we have increasingly used technology within our business to reduce risk and maintain quality and consistency in the services that we provide to clients.

Lucy Frew: Walkers is very focussed on leveraging technology to benefit clients. But regarding the use of AI by investment managers, I would not entirely agree with Ronan. Of course, I think that there will always will be some human intervention, but *I also believe there is genuinely a place for artificial intelligence which is different and beyond the sort of algorithms and auto-trading which have been around for many years now.*



True artificial intelligence is technology that genuinely thinks on its own. There are some managers which have invested enormously in this technology. It comes back to the outsourcing question we discussed before: from a legal perspective, one must consider whether the manager is outsourcing its responsibility to a robot. As we know, a robot has no legal personality itself and therefore cannot be sued (as well as presumably not having assets). Presumably any claim or investigation would be against the manager, perhaps on the basis of negligence. And where two robots interact with each other on each side of a transaction there will be other interesting questions. Developments in this area are likely to be the realm of a few significant managers. It is necessary to significantly invest in developing proprietary technology because this is not an area where a manager will want to be licensing a third party's technology if they really want to be ahead of the pack. Possibly those firms that have significantly invested in these technologies may have found another route to alpha investment.

Juliette Maynard:

There are jurisdictions using **robo-advisors**, either as full advice or a hybrid. Depending on the preferences or responses from the user, there would be some element of human interaction. I was wondering how widespread has robo-advice become in the industry?

Also at CIMA we are working on automating more processes in terms of the collection of information, particularly through the REEFS system whereby registration, change requests, terminations and the filing of reports or audited financial statements can be made online. It is also about increasing efficiencies and finding improved ways of receiving and analyzing information; and of course reducing paper.

Craig Smith:

I think that's the key concept here, using this technology to increase efficiency and have humans for oversight and making final decisions.

Juliette Maynard:

That is correct, and also working to ensure that information and intelligence can be extracted from all the data that is being collected, to be in a better position to undertake more meaningful analysis on a timely basis.



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