Keeping up with Alternative Investment Funds

March 2022

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Introduction

Welcome to our March edition of Keeping up with Alternative Investment Funds.

Our newsletter this month a broad variety of topics, including an article with the overview of the recently published Summary of Responses from the review of the UK funds regime.

In addition, we have got a separate article devoted specifically to VAT aspects of the Summary along with some other considerations related to VAT and the management of funds in the UK.

We are also talking about a consultation on the UK government on implementation of Pillar 2 rules, including on how the Income Inclusion Rule and the Undertaxed Payment Rules will be introduced in the UK.

There also is an update on the ongoing ESG regulatory agenda in the EU and UK with the key topics being reviewed.

We wanted to remind you that we are hosting our second **Alternative Investment Funds annual conference** on Wednesday 27 April from 1:30pm at our More London office. This conference will focus on a broad spectrum of issues arising for asset managers who provide alternative investment solutions to their clients ranging across private equity, private credit, hedge funds, liquid trading / crypto assets, infrastructure and real estate investing. The afternoon will feature a plenary session, panel discussions and elective deep dive breakout sessions from a mixture of speakers.

In addition, we will be showcasing industry focused digital solutions during the breakout and networking sessions. After the conference, you will get a chance to network with industry colleagues and PwC's Alternative Investment Funds team over drinks and canapés.

Please register here. For queries, please email uk_alternative_investment_funds@pwc.com.

Please do continue to reach out to your usual PwC contacts if you would like to discuss any of the above, and please do share your feedback with us if there is a particular topic or issue you would like us to cover in the future.

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Summary of responses from the review of the UK funds regime

HM Treasury ('HMT') published its *Review of the UK funds regime: a call for input* on 26 January 2021. At the time, the overarching objective of the review was to "identify options that will make the UK a more attractive location to set up, manage and administer funds".

The context to this call for input was not solely Brexit, but a wider recognition that while the UK remains a Financial Services centre of choice, the UK's share of the regulated and alternative investment funds product market falls short of Ireland and Luxembourg.

PwC and others in the industry provided input to HMT, and a summary of the responses from the call for input has recently been published (the 'Summary of responses'). This summary of responses gives us an insight into the potential developments that HMT will be prioritising going forward and those where it is not persuaded of the benefits. In this article, we discuss what this means for the status of UK fund vehicles in the alternative investment space.

For Alternative Investment Funds, the Limited Partnership remains the fund vehicle of choice, and the majority of the jurisdictions with which the UK competes, each have a limited partnership offering which largely works and is well understood by the market.

The UK's Limited Partnership offering is equally well understood as a fund vehicle, and indeed, generally comes with less tax complexity than its main 'onshore' competitor, the Luxembourg SCSp (e.g., UK LPs aren't subject to the reverse hybrid rules).

However, even prior to Brexit, the UK was at a competitive disadvantage to the likes of Guernsey and Jersey, and more recently Luxembourg, due to the better management fee VAT outcomes that can be accessed where funds/fund managers are established in those jurisdictions. Following Brexit, the competitive disadvantage to Luxembourg increased further as fund managers could no longer use the AIFMD marketing passport to market UK funds in the EU.

However, despite the above, we are of the view that there is an emerging list of new factors that will cause fund managers to look again at the UK as a jurisdiction for all or part of their fund. On this list are the following:

- Increased cost of doing business and cost/shortage of staff in traditional fund/holding company jurisdictions.
- The introduction of a credible asset holding company regime in the UK (the 'Qualifying Asset Holding Company' regime) coupled with (i) an increasing need for 'substance' and (ii) the perceived benefits of having the fund manager, fund and investment holding companies in a single jurisdiction.
- Less complexity and tax risk around investment decision making processes in wholly UK structures (where the fund manager is UK headquartered).
- A potential natural improvement in the VAT position for UK funds investing in non-UK assets post-Brexit (such activity could lead to the fund having some VAT recovery).

Summary of responses from the review of the UK funds regime (continued)

The opportunity therefore exists for the UK to respond to these drivers with a funds regime for alternative funds which allows fund managers to increase their footprint in the UK without adding material cost and complexity to their operations. We have set out our thoughts on some of the specifics below:

- As alluded to above, from a tax perspective, the main difference between a UK based fund and the non-UK equivalents is the difference in VAT outcomes. In this regard, while there is a separate consultation process regarding the VAT treatment of fund management fees, in their responses to the UK Fund regime call for input, PwC and others stressed the importance of bringing the UK VAT position into line with other fund jurisdictions. In the summary of responses HMT have understandably ruled out a move to a zero rating of fund management fees given the wider fiscal position at this time. Whilst this means that the VAT position for UK funds will not be equivalent to foreign competitor there is still much which can be achieved through the wider consultation and PwC will continue to work with HMT to explore other avenues to shift the VAT landscape for UK funds.

- Many of the tax responses (including those submitted by PwC) involved suggestions making minor improvements to certain tax aspects associated with English and Scottish limited partnerships. These included:
    - Changes to the loss restriction provisions to allow PPS structures to operate as they did prior to 2017;
    - Simplification of the tax filing rules e.g. investor UTR requirements and reducing the number tax bases partnership returns need to be prepared under;
    - Steps to allow more certainty on the trading v investment analysis for English/Scottish limited partnership funds; and
    - Simplification of the Stamp Duty and Capital Gains Tax position on transfer of partnership interests.

- In addition to a range of tax points, the Summary of responses also highlights that respondents (including PwC) brought up long standing non-tax issues such as the inability to access the AIFMD marketing passport and the potential requirement to file publicly available accounts introduced by the Partnership (Accounts) Regulations 2008.

- The decision by HMT to moved forward with a unauthorised contractual scheme as a potential new UK onshore fund vehicle is welcome. PwC will continue to work with industry to lobby for a similar regime to be adopted for an unauthorised onshore tax exempt corporate fund so the global hedge fund industry will have an onshore hedge fund option so that, from a substance perspective, manager and fund activity can be brought together in one jurisdiction.

Summary of responses from the review of the UK funds regime (continued)

In several areas HMT's response to these points in the Summary of responses is unclear, for example, in relation to the impact of the loss restriction rules, this was highlighted as an area that already been consulted upon.

In other areas, there is scope for continued engagement with HMT in areas where HMT have noted that they will keep points 'under review' and that further representations from industry are welcome in places.

If industry wishes to see the above mix of tax/non-tax points addressed, then managers, industry associations and professional services firms will need to maintain the level of proactive engagement in order to continue to make the case for change.

PwC plan to continue making the case for change here, both on the larger points (marketing permissions, onshore corporate fund regime and VAT) and the collection of minor tax points. Particularly with regard to the latter, we feel there are some potential wins here which would help move the UK regime for alternative funds in the right direction.

The international asset management is a competitive landscape and other jurisdictions are not standing still. The UK consultation framework represents a step forward to making the UK internationally competitive.

Next steps for asset and wealth managers

Asset and wealth managers should keep a look out for the future deep dives we will be publishing in the coming months.

Whilst the UK Funds Regime consultation represents a step forward to making the UK internationally competitive, clients, industry bodies and professional advisors will need to stay engaged with HMT to deliver progress.

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Summary of responses – VAT

Whilst the summary of the responses to the UK funds regime consultation document is not the long-awaited consultation document in relation to VAT, there are many references to VAT throughout this document, reflecting the high degree of attention given to this topic in the responses provided to the consultation. In this article we discuss the way in which HM Treasury has presented its conclusions from the consultation exercise, and consider what is next for this consultation.

The history of the consultation

Consultations in relation to the financial services sector were launched in the March 2020 budget, which aimed to look forwards beyond Brexit to the future UK economy.

Whilst the consideration of the taxation of UK funds is linked to Brexit, it wouldn't be accurate to say that this was caused by Brexit. Indeed, in June 2016 when the Brexit vote took place, an informal consultation was already underway in relation to VAT and the management of funds in the UK.

The VAT treatment of fund management has been in a state of flux since 2007. Since 2007, the *JP Morgan Claverhouse*, *Wheels*, *GfBk*, *ATP* and *Fiscale Eenheid X* cases (amongst others) have considered this matter. Discussions have taken place in relation to the funds which are potentially included within the VAT exemption, including life companies, charity funds, tax efficient investment opportunities (i.e. investments which enable investors to access Enterprise Investment Scheme and Inheritance Tax relief), and more recently, model portfolios. Similarly, the bandwidth of the term "management" has been considered in relation to research (particularly post-MiFID II), tax reporting, and technology services.

It is also acknowledged that different EU Member States (and more distant shores) apply indirect tax rules in a very different manner, such that the choice of location of fund can have a material impact upon the VAT cost incurred by such funds; specifically, in certain territories which do not qualify as a special investment fund for UK VAT purposes, but which do qualify as special investment funds under the definition adopted in the territory in which they may be based, a more favourable set of VAT rules apply to non-UK funds.

Specifically, where territories (such as Luxembourg and Ireland) operate a broad VAT exemption for the management of investment funds, funds located in those territories do not incur VAT upon investment management fees. Where such management fees are supplied to Irish or Luxembourg funds by a UK manager, this can lead to a scenario where the UK manager is able to deduct VAT upon its costs, where the UK manager does not need to charge local VAT, and where the fund does not need to self account for VAT upon receipt of services. Overall, this is a very VAT efficient result for the UK manager and the Irish / Luxembourg fund.

By way of comparison, a UK alternative fund would typically incur VAT upon the management fees, or alternatively incur irrecoverable input tax where a VAT group is put in place. In either instance, there is a VAT cost in the supply chain, which would not arise with certain non-UK funds.

The consideration of UK VAT is not happening in a vacuum. Following the UK's departure from the European Union, the regulatory landscape has changed from a UK perspective. Where a fund is to be marketed to an EU audience, an EU product is needed, whereas under the UK's intention to operate an open market for investment products, there would be no countervailing requirement for there to be a UK product in order to permit marketing to UK investors. There is accordingly an imbalance in the starting position; for funds which may seek investors from both the EU27 and also the UK, there is already a requirement for an EU vehicle; for a UK vehicle to be successful it would need to be able to articulate the benefits it would bring, and it could not afford to be uncompetitive with EU products.

Summary of responses – VAT (continued)

The recent engagement

Mentioned above, in the March 2020 budget, two consultations were announced which were directly relevant to the tax rules applicable to funds. These were a review of the UK funds regime, and a review of the VAT treatment of fund management.

*"**The government will undertake a review of the UK's funds regime during 2020. This will cover direct and indirect tax**, as well as relevant areas of regulation, with a view to considering the case for policy changes. The review will begin with a consultation, to be published at the Budget, on whether there are targeted and merited tax changes that could help to make the UK a more attractive location for companies used by funds to hold assets. **The review will also consider the VAT treatment of fund management fees and other aspects of the UK's funds regime**".*

Shortly after the March 2020 budget, the UK entered into the first COVID lockdown, and resources (both in terms of Treasury personnel and the financial resources of the Treasury) were understandably redeployed to address the urgent and unprecedented challenges of the pandemic.

The UK fund regime review was launched in January 2021, and closed on 20 April 2021. The publication issued on 10 February 2022 was the collated responses to that consultation, and the Treasury's response to those responses.

The VAT consultation, by contrast, has not been formally published. However, that does not mean that it has completely fallen from the radar.

What has been happening with the VAT consultation?

Through 2020, HM Treasury engaged Policy Lab to conduct a series of informal discussions to understand the sector better, and how the VAT treatment operates in practice. The content of these discussions was reviewed, but it is understood that HM Treasury is now seeking a different course.

HMRC Policy and HM Treasury attended meetings during 2021 where the future VAT policy in this area was discussed at length. HM Treasury noted that a lot of the responses to the UK funds regime consultation had highlighted VAT as an area in which it was important for the UK policy to be calibrated carefully, in order to ensure that the UK funds would not be uncompetitive when compared with non-UK funds. A range of options appeared to be under consideration.

The VAT and fund management review was again mentioned in a statement by the Chancellor in July 2021. In this statement, the Chancellor set out a vision for the UK financial services sector.

To deliver this vision we have:

***Launched a review of the VAT treatment of fund management** and established an industry working group to examine the case for reviewing the VAT treatment of financial services. **This work aims to ensure that the VAT system supports our wider objectives for the sector and is fit for the future**.*

More recently, in the Autumn Statement 2021, delivered on 27 October 2021, the VAT and fund management consultation was referenced, albeit the focus from HMT seemed to have shifted from earlier statements around competitiveness towards simplification.

Summary of responses – VAT (continued)

What does the funds regime review document say?

As noted in the prior article, there are a wide range of topics covered in this document, including:

- The UK fund regulatory environment and how this might change to encourage the establishment of UK domiciled funds
- The UK tax environment and its impact of fund establishment, including the VAT treatment of fund management fees, the efficacy of the UK's double taxation treaty network and the opportunities for wider tax simplifications in respect of funds
- The implementation of new fund structures in the UK to facilitate specific investment types
- The suitability of and improvements required in relation to mechanisms to allow for investments in property assets

One of the key themes which recurs through the document is VAT, which was highlighted by a number of respondents against a number of different questions in the consultation (although we note that the consultation itself did not ask VAT specific questions).

The document provides Treasury's views in relation to the VAT submissions which were received, which can be summarised as follows (numbering refers to the paragraphs in the Treasury document):

- Acknowledgement that a number of participants had highlighted VAT as a necessary part of considering the attractiveness of the UK as a fund location (2.2)
- There will be a consultation in relation to VAT and fund management, but this will not look at zero rating for fund management fees (2.3)
- An explanation behind this decision is the Exchequer impact (2.3)
- The ruling out of zero rating appears to be a decision (2.170) and the Government's position (2.42)

As a consequence of the above, Treasury specifically notes that a number of items which it otherwise proposed to consider are not viable. These are:

- Unauthorised limited partnerships
- Unauthorised corporate structures

Given the wider economic backdrop and the post pandemic government fiscal position, it is not surprising that the primary concern on the part of the Treasury around providing a zero rate appears to be the financial cost of this. This has been a point under discussion between industry groups and HM Treasury in recent months.

Summary of responses – VAT (continued)

What next?

Whilst many in the industry would have welcomed a move to a zero VAT rate, we have to acknowledge the wider fiscal position and focus on engaging with HMRC as the focus of the forthcoming VAT consultation shifts to VAT simplification.

HM Treasury clearly acknowledges the importance placed on VAT by numerous respondents to the consultation. HM Treasury also indicates that the VAT consultation is coming, and that the UK funds regime consultation was explicitly not a consultation on the VAT treatment of fund management fees.

Whilst not securing a zero rated VAT position at this time may still mean that UK domestic funds are at a competitive disadvantage in relation to certain EU funds, providing the evidence for and building the fiscal case for a zero rate of VAT over the longer term should still be an objective for the UK funds industry.

We note that there are other matters which could be consulted upon which would serve to make the UK a more competitive fund location when compared to other territories, such as Ireland and Luxembourg. Simplification is something which would be welcomed, particularly given some of the complexities faced by investment managers in relation to partial exemption methods and VAT administration and complexity.

What happens next will be of great interest in the asset management community, far beyond those individuals responsible for VAT accounting. HM Treasury has acknowledged the need for reform of investment management VAT and we look forward to working with them and industry in this regard.

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Pillar 2 – UK consultation on implementation

Following the publication of detailed Pillar 2 rules by the OECD on 20 December 2021, to ensure that multinational enterprises ('MNE') are subject to a minimum tax rate of 15% from 2023 in each jurisdiction in which they operate, the UK government published a consultation on 11 January on how those Pillar 2 rules will be implemented in the UK. The consultation closes on 4 April 2022.

The consultation reconfirms the UK's intention to introduce an Income Inclusion Rule ('IIR') from 2023 and a Undertaxed Payment Rules ('UTPR') together with a Domestic Minimum Tax from 2024 (at the earliest). The consultation notes that the OECD will publish the commentary on the Model Rules in the first quarter of this year and the Implementation Framework by the end of this year.

We have set out below key points from the consultation:

Timing

- The Government anticipates that the parts of this legislation relating to the IIR would be included in Finance Bill 2022-23 and would have effect from April 1, 2023.
- The Government anticipates that both the UTPR and the domestic minimum tax would be introduced from April 1, 2024, at the earliest. The UTPR is expected to be applied in only very limited circumstances, as explained in the consultation, for example where an overseas-based MNE's ultimate parent entity is not subject to an IIR.

UK income inclusion rule

- The rule ordering in the Model Rules means that the UK's IIR would apply at different points in the group structure depending on the particular circumstances of the group.
- It will apply to all such MNEs which are headquartered in the UK, with the UK IIR applied to the ultimate parent entity of the group.
- The UK IIR will also then apply to UK intermediate parent entities of foreign headquartered groups where those entities are more than 20% owned by minority investors or are controlled by parent entities that are not located in a jurisdiction that has introduced Pillar 2.
- The UK IIR will impose a top up tax on these parent entities based on their interests in overseas subsidiaries and branches which are located in jurisdictions in which the MNE has an overall ETR in the jurisdiction below 15%.

Applying the IIR to smaller groups

- The consultation notes that the Model allows for countries to applying the IIR to smaller groups below the €750m threshold and suggests that the UK does not intend to impose a lower threshold for the following reasons:
- The government shares the view that the relatively high threshold of €750m is necessary to ensure Pillar 2 was proportionate.
- Groups below the threshold are less likely to have substantial overseas operations and are therefore less likely to pose the risks that Pillar 2 is designed to protect against.
- As these groups would also not be subject to an IIR or UTPR in another jurisdiction, introducing the IIR to these groups could damage the UK's attractiveness as a parent location for limited gains.

UK reporting process

- Groups will be required to notify HMRC that they are within the scope of the Globe through a new registration process. This will enable groups to send their Globe return to HMRC where they are a filing entity, or alternatively to issue a notification with the details of the relevant filing entity.
- The government is considering allowing businesses 6 to 9 months from the end of their Fiscal Year/Consolidated financial reporting period to complete this registration.
- There are different approaches which could be taken to the reporting of liabilities under the IIR or UTPR. For example, information about liabilities under the IIR could be reported through the Corporation Tax return or taken directly from the Globe return itself. This process is still to be determined as it depends on the level of information which is included in the Globe return. But HMRC's preference would be to take the relevant data directly from the Globe return.

Pillar 2 – UK consultation on implementation (continued)

Payments

- The government recognises there is a significant amount of information required to calculate liabilities under the Globe rules and that it would be challenging to forecast these liabilities during the fiscal year.
- The government consequently prefers that liabilities under the IIR or UTPR are paid annually after the end of the fiscal year to ensure the compliance burden from these rules is proportionate and proposes to align the payment due date rules with the normal due date in CT (i.e. 9 months from the end of the Fiscal Year). This would provide businesses with more time to collect information about their ETR in overseas jurisdictions and their liabilities under the Globe.
- However, it should be noted these changes would only be possible if the IIR is collected outside of the CT return. The government is considering making UK constituent entities joint and severally liable for IIR and UTPR debts that were charged to UK constituent entities.

Other comments

- The consultation notes that it will be necessary for the UK rules to follow the OECD Model Rules (deviating only if necessary to meet specific UK legal requirements). It then sets out the structure of the model rules in some detail inviting comments on various aspects as they might relate to UK implementation. These include whether there are any uncertainties that could be clarified in the UK's domestic legislation whilst respecting the intended outcomes in the Model Rules relating to any adjustments made to the accounting profit.
- There is also a discussion regarding GILTI grandfathering/co-existence where it is observed that this is an ongoing discussion in the Inclusive Framework pending the outcome of tax reform in the US.
- At the end of the consultation there is a section on whether Pillar 2 will mean that existing BEPS measures (such as the controlled foreign companies ('CFC' rules) are no longer required. The conclusion appears to be that wholesale reform of any of the existing measures would not be appropriate.

Next steps

We understand from a series of HMRC stakeholder meetings at the beginning of February that HMRC's current thinking is that the IIR will apply for accounting periods ending after 1 April 2023. However they have not completely ruled out the possibility of the rules applying for accounting periods commencing after 1 April 2023. This means that for groups with September year ends, they will have just under 8 months in which to start applying these rules.

Many Funds may expect to fall in the investment fund carve out however asset and wealth managers should consider these rules carefully to ensure that all the conditions are met.

As noted in our last month's edition, the introduction of Pillar 2 will have a significant additional compliance burden for international groups, whether or not they actually have a tax charge as a result of this. If not already done so, impacted groups may want to start assessing its potential impact. This should include understanding the potential future impact on ETR, what information will be required and the additional resourcing requirements as well as the potential implications of the transitional rules when analysing the tax consequences of any transactions they undertake from now on. Many groups have started to model the impact, using CbCR information as a starting point but understanding that many other important details need to be considered.

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Preparing for the continual deluge of ESG regulations

We continue to see alternative investment managers needing to react to the ongoing ESG regulatory agenda in the EU and UK. In this article, we will examine some of the key hot topics that firms are facing, and where they need to take action sooner rather than later.

What are regulations covering?

Primarily, new ESG regulation is looking at disclosure - helping fund investors understand the exposure of their fund to certain sectors, such as high carbon-emitting companies. Further, regulations seek to categorise funds into various different ESG investment strategies - ensuring only those funds seeking demonstrable sustainable or ESG outcomes are able to market themselves as such. These regulatory requirements come through (in the EU) the Taxonomy Regulation and the Sustainable Fund Disclosures Regulation ("SFDR") and (in the UK) the Sustainability Disclosure Requirements ("SDR") and the FCA's implementation of the Task Force for Climate-related Disclosures ("TCFD") reporting requirements for entities and funds.

Across all of these regulations there is one key theme - alternative fund managers need to understand what data they need to disclose to their investors. Typically they will need to make changes to their existing strategy, technology or reporting to ensure this data is collected, validated and reported to investors as is required.

Client demands around ESG funds

On top of this, we hear from a number of our alternative fund manager clients from across the globe that their investors are making demands based primarily on the SFDR categorisations. SFDR splits funds into three categories - "Article 6" funds, which have no ESG investment strategy; "Article 8" funds, which use some ESG characteristics in their investment strategy (such as excluding certain sectors, and using screening tools to screen out poorly scoring ESG companies); and "Article 9" funds, which directly seek out positive ESG outcomes, including use of an ESG benchmark. Our clients are continually told by their clients that they want any new fund to be "at least an Article 8 fund", regardless of whether SFDR applies to the manager or not (SFDR applies to EU funds, or non-EU funds marketed into the EU).

Investors are clearly now viewing ESG as part of their investment strategy. For certain investors, and notably pension schemes, this is being driven by regulation. UK pension schemes are being compelled to consider ESG as part of their investment strategy. Pension schemes are now routinely seeking to check the ESG credentials, including tax, as part of their selection process. This ESG focus applies equally to the investment strategy and to the position of the supplier.

Preparing for the continual deluge of ESG regulations (continued)

What alternative fund managers should be doing now

Alternative fund managers should be keeping track of all these new regulations, the implementation timelines and impacts on their funds and operations. In our experience, some firms are implementing requirements sooner than the compliance date due to the aforementioned investor demands. This all creates a number of complexities that need to be managed:

- Keeping track of the regulator impact - the volume of the regulation coupled with competing implementation timelines in different jurisdictions where you may have funds established, managing entities or investors can be challenging to manage within usual horizon scanning activities. In particular, there are a number of non-financial services impacts (such as from the Taxonomy Regulation and TCFD reporting requirements) which might impact your investors, or your portfolio companies - so you need to track these requirements, as well as those that directly impact your operations.
- The regulatory requirements around ESG are fairly similar. Typically they require additional data points to be collected so that you can report on the ESG impact of your investments, or the exposure of your portfolio to certain factors (such as carbon or greenhouse gas emissions). Firms that are most advanced in their thinking are looking at the ESG regulations in a holistic way - thinking about how to amend their operating models, data strategy and reporting processes once to meet a number of different regulatory requirements, rather than doing this as each regulation applies. This is the most effective approach, and brings a number of benefits - such as getting ahead of your peers in complying with regulation and bringing additional ESG data to your investors.

We're having a number of these conversations with our clients - primarily driven by the changing regulation and the alternative fund manager's need to meet their investor expectations around fund categorisation. Increasingly, firms are coming to us with the starting point that their fund needs to be designated as an Article 8 fund - so need help identifying whether the investments, and investment strategy, fits with that outcome. Firms are also reviewing their overall product governance framework to align their fund strategy with the ESG fund categorisations.

All of this means a number of changes to internal processes are needed to meet market, regulatory and investor demands. These changes and demands are likely to increase before the volume of ESG regulation eases.

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