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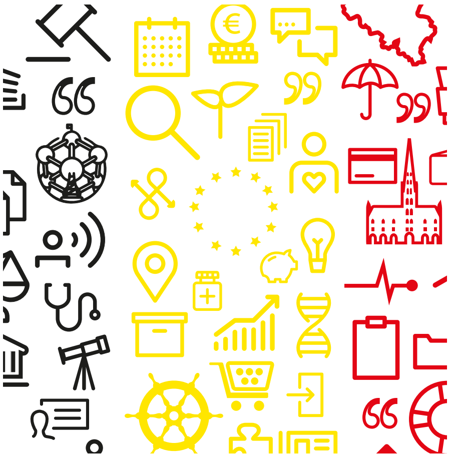
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Foreword

Dear readers,

In many ways, this 21st edition of Performance marks the passage of time. As the seasons change with marked differences in temperature and colours, Deloitte is undergoing its own vivid transformation.

Much has been said and written about companies when they unveil a new look; every little detail is scrutinised to discover any hidden meanings behind the change of a logo or the use of different colours, shades and tones. Think of our branding change as an evolution rather than a revolution; like giving a room a makeover. The essence of the room's functionality, purpose and meaning remains the same yet it looks and feels revitalised.

For Deloitte, this is exactly what we set out to do - our core values, strategy and vision - all remain the same but our evolved identity is visually striking. It remains simple and straightforward, clean and cohesive yet bold and beautiful. A look and feel that is unquestionably new, yet utterly familiar. Interestingly, 15 years ago during our last makeover, our famous "green dot" was going to be fushia until someone reconsidered the choice of colour.... Think how different the world would look today.....

Change is at the heart of evolution and the investment management industry is continuously at the forefront. Although challenging on many levels, change must be positively embraced. Twenty years ago, email communication and the internet was in its infancy with information shared via letters, memoranda or during crackly conference calls at sometimes unusual hours; today we can access emails and the internet 24/7 almost anywhere in the world. Nevertheless, technology is not the sole reason for change; for our industry the defining catalyst is the constant regulatory evolution. This requires us to devise new technologies to develop new financial services and products. Buzzwords like FinTech, Smart Beta and RegTech are added to the multitude of regulatory acrynoms we come across on a daily basis.

On the other hand, thanks to technological innovation, globalisation has enabled investment management to create unique strategies and applications for its astute clientele using strong local insights and on-the-ground resources. Yet globalisation is not all about our clients locations', it also impacts us as human beings, our knowledge and interaction with each other. This knowledge is what makes Performance truly global – each edition providing thought provoking insights for an enriching read.

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EMEA Investment
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Editorial

Dear readers,

Southeast Asia is made up of ten countries with different languages, cultures, political environments, and levels of economic development. The ten countries also form the Association of Southeast Asian Nations (ASEAN) bloc. It is home to more than 600 million people and is one of the most dynamic markets in the world. With a nominal GDP of US$2.31 trillion, ASEAN is fast becoming a major economic force and a driver of global growth. The move by ASEAN to promote economic integration via the ASEAN Economic Community (AEC)—a single market for goods, services, capital, and labor—is a major milestone and serves to reinforce the regional growth potential. The AEC has the potential to transform the region into one of the largest markets in the world, rivaling that of China and India.

Global investors face the challenge of balancing growth opportunities in the region with economic and political risks. The first step to overcoming this challenge is understanding the politics and local business environment of the region. Located at the heart of the Asia Pacific and in close proximity to India, China, and Japan, ASEAN is geographically well positioned to benefit from trade with these countries. ASEAN's largest trading partners in 2015 include China, Japan, and the US with a combined 35 percent share to total ASEAN trade. The region's impressive diversity as a trading bloc is one of its advantages, as it can offer a package of different services across the region, supported by a young and skilled/semi-skilled workforce, booming urbanization, as well as a favorable geographic location.

The AEC is designed to increase the economic bloc's global competitiveness, removing trade and investment barriers and increasing intra-ASEAN trade. While there is strength in the region's diversity, it has also proven to be one of the key stumbling blocks to ASEAN's formal economic integration. While economic integration may seem like an ambitious goal, it is not entirely impossible.

Notwithstanding complex economic and regulatory challenges, much remains to be done to improve the region's infrastructure, economic inequality, and education standards.

The numbers don't lie: global investors look to ASEAN as the region now receives more foreign direct investment (FDI). According to the recent ASEAN Investment 2015 report, FDI into ASEAN has risen for the third consecutive year from US$117.7 billion in 2013 to US$136.2 billion in 2014. With fierce competition for FDI comes competition for capital. Frontier markets in Southeast Asia such as Laos and Myanmar will face a different challenge than the region's more developed economies, where increasing productivity and maintaining competitiveness is critical.

Regardless of these challenges, the region is on its way to becoming an economic powerhouse. Financial institutions would do well to understand the region and the opportunity that knocks on the doors of Southeast Asia.

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Building a Smart Financial Center

Mohit Mehrotra, Partner in Consulting at Deloitte recently met with Mr Sopnendu Mohanty to discuss Mr. Mohanty's views on FinTech and how Singapore is working toward becoming a world leader in the FinTech industry.

Sopnendu Mohanty
Chief FinTech Officer, Monetary Authority of Singapore

FinTech, which involves using technology to devise new financial services and products, is quickly gaining global momentum.

Not to be outdone by other parts of the world, the FinTech industry is evolving at varying degrees in different countries in Southeast Asia. Playing an important role in this growth are the different programs that exist in the region and one country at the forefront of this phenomenon is Singapore.

In November 2014, Singapore embarked on the Smart Nation program, which seeks to harness info-comm technology, networks, and data to support better living, create more opportunities, and to support stronger communities. The financial sector is an integral part of Singapore's ambition to be a "Smart Nation". The Monetary Authority of Singapore (MAS) seeks to create a Smart Financial Center where technology is used pervasively in the financial industry to increase efficiency, create opportunities, allow for better management of risks, and improve lives. We sat down with MAS Chief FinTech Officer, Mr. Sopnendu Mohanty, to discuss his views on FinTech and how Singapore is working toward becoming a world leader in the FinTech industry.

Singapore is a major financial center of international repute.

Mr. Mohanty is responsible for creating development strategies and regulatory policies around technology innovation at MAS. Prior to joining MAS, Mr. Mohanty was with Citibank as their Global Head of the Consumer Lab Network and Programs, which included driving innovation programs and managing innovation labs across multiple areas.

Mr. Mohanty has spent 20 years in the Asia Pacific (APAC) region and has held various roles in technology, finance, productivity, and business development. He was Citibank's APAC regional head of branch operations along with the head of the Consumer Innovation Lab in Singapore. He spent a significant time in Japan, where he was Citibank's Retail Business Development head and also did leadership stints in various functions within operations and technology. Globally, he played a significant subject matter expert role in driving Citibank's global smart banking program, in order to transform the bank's physical network to digital first, smart and innovative, client-centric, and a highly delightful customer engagement center. Mr. Mohanty has also co-authored various patented work in the area of retail distribution of the financial sector.

Deloitte: How would you describe the FinTech environment in Singapore?

Sopnendu Mohanty: The FinTech landscape is quickly evolving, with a proliferation of technological innovations and solutions. Singapore's FinTech landscape has reached a level of maturity that has all the elements of an ecosystem, in some form or shape. Our FinTech landscape is vibrant and well-connected. We have 1200+ financial institutions, 5000+ startups, and 200+ FinTech startups and we are ranked fourth among key FinTech regions such as the UK, US, Germany, Hong Kong, and Australia. The FinTech landscape in Singapore has reached the optimal time, wherein the platform can be enhanced to truly build a world-class FinTech ecosystem. Technology makes up a large part of the FinTech landscape, and how developed we are on the technology-side of FinTech will determine the true character of FinTech in Singapore.

Here in Singapore, we are in the process of establishing technological capabilities through our universities, research centers, and bank innovation labs as well as through the MAS programs and policies to partner with the industry on various strategic and technology-driven financial services initiatives.

Singapore is a major financial center of international repute. Singapore is ranked third in the Forex Global Ranking in terms of size, and ranked second in terms of OTC Interest Rate Derivatives in Asia in the 2013 Triennial BIS Survey. According to SWIFT, Singapore was also ranked second in being an offshore RMB clearing center in terms of size.

Singapore has established itself as a leading business hub in the region with its sound legislation and policies. Singapore has consistently done well in internationally recognized world rankings, including:

- **First in Investment Potential Ranking** – BERI Report 2015
- **First in Ease of doing business** – Doing Business 2014, Word Bank
- **Fist in Global Innovation Raking** – Global Innovation Index 2015, Cornell, INSEAD, WIPO
- **Second in IP Protection Ranking** – Global Competitiveness Report 2013-2014, World Economic Forum

As a premier knowledge, financial, and business hub, Singapore's FinTech landscape is set to grow exponentially over the next few years.

The biggest challenge would be the ability of financial services firms to adopt the use of FinTech.

D: What are the biggest trends you've seen in FinTech over the past few years? Which developments excite you the most?
SM: The biggest and most sustainable trend in the FinTech space is its potential to revolutionize financial inclusion. This is also the development that is the most exciting to witness.

Technology will enable financial services in a big way by providing individuals and business owners access to capital and financial services that they would normally not have access to.

Once you provide the underserved communities with access, it will pave the way for a new economy, which until now has not been fully realized. FinTech will play a significant role in enabling financial inclusion. In my opinion, this is the single biggest opportunity.

In terms of core asset classes, the retail space has had the most fanfare, especially in alternative payment methods and lending as well as in the distribution of insurance products. Insurance, especially, has been remarkably limited in its reach due to distributional inefficiency. The entire insurance sector is in for a notable transformation with more digital distribution of products and the use of big data to price insurance products dynamically and competitively.
For the financial markets and corporate banks, FinTech will play a large role in upgrading existing infrastructure, which is not necessarily the most efficient. This may be based on distribution ledger platforms and will make use of open Application Programming Interface (API) architecture.

D: In your current position as the Monetary Authority of Singapore's Chief FinTech Officer, what's your take on FinTech? Is it a disruptor or enabler?
SM: FinTech is a huge enabler. FinTech has helped the financial services industry improve profitability and be more agile when addressing evolving customer demand. Millennials are going to be the largest adult segment by the end of the decade, and financial institutions are more and more challenged by the fact that this segment is demonstrating different behaviors compared to older generations. FinTech can help fill the gap between financial institutions and their changing customer base by creating a new architecture of engagement through digital platforms and new business models.

However, I would also say that FinTech is disruptor; but not in the traditional sense. When people talk about disruption and disruptors, they normally tend to refer to the act of taking away existing business models and creating an alternate opportunity. Think about, for example, the ability of FinTech to potentially revolutionize financial inclusion. Traditionally, banks would not normally see the underserved as a potential market to tap into.
As a disruptor, FinTech has created an opportunity for a new market whereby individuals and SMEs alike can gain access to capital where they previously could not.

D: What challenges do you see on the horizon for FinTech? How will these challenges affect Singapore and the island city's position as a pre-eminent financial center in Asia?
SM: The biggest challenge would be the ability of financial services firms to adopt the use of FinTech. Historically, the financial sector has been too reactive in terms of updating infrastructure technology. Financial services firms have always been at the forefront of front-end and middle office technology, where companies use technology to create complicated business models and financial products. However, when it comes to infrastructure technology, the financial services sector has been falling behind.

This is the result of the lack of skilled talent in the FinTech space. In order to effectively adopt FinTech in the industry, Singapore is investing heavily to transform itself into a knowledge hub for future investors.

At the same time, the same macro- and microeconomic shocks that have affected the world present both challenges and opportunities to FinTech. First, European financial institutions, and by extension FinTech firms, face continuing uncertainty about the future of critical market access issues such as passporting rules and regulatory uncertainty in a post Brexit world. Will there be large scale capital-raising by UK subsidiaries of European institutions that then affect the availability of funding for FinTech startups? What will happen to freedom of movement for talented developers? The future is hard to predict at this point in time.

As regulators turn their eyes toward FinTech and the risks that arise from these alternative finance products, one

can count on more rules and restrictions. Cross-jurisdictional regulatory differences will emerge as each country deals with idiosyncratic FinTech blow-ups in their own way. These can be incompatible rules across jurisdictions making it difficult for FinTechs to nagivate the landscape as well as hindering the passports for new products.

Singapore believes in working within international bodies to accelerate the discussion of standards and rule harmonization to help the industry overcome these challenges.

D: To what extent do you think FinTech can be encouraged by government regulation, and what is being done to allow innovation to flourish in Singapore?
SM: The financial services industry is a regulated industry—and a regulated industry needs a regulator that is willing to think progressively on how to apply technology in order for innovation to flourish.

The financial sector is an integral part of Singapore's ambition to be a Smart Nation. MAS seeks to create a Smart Financial Centre where technology is used pervasively in the financial industry to increase efficiency, create opportunities, allow for better management of risks, and improve lives. FinTech is a key ingredient in building a Smart Financial Center.

Singapore offers a distinctive value proposition for FinTech development.

These include:

- A vibrant and collaborative FinTech ecosystem comprising of startups, technology companies, financial institutions, investors, research institutes, institutes of higher learning, innovation professionals, and government agencies
- An open banking platform through APIs for faster innovation and integration of new and legacy IT systems within the sector
- "Sandboxes" as safe spaces to experiment and roll out innovative products and solutions within controlled boundaries
- A Financial Sector Technology & Innovation (FSTI) scheme to support the creation of a lively ecosystem for innovation
- A strong talent pool of researchers, innovators, and experts; and continuously building capabilities in FinTech

Regional private banks face an increasingly sophisticated clientele who expect portfolio-level performance and risk management.

D: What initiatives have been developed to attract capital for FinTech in Singapore?
SM: Singapore's FinTech landscape is one of the most active in the world. We have launched several initiatives to attract capital for FinTech in the country.

In August 2015, MAS formed a Financial Technology & Innovation Group (FTIG) to drive the Smart Financial Center initiatives. The group is responsible for formulating regulatory policies and developing strategies to facilitate the use of technology and innovation to better manage risks, enhance efficiency, and strengthen competitiveness in the financial sector. FTIG has also been constantly engaging the FinTech community to work on various projects, overcome hurdles, and most importantly—join the group itself. The development of a vibrant FinTech ecosystem requires close collaboration among government agencies in Singapore. A FinTech Office, established on 3 May 2016, serves as a one-stop virtual entity for all FinTech-related matters and to promote Singapore as a FinTech hub.

From 14 to 18 November 2016, MAS together with the Association of Banks in Singapore (ABS) will organize the inaugural Singapore FinTech Festival. The week-long festival—the first of its kind in Asia—will bring together a series of distinct, back-to-back FinTech events. The festival will provide a platform for collaborations, connections, and co-creations within the FinTech ecosystem in Singapore and around the region.

The Singapore FinTech Festival (14-18 November 2016) will comprise of three components:

01. Global FinTech Hackcelerator
In May 2016, the global FinTech community was invited to ideate and co-create solutions to specific problems or challenges solicited from the financial industry. Up to 20 teams will be selected from across the world to develop market-ready solutions for these problems over the following months.
The selected teams will present their completed solutions on Demo Day, on 15 November 2016, during the festival.

02. MAS FinTech Awards
The awards will recognize innovative FinTech solutions that have been implemented by FinTech startups, financial institutions, and technology companies.

03. Conferences and events
The festival will include the MAS FinTech Conference, ABS-MAS Tech Risk Conference, and ABS-MAS Regulation Technology (RegTech) Forum. The festival will also feature other community and networking activities like the Innovation Lab Crawl, where innovation labs across Singapore will be open for visits to their labs, and where new products and solutions can be tested. It will be a good opportunity to network with startups and key innovation executives.

MAS has also organized several Singapore FinTech roadshows as part of a series of global outreach initiatives to draw the attention of the global FinTech community to the possibilities for innovation and collaboration that Singapore's growing FinTech ecosystem offers. The first event was held in New York in April 2016. More than 200 members of the FinTech community, including bank and investment executives, FinTech startups, technology experts, and innovation practitioners attended the event. Other cities such as Sydney and Mumbai have followed.

D: How big of a role will FinTech play in helping Singapore realize its vision to be recognized as a premier wealth management hub?

SM: Regional private banks face an increasingly sophisticated clientele who expect portfolio-level performance and risk management. This is no trivial change; one can extrapolate the difficulties that banks have with internal models used for risk managing and valuing their own trading books to infer the challenges for large scale for clients as well. Think of regional clients with significant real estate holdings, commodities exposure, and FX risk that organically arise from having family businesses that span across volatile regional currencies—how will wealth managers advise these clients holistically?

We expect that many private banks will not choose to build these portfolio risk systems in-house, given the diversity of market data and models. Instead, they may either look for a utility-like solution for data collation, or connect to FinTech firms with the deep expertise to do so.

We anticipate this to result in a profound shift in how clients manage their risks and perhaps increase their willingness to participate more fully in the markets.

Therefore, we would like to promote the formation of a cluster of sophisticated risk analytics and portfolio management FinTech companies to meet the needs of wealth managers as they transform their practices for new customer expectations. The mass affluent market will benefit from the trickle-down of technology and know-how to the burgeoning robo-advisory platforms. We expect a virtuous cycle of increasing scale economies.

Understanding Southeast Asia's dynamism and diversity

Ei Leen Giam
Southeast Asia Investment Management Leader
Deloitte

Asia's asset management industry is one of the fastest growing in the world. Recent developments in Asian securities regulation, deepening capital markets, the emergence of a large and affluent middle class, and high saving rates combine to create huge opportunities for asset managers.

Asia is a continent of contrasts, with huge variations in natural resources, business environments, and cultures. Southeast Asia, in particular, is made up of a mix of mature, emerging, and frontier markets, reflecting economies that are uniquely diverse. Asset management firms will need to navigate the challenges outlined below that come with Southeast Asia's diversity in order to come out on top.

The lack of a common cross-border mutual fund regime is one of the biggest challenges facing the region. For many years, asset managers have waited for an Asian equivalent of Europe's successful UCITs directive, the European regulatory framework for investment vehicles. In 2013, not one but three possible versions of cross-border mutual fund initiatives across Asia were announced:

- **Asia Region Funds Passport (ARFP):** The Memorandum of Cooperation—signed by representatives from Australia, Japan, South Korea, New Zealand, and Thailand—on the establishment and implementation of the ARFP came into effect on 30 June 2016, after over six years passed since the idea for the passport was recommended by the Australian Financial Centre Forum in its Johnson report.[1] These five economies will have up to 18 months to implement the arrangements through their national laws. Singapore is notably absent, despite being one of the countries to sign a Statement of Intent on the ARPF, and which has been involved in drafting its framework since 2013. Singapore remains open to participate in the ARFP, pending the commitment to resolve the issue around the treatment of onshore and offshore funds. While the high barriers to entry continue to be a challenge, the ARFP is a positive step toward the alignment of funds laws and regulations in the region, which may lead to more streamlined processes in the future.
- **ASEAN Collective Investment Scheme (CIS) Framework:** The CIS Framework went live in August 2014, allowing the cross-border distribution of funds between Singapore, Thailand, and Malaysia. As of March 2016, 13 funds have been recognized by their home jurisdictions as Qualifying ASEAN CIS, five of which have been successfully approved and launched in a host jurisdiction.[2]

1 Asia Region Funds Passport's Memorandum of Co-operation Comes Into Effect http://fundspassport.apec.org/2016/06/30/asia-region-funds-passports-memorandum-of-co-operation-comes-into-effect/

2 ASEAN capital market regulators roll out initiatives under ACMF's new 5-year roadmap http://www.theacmf.org/ACMF/upload/press_release_for_acmf_meeting_25_mar_2015.pdf

- **The Mutual Recognition of Funds (MRF) between Hong Kong and China:** The MRF has achieved relatively better traction, given the strong interest in the Chinese market. This MRF allows access to the large Chinese market through the Hong Kong platform. Hong Kong's MFR only has six northbound funds (HK-based and marketed in China) that have been approved as of 15 April 2016, along with 32 southbound funds.[3]

In order to reach the full potential of these cross-border mutual fund initiatives, more countries will need to be included, and more work will need to be done to harmonize regulation, reduce barriers to entry, and mitigate associated operational challenges.

The landscape of today's asset management industry in Asia is reminiscent of the 1980s in Europe, when the UCITs directive kick-started 30 years of growth, creating the second-largest investment fund industry in the world. There is potential for Asia to replicate that growth in its local markets; yet realizing it will not be smooth sailing.

Southeast Asia's deep economic integration with the rest of the world means that global developments are bound to have an impact on the region; take for example the Asian Financial Crisis in 1997, the Global Financial Crisis in 2008, and the threat of a Greek exit from the EU (Grexit) in 2015. With the recent decision of Brexit (British exit from the EU), there are concerns among analysts about its ramifications for the fund market. Investment management firms are aware of the huge risks to their businesses and will have to ensure they are set up to navigate the immediate risks and impacts of an exit, and have the processes and people in place to manage a period of upheaval.

Financial services regulation will continue to dominate the agendas of financial institutions. Beyond upcoming regulatory policy initiatives, financial institutions in Southeast Asia will continue to face challenges with the implementation of regulatory requirements in 2016 and beyond. This challenge is heightened for those institutions that operate across borders and are subject to multiple regulatory jurisdictions. Financial services firms spend hundreds of millions of dollars on compliance and risk programs; approximately 30 percent of compliance costs could be saved just by employing the right technology.[4] For example, Deloitte Singapore's risk analytics center develops strategies promoting the use of analytics in risk management and regulatory compliance in the region. The use of technology helps our clients understand the gaps they need to address more efficiently. It makes it more effective for firms to automate the way in which they adhere to different regulatory compliance laws and regulations.

Southeast Asia's unique markets create the need for tailored strategies, and success requires strong local insights and on-the-ground resources.

Technology also plays a vital role in devising strategies to scale up distribution and drive down costs while serving multiple markets. The use of robo-advisers is likely to be a game changer as it aims to independently replicate activities performed by asset managers through online access, at a lower cost. While traditional asset management services are usually reserved for high-net-worth individuals, robo-advisers target a broader customer base, including mass affluent and retail investors with little to no minimum investment amount. Robo-advisers and some early-adopting traditional adviser firms in developed countries are pursuing multiple strategies—such as marketing directly to retail clients and as a white-labelled offering for financial advisors—to scale more rapidly and sustain profits. Although it is only the beginning, asset managers should react, as this hybrid service model will likely become the new norm.

Investors in Southeast Asia, as well as greater Asia (China, India, and Japan), are on the lookout for new products. Product innovation will play an important role to persuade investors to buy asset management products. Southeast Asia is home to a population of approximately 622 million relatively young people and it has an emerging middle class with growing spending power.[5] While first-generation wealth creators in the 1980s invested in their businesses and real estate, millennials are turning to professionally-managed investments. Millennials will be the largest client group driving asset managers to assess their business model, as well as assess the way in which they interact with clients, to identify which adjustments are necessary to successfully serve this group of people. Early adoption will enable firms to protect their market share and establish their brands.

Southeast Asia's unique markets create the need for tailored strategies, and success requires strong local insights and on-the-ground resources. As the region's asset management industry continues to grow, investment products will become more well-known and widely understood, and new passport initiatives and digital technology will allow funds to be distributed easily across markets, providing international asset managers with an opportunity to carve out strong market positions and keep their leading position.

3 Passports for prosperity http://www.euromoneyseminars.com/articles/3549692/passports-for-prosperity.html

4 Spend on tech, save on compliance costs http://www.straitstimes.com/business/companies-markets/spend-on-tech-save-on-compliance-costs

5 Selected basic ASEAN indicators: http://www.asean.org/storage/2015/09/selected_key_indicators/table1_as_of_Aug_2015.pdf

The future of investment management
Open application programming interfaces

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Application Programming Interfaces (APIs) allow organizations to leverage their existing IT assets to generate new business value via mobile apps, connected devices, and the cloud.

APIs have been elevated from a development technique to a business model driver and boardroom consideration. An organization's core assets can be reused, shared, and monetized through APIs that can extend the reach of existing services or provide new revenue streams.

Applications and their underlying data are long-established cornerstones of many organizations. All too often, however, they have been the territory of internal R&D and IT departments. From the earliest days of computing, systems have had to talk to each other in order to share information across physical and logical boundaries and solve for the interdependencies inherent in many business scenarios.

The trend toward integration has been steadily accelerating over the years. It is driven by increasingly sophisticated ecosystems and business processes that are supported by complex interactions across multiple endpoints in custom software, in-house packaged applications, and third-party services (cloud or otherwise).

The open API-oriented approach toward technology architecture is generating lot of attention. APIs are expected to reduce the time to market for various products/ services and lower the cost of build by "plugging in" with open API.

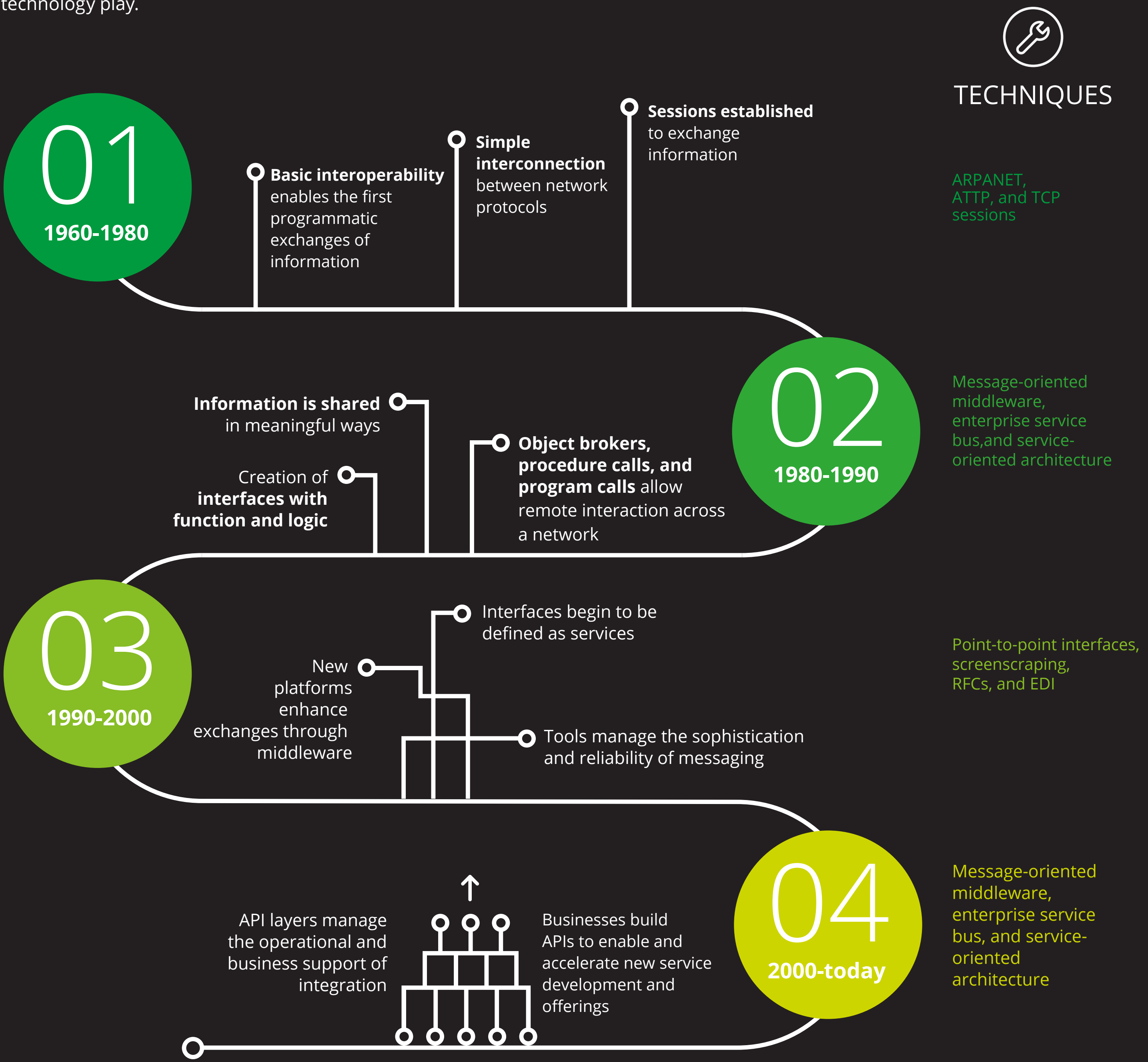
APIs in financial services

The growth in banks and financial services firms exposing APIs to their legacy systems is primarily driven by the need to deliver more functionality and faster time-to-market. For example, when launching a new digital bank, if every single feature of the digital bank was built in-house, it would take a huge amount of time and investment to build all the functionality needed to run such a bank. Instead, the bank can leverage best-of-breed software and integrate them into their solution via APIs.

Similarly, in the case of the investment management industry where market data is the lifeblood of any organization's business, getting accurate and timely market data in the requisite format continues to be a time consuming and evasive process. However, these businesses now have the option of linking their systems with external data feeds, which provide real-time, historical, and reference data without the need for complex in-house data management systems. These offerings can also be potentially sold by investment management firms as additional products over and above the suite of investment management offerings.

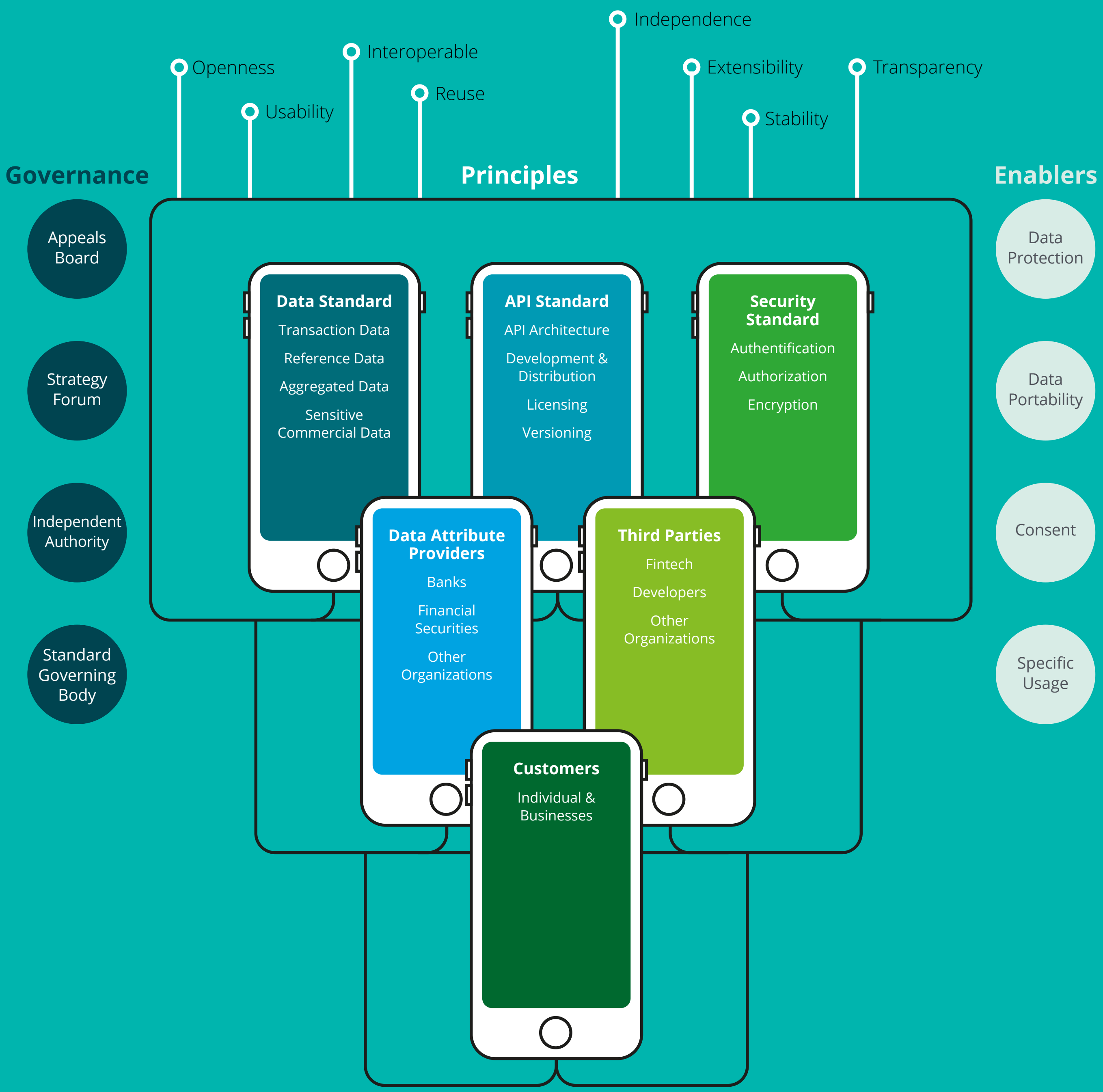
The evolution of APIs

There are more than 12,000 APIs that give fantastic opportunity for investment management firms to explore ways to further develop the next generation of technology play.



Currently APIs are increasingly scalable, monetized, and ubiquitous, with more than 12,000 listed on Programmable Web, which manages a global API directory

The open API-oriented approach toward technology architecture is generating lot of attention.



To manage the cost of building and delivering solutions, service providers need to consider development on clear standards that help in articulating this across not just the entire technology organization but also the business. This makes it easier to develop various ecosystems not just with small corporates but also large ones.

The degree of openness, elements of usability and/or re-usability, and how we can make the framework easy to interpret, as well other elements such as feasibility, stability, and transparency are key priorities of an API management framework. Organizations will need to think clearly about the transition from legacy architecture to micro-services and how these transitions will help them not only better manage the maintenance budgets, but also reduce time to market.

Here are a few vital questions firms should ask themselves before embarking on an open API journey:

01

How do we develop data standards around transaction data, reference data, and, more importantly, sensitive commercial data? Firms should consider elements such as data protection, data portability, and consent.

02

How do we build security standards that ensure the right level of authentication, authorization, and encryption?

03

How do we manage relationships with the various stakeholders such as data attribute providers, third parties, and customers?

In summary, organizations need to ensure APIs have the clarity of a well-positioned product—a clear intention, a clean definition of the value, and perhaps more importantly, a clearly defined audience. It is important to plant the seed of how business services and APIs can unlock new business models.

To the point:

- APIs allow organizations to leverage their existing IT assets to generate new business value via mobile apps, connected devices, and the cloud
- The growth in banks and financial services firms exposing APIs to their legacy systems is primarily driven by the need to deliver more functionality and faster time-to-market
- In the investment management industry, where market data is the lifeblood of a firm's business, getting accurate and timely market data in the requisite format continues to be a time consuming and evasive process
- With APIs, these businesses have the option of linking their systems with external data feeds which provide real-time, historical, and reference data without the need for complex in-house data management systems
- Organizations will need to think clearly about the transition from legacy architecture to micro-services and how these transitions will help them not only better manage the maintenance budgets, but also reduce time to market

A rapidly changing tax landscape
Recent Asian tax developments

Michael Velten
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The tax environment in Asia continues to evolve. The diversity of tax systems in Asia (and their differing maturity) notwithstanding, there are a number of broader trends in Asian tax that can be discerned.

These include:

- Indirect tax reform such as the introduction of the Malaysia Goods and Services Tax (GST) in 2015 and the recent expansion of the China Value Added Tax (VAT) to cover the financial services industry; we have seen developments in Japan and South Korea, and the India GST reform is pending
- Monitoring of *Base Erosion and Profit Shifting* (BEPS) developments and adoption of recommendations—although the rate of adoption varies across the region with a clear group of fast movers (e.g., Australia, China, Japan and South Korea)
- Support for tax transparency initiatives
- Consistent with the Organization for Economic and Co-operation and Development's (OECD) BEPS objectives, the introduction of measures to protect the integrity of the domestic tax base

In this article we cover several recent developments in Asia that are directly relevant to asset managers.

China: Transition to VAT

On 1 May 2016, the China VAT reform that began back on 1 January 2012 was completed, with the remaining industries—including financial services and insurance—transitioning from the Business Tax (BT) regime to VAT. A broad range of financial services will now be taxed at a VAT rate of six percent (versus the previous BT rate of five percent), although with an ability to deduct input VAT paid on expenses.[1] Financial services have been defined to include finance and insurance businesses, that is, loan services (lending and borrowing), fee-based financial services (including asset management services), insurance, and the transfer of financial products.

There is some roll-over of the current BT exemptions into the new VAT regime. Even with the inclusion of these exemptions, the scope of the China VAT on financial services is broader than what is found in other VAT jurisdictions. In China, imposing indirect tax on these activities is not new, as the VAT treatment aims to represent a continuation of the BT regime. In fact, the VAT applies to trading activities in a manner similar to a turnover tax, with the trading business required to calculate the VAT due based on the net realized gain, and any losses made can be carried forward to offset against the gain, but not beyond the same calendar year. This means that funds are brought into the VAT system as VAT taxpayers with few exemptions (e.g., QFII, RQFII, and other qualified foreign investors).

Although the move to VAT effectively reflects a roll-over of the existing BT approach into VAT, the one percent increase in rate (from five percent to six percent) must be fully assessed and costed in terms of the impact to margins and pricing. In particular, although VAT is intended to be imposed on the customer, commercially this can be challenging. Since the BT was previously absorbed by the business, in effect this can result in an additional one percent cost.

While entry into the VAT regime means that there is the ability to recover VAT paid on expenses, this cost is not entirely removed. The China VAT regime operates with multiple rates (from 3 percent to 17 percent); in scenarios where the input VAT exceeds the output VAT, refunds are generally not paid in cash refunds and need to be carried forward. If an exemption applies, the input VAT would not be recoverable and therefore the VAT on asset management services paid by exempt funds would be a cost.

The transition to VAT also brings in the scope for VAT exemption for export services on asset management services to parties outside of China. The relevant in-charge tax bureau must approve the exemption, although the application procedures still need to be clarified. Businesses and the tax authorities are still grappling with some of the technical and practical issues in the shift to the new regime. We expect that there will be more developments in the coming months.

Hong Kong Profits Tax (HKPT) Exemption changes

In 2015, the HKPT exemption for offshore funds to non-resident private equity (PE) funds, called the Offshore Funds Law, was extended. Previously, tax exemption was not available to non-resident funds on transactions in securities of private companies. In effect, this excluded non-resident PE funds from enjoying HKPT exemption under the Offshore Funds Law. In order to enhance Hong Kong's position as an asset management center, the extended Offshore Funds Law introduces various concepts that will allow PE funds to also benefit from HKPT exemption.

Broadly, the key changes are:

- Transactions in securities in certain private companies that fall within the definition of an "excepted private company" are tax exempt "specified transactions": Broadly, such an excepted private company has to be an offshore portfolio company incorporated outside HK that meets the conditions within a three year "lookback" period, including not having a permanent establishment in HK and the 10 percent "de minimis" thresholds on its HK assets.

1 Note that input VAT deduction is not allowed on interest expenses and direct loan related fee expenses.

- Qualifying fund: Prior to the extension of the Offshore Funds Law, specified transactions have to be arranged or carried out by a "specified person" in order to be HKPT exempt. A specified person generally refers to a person licensed under the Securities and Futures Ordinance, by the Securities and Futures Commission (SFC). A non-resident PE fund may not necessarily have an SFC-licensed person undertake such transactions. With the extension of the Offshore Funds Law, a non-resident PE fund that is not managed by an SFC licensed person may also enjoy HKPT exemption if it meets certain conditions (e.g., a minimum of five investors apart from originators and their associates, or capital commitments made by unrelated investors exceeding 90 percent of the fund's aggregate capital commitments).
- Special Purpose Vehicle (SPV): Recognizing that a PE fund typically uses an SPV to hold its investments, HKPT exemption would be provided to an SPV on its profits derived from transactions in certain securities of an interposed SPV or an excepted private company (such as gains from the disposal of an offshore portfolio company). The SPV must be established solely for the purpose of holding and administering one or more offshore portfolio companies.

The new legislation was widely anticipated and enables key investment activities such as the negotiation, conclusion, and execution of the acquisition and disposal of investments to be carried out in HK by fund managers in HK without causing the fund's profits to be sourced in HK and subject to HKPT.

On 31 May 2016, the Inland Revenue Department (IRD) issued Departmental Interpretation and Practice Notes No. 51 (DIPN 51) to clarify the key provisions. However, in DIPN 51, the IRD also sets out its position on fund management fees and carried interest, which has been a focal point of recent tax investigations and audit in HK. The IRD stated that it does not likely consider a cost plus basis of remuneration of a HK sub-manager/investment advisor in HK to be an arm's length rate, and, if applying the general anti-avoidance provisions of the Inland Revenue Ordinance of HK, carried interest may be attributed to their services rendered and subject to HKPT unless the return is an arm's length return on genuine investment.

In China, imposing indirect tax on these activities is not new, as the VAT treatment aims to represent a continuation of the BT regime.

In 2015, the HKPT exemption for offshore funds to non-resident private equity (PE) funds, called the Offshore Funds Law, was extended.

Carried interest received by fund executives who provide services in HK by way of distributions from the fund's general partner or carried interest partner may also be caught by the general anti-avoidance provisions and subject to HK tax as employment income or service fee. An important consideration for fund managers is whether relying on the Offshore Funds Law to obtain HKPT exemption for their funds, thereby carrying on more fund management activities in HK, would adversely affect the taxability of fund management fees or carried interest.

Singapore and Hong Kong join the OECD's BEPS Project as BEPS Associates

In June 2016, Singapore and HK announced that they will join the OECD's BEPS Project as BEPS Associates.[2]

Singapore announcement

Singapore announced that it is committed to implementing the four minimum standards under the BEPS Project as an Associate. Singapore also detailed its position on the four minimum standards under the BEPS Project, as follows:

- Countering harmful tax practices (Action 5): While Singapore uses tax incentives to promote investment in certain areas, incentive recipients must have substantive operations in Singapore regularly review its tax incentives. Singapore has allowed some tax incentives to lapse and refined several others over the years.
- Preventing tax treaty abuse (Action 6): Singapore does not condone treaty shopping. A number of Singapore's bilateral tax treaties contain anti-treaty shopping provisions. Singapore is currently part of a group of jurisdictions working to develop a multilateral instrument for incorporating BEPS measures into existing bilateral treaties.
- Country-by-Country Reporting (CbCR) for transfer pricing documentation (Action 13): Singapore will commit to implement CbCR for financial years beginning on or after 1 January 2017 for multinational enterprises whose ultimate parent entities are tax resident in Singapore, and whose group turnover exceed S$1,125 million. IRAS will exchange CbC reports with jurisdictions that Singapore

2 The first meeting between BEPS Associates was held on 30 June to 1 July 2016, where the OECD announced that a total of 82 new countries and jurisdictions have joined as BEPS Associates. Another 21 countries and jurisdictions attended the meeting as invitees, and will consider whether to commit to the implementation of the BEPS package.

has entered into bilateral agreements with for automatic exchange of CbCR information. Further details are expected to be released by September 2016.

- Enhancing cross-border tax dispute resolution (Action 14): Singapore will work closely with other jurisdictions to monitor the implementation of minimum BEPS standards on dispute resolution

Hong Kong announcements

As an Associate, HK will join with other countries and jurisdictions to design, review and monitor the implementation of the four BEPS minimum standards. The Secretary for the HK Treasury Professor KC Chan stated: "...HK's commitment to implement the BEPS package is subject to timely passage of the necessary legislative amendments. We will take into account relevant factors such as the characteristics of the domestic tax regime, the envisaged magnitude of legislative changes involved, and the practical need to prioritize amongst the BEPS measures."[3]

It is expected that HK will engage with industry members to develop a strategy for implementing the relevant guidelines and protocol, and will release more information in the coming months.

CRS implementation in the region

The OECD CRS provides for the automatic exchange of information between tax authorities of signatory countries. Currently over 100 jurisdictions have committed to CRS, with the first exchange of information due to happen as soon as 2017 for "Early adopter" or "Wave 1" jurisdictions.

Within the region, India and South Korea are "Early adopters" or "Wave 1 jurisdictions". More commonly however, Australia, Brunei Darussalam, China, Indonesia, Japan, Macau, Malaysia, New Zealand, and Singapore have committed to CRS as "Non-early adopters" or "Wave 2 jurisdictions", with the first exchange due to happen in 2018.

The status of CRS implementation in each respective jurisdiction varies. Financial institutions will need to closely monitor local CRS developments in each jurisdiction where they operate.

Some recent key developments this year with respect to CRS implementation in the region include:

- Legislation to implement CRS in **Australia** was enacted in March 2016 and Guidance was released in April 2016.
- Legislative Council of the **HK Special Administrative Region** passed the HK Inland Revenue (Amendment) Bill in June 2016.
- Updated FATCA and CRS Guidance was released in **India** in May 2016.
- The National Tax Agency in **Japan** released unofficial Q&As in April 2016 to address questions from the industry.
- Inland Revenue in **New Zealand** released a CRS consultation document and submissions were due by March 2016.
- Legislation to implement CRS in **Singapore** was passed on 9 May 2016 and published in the gazette on 4 July 2016. CRS Regulations were also released in June 2016 for comments as part of a private consultation with the industry.

The majority of Asian countries have signed the Multilateral Competent Authority Agreement (MCAA) with the exception of Brunei Darussalam, HK, Macau, and Singapore. The MCAA specifies the details of what information will be exchanged and when.

3 Hong Kong Government Press Release dated 20 June 2016 available here: http://www.info.gov.hk/gia/general/201606/20/P201606200520.htm.

The Singapore-India tax treaty provides that the capital gains tax exemption for Singapore residents on disposal of shares in Indian companies is conditional upon similar rights being available under the Mauritius-India tax treaty.

India addresses capital gains exemption under tax treaty with Mauritius

On 10 May 2016, India and Mauritius signed a protocol to amend the existing 1982 tax treaty.

Currently, the India-Mauritius tax treaty provides that capital gains derived by an entity are taxable only in the state of residence of the seller. This forms the basis of the "Mauritius route": gains derived from a Mauritius company from the sale of shares in an Indian company are not taxable in India under the treaty. The most significant of the changes is that the protocol will grant India taxing rights over gains derived by a Mauritius company from the sale of shares in an Indian company. This will effectively close off the "Mauritius route" for investment into India. Investments made on or before 31 March 2017 may be "grandfathered" (i.e., the rules do not apply retrospectively) and a lower tax rate on capital gains applies during the two transition years ending on 31 March 2019.

Consistent with the changes negotiated to the India-Mauritius tax treaty, Cyprus announced on 30 June 2016 that it had completed negotiations to amend its tax treaty with India. The amendment provides a source-based taxation for gains from disposal of shares. Investments undertaken prior to 1 April 2017 would be grandfathered so that taxation of disposal of such shares at any future date remains with the contracting state of residence of the seller.

Implications for the Singapore-India tax treaty

The Singapore-India tax treaty provides that the capital gains tax exemption for Singapore residents on disposal of shares in Indian companies is conditional upon similar rights being available under the Mauritius-India tax treaty.

As a result of the changes to the Mauritius-India tax treaty, the residency-based taxation treatment under the Singapore-India tax treaty may not be available by 1 April 2017.

The respective Ministries of Finance are expected to commence negotiations on a new protocol to the tax treaty. While this will take time, the concerns of the industry and the need for certainty (especially around grandfathering) are well understood by the Singapore authorities.

Alternative investment options

Depending on the circumstances of each investor, a number of options for investment into India through Mauritius may still be available:

- As capital gains tax exemption continues in the India-Mauritius tax treaty for bond investments, and interest income is taxed at 7.5 percent, which is the lowest rate of any country with agreements with India, investors may consider structures involving participating loans.
- As gains arising from derivatives are exempt from Indian capital gains tax, portfolio investors (i.e., with investments of less than 10 percent) may continue to route derivative trades through Mauritius.
- PE investors may explore conversion of Indian companies into Limited Liability Partnership (LLPs), as alienation of interests in LLPs continue to be exempt under the India-Mauritius tax treaty (although we note there are some limitations to this, including restrictions on foreign direct investment in LLPs).
- PE investors may explore investing in partly paid-up shares prior to 1 April 2017 and bring-in balance funds (i.e., call money) within 12 months as required by the exchange control regulations in India.

India has a number of other tax treaties that provide exemption from capital gains tax in India.[4]

General anti-avoidance rule (GAAR)

The GAAR will commence on 1 April 2017. The GAAR provisions will only apply to transactions entered into on or after 1 April 2017.

To the point:

- The tax environment in Asia continues to evolve and companies should monitor relevant developments and take action where appropriate.
- International tax reform and transparency continue to be important issues for investment managers.

4 See for example: Belgium (shareholding must be less than 10 percent); Denmark (shareholding must be less than 10 percent); France (shareholding must be less than 10 percent); Indonesia; Jordan (capitals gain to be subject to tax in Jordan); Kenya; Korea; Netherlands (shareholding to be less than 10 percent or sale of shares should be to a non-resident); Philippines; Sweden (capital gains to be subject to tax in Sweden); Zambia; Malaysia; and Spain (shareholding to be less than 10 percent).

The asset owners' conundrum
Insourcing of asset management

Kerrie Williams
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Global trends and evolution

The level of interest around insourcing has risen amongst institutional asset owners, and there is more talk about whether or not to adopt an insourcing strategy, as well as how to find the best approach. Frontier's Governance Advice, Risk, Decisions, and Strategy (GARDS) team completed detailed research on the insourcing trend earlier this year, publishing its analysis in March 2016. The most commonly cited driver for the change was cost reduction. While cost continues to be an important factor, we think the impetus behind the recent progression is a combination of a lower expected return environment and the increased scrutiny on external management fees—the latter likely exacerbated by the lower return environment and regulatory pressure.

These global trends have been driven by asset owners who also want to get closer to their assets and gain greater control over their investments. The fact that insourcing can help address capacity constraints with external managers is becoming an incentive for some large asset owners. For instance, our clients based in Australia continue to grow in terms of assets under management, and they are no longer able to get sufficient capacity with some external active managers. This leads some to build up their own internal teams to invest directly. West Midlands, a government scheme in the UK, is a strong believer of internal management. They identify cost savings as the predominant motivation but also because not all of their third-party relationships offered the best value.[1]

Relative to larger asset owners, smaller asset owners (less than US$500 million in AUM)[2] placed greater importance on an improved ability to negotiate with external managers when deciding whether to manage assets internally; they also place a proportionately greater emphasis on enhanced oversight and reporting capabilities. Overall, the most important rationales behind managing assets internally, cited by a range of small, mid-sized, and large asset owners, were cost reductions and improved net of fee returns.

From our observations, the most common asset classes being insourced by asset owners are cash and fixed income, and this remains true irrespective of fund size or location. Interestingly, alternative asset classes (asset classes other than cash, fixed income, and equities) are most common among the large and small asset owners but less common among the mid-sized asset owners.

The following two tables from Frontier's March paper on insourcing compare the examples of the different stages of insourcing across Australian, European, Singaporean, US, and Canadian asset owners.

Table 1: What are Australian asset owners insourcing?

	AustralianSuper	QSuper	UniSuper	REST	Sunsuper	Telstra Super
Fund size	AU$99.5B	AU$59B	AU$49.2B	AU$37B	AU$33.5B	AU$17B
Investment staff	~115	~20	Not disclosed	~30	~25	Not disclosed
Types of investments managed by internal teams	• Australian Equities • Capital Guaranteed • Currency Overlays • Fixed Interest • Infrastructure • International Equities • Private Equity • Property	• Cash • Global Fixed Interest • Real Estate • Infrastructure • Alternatives • Private Equity	• Australian Equities • Global Equities • Listed Property • Fixed Interest • Cash • Infrastructure	• Australian Equities • Bonds • Cash • Growth Alternatives • Infrastructure • Property	• Infrastructure • Fixed Interest • Cash	• Property • Australian Fixed Interest • Infrastructure • Cash • Currency Overlay • Asset Allocation Overlays • Private Equity
Total portfolio internally managed	~19.0%	Not disclosed	~47.6%	~16.4%	~5.9%	~30%

Source: Based on information supplied in the fund's annual report

1 Sarah Rundell (April 2016) – "West Midlands welcomes pooling," www.top1000funds.com
2 BNY Mellon and P&I Content Solutions Group (February 2016) – Rightsourcing

Table 2: What are international asset owners insourcing?

	Norges Bank Investment Management (NBIM) (Norway)	Ontario Teachers' Pension Plan (OTPP) (Canada)	California Public Employees' Retirement System (CalPERS)	California State Teachers' Retirement System (CalSTRS)	Canada Pension Plan Investment Board (CPPIB)	GIC Singapore
Fund size	NOK$7,019B ~AU$1.45T	CA$154.4B ~AU$155.9B	US$301B ~AU$405.2B	US$191.4B ~AU$257.7B	C$282.6B ~AU$285.3B	Not disclosed, estimated to be AU$279B
Investment staff	~195	Not disclosed	Not disclosed	~117	~400	Not disclosed
Types of investments managed by internal teams	Broad application across the portfolio, with the exception of emerging markets and small cap primarily	• Private Equity • Venture Capital Funds • Real Assets (Real Estate and Infrastructure) • Absolute Return/ Hedge Funds • Renewable Energy • Opportunistic Alternatives	• Global Equities • Fixed Income • Liquidity • Inflation Strategies • Private Equity • Real Estate	• US Equities • Global Equities • Fixed Income • Alternatives (Private Equity and Real Estate)	• US Equities • Global Equities • Government Bonds • Private Debt • Real Estate • Infrastructure	• Equities • Fixed Income • Real Estate • Private Equity • Infrastructure
Total portfolio internally managed	~95.9%	~80%	~69%	~45% (with plans to increase to 60%)	~64%	~80%

Source: Based on information supplied in the fund's annual report

The case for insourcing asset management

Insourcing strategies will continuously evolve; due to that, asset owners should constantly assess their strengths and weaknesses to decide the most appropriate strategy. The hybrid model of internal and external management creates greater flexibility and control—when for example a number of key staff leave the fund. Harvard University in the US used to manage 75 percent of its assets internally, but after the high remuneration of investment staff was made public (due to public disclosure rules), it caused conflicts among staff members, and several employees resigned as a result. Harvard University subsequently reduced its internal asset management to 60 percent of the fund and now has a separate external entity managing most of its assets to reduce the sensitive remuneration conflict. A recent report from Bloomberg[3] stated in late June that Harvard University had further reduced its internal investment staff numbers and would redirect more money to external managers, although the exact amount has not yet been disclosed. It was reported that the direct equity strategy would not continue and an additional four members of staff departed as a direct result.

We have observed that the common next step for some asset owners who are comfortably managing assets internally, but actively seeking ways to bring more strategies in-house, is to expand their existing capabilities from domestic equities and fixed income to include the internal management of global equities. California State Teachers' Retirement System and Michigan Municipal Employees' Retirement System in the US, and AustralianSuper in Australia have each publically stated their plans to expand their internal asset management capabilities to include global equities.

In the UK, West Midlands'[4] internal investment team has established a passive overseas equity portfolio that sits alongside its internally run domestic equity, private equity, and fixed income portfolios. The fixed fee for internal passive management is cited as a key benefit. The scheme's in-house team manages 75 percent of the assets, reporting a cost saving on investment fees of almost £25 million, due in part to rationalized and renegotiated fee structures with external managers.

Alternative drivers for insourcing

Insourcing asset management can also be motivated by external factors, such as regulator-driven consolidation. One example is the Netherlands, where the largest pension funds currently manage the majority of their assets in-house. It is reported[5] that Dutch funds withdrew nearly €30 billion from third-party managers over a four-year period to 2015. Investors in Europe and the Middle East pulled more than €45 billion from segregated mandates during 2015 alone.

Cost aside, another reason for insourcing is to improve alignment and get closer to the fund's assets. Asian pension funds looking for a way to improve alignment and leverage economies of scale are finding benefits through partnerships, co-investments, and asset pooling, seeing these as a preferred alternative to merging while still reaping immediate scale benefits. Mergers among Asian funds are relatively uncommon,[6] whereas cooperative agreements are more prevalent and can be made across multiple jurisdictions. This can help the involved funds enjoy better access to illiquid (less transparent) asset classes and to better align interests. More mature Asian investors like Singapore's Government Investment Corporation (GIC) are managing their own assets in-house and have established their own investment arm to allow them to reach into more specialized asset classes.

Insourcing asset management can also be motivated by external factors, such as regulator-driven consolidation

3 Michael McDonald, Sabrina Wilmer (June 2016) – "Harvard shifts more investments to outside money managers," www.bloomberg.com

4 Sarah Rundell (April 2016) – "West Midlands welcomes pooling," www.top1000funds.com

5 Nick Reeve (June 2016) – "Europe's asset management crunch," Chief Investment Officer

6 Spence Johnson (May 2016) – "Deeper Perspectives #36: Asia Pacific institutions – strengths in numbers"

Challenges associated with insourcing asset management

Governance

Strong governance is vital to the success of internal asset management and requires the support of an appropriately resourced board and investment committee. This is equally important regardless of whether the asset owner has 10 percent of its assets managed internally, or 90 percent. When setting the strategy for your own fund, consider the scope, scale, and pace. A strong support structure will not only help the asset owner to achieve its objectives but also improve the asset owner's resilience in times of internal and external stress.

A successful long-term insourcing strategy relies on monitoring, reporting, and effective communication to the board on how the strategy is achieving its objectives and providing benefits.

> We continue to believe that there is no "one size fits all" solution and that the decision needs to be carefully considered, planned, monitored, and reviewed. Insourcing is not a set and forget strategy

Recruiting and retaining talent

Recruiting and retaining investment staff remains one of the key challenges for asset owners across the globe; remuneration was cited as the biggest challenge for most public funds, which often lack the necessary budgetary resources. For our clients based in Australia, finding staff who are appropriately qualified and are a good cultural fit for the organization is not without its difficulties. Investment views based on philosophic alignment and with members' best interests as a focus are important for an internal investment team member. The challenge of recruiting and retaining staff can be particularly difficult for funds that are restricted by state or federal rules; however, most of these funds are confident that the fund's reputation will help them acquire the necessary internal investment expertise. Asset owners who may not be subject to the same rules are seeing merit in benchmarking their compensation structure against private sector banks and asset managers—as competition for the best investment professionals is becoming "fierce." The State of Wisconsin Investment Board (SWIB) has adopted this approach, and CIO David Villa[7] describes attracting and retaining the best investment professionals as a "war."

No "one size fits all" solution to insourcing

We continue to believe that there is no "one size fits all" solution and that the decision needs to be carefully considered, planned, monitored, and reviewed. Insourcing is not a set and forget strategy—it requires regular review like any business and investment strategy. It is a business strategy decision that requires the same level of monitoring.

To the point:

- Limited capacity at external managers is a driver to insource investment management for asset owners in Australia as they continue to grow assets under management
- Harvard University reduced the level of internal investment management to 60 percent in response to issues associated with remuneration
- As an alternative to insourcing, some Asian asset owners utilize partnerships, co-investments, and asset pooling to leverage economies of scale and increase alignment
- External factors, such as regulator-driven consolidation in the Netherlands have resulted in the withdrawal of €30 billion of funds from third-party managers over a four year period
- Hybrid model of internal and external management creates better flexibility and control, minimizes agency risk, and reduces information asymmetry from being removed from the capital markets
- Strong governance is vital to the success of internal asset management to manage potential conflicts of interest and key person risk within the investment team
- Recruiting and retaining talented investment staff remains one of the key challenges for asset owners across the globe

7 Sarah Rundell (April 2016) – "SWIB Sits out the long winter," www.top1000funds.com

Seriously sustainable

The portfolio managers who help investors to put their money where their values are

Chris McKnett
Head of ESG
State Street Global Advisors

Jordy Miggelbrink
Co-Founder
FusionATCM

Pascal Martino
Partner
Advisory & Consulting
Deloitte

If money is power, then trends in the investor community give sustainability advocates a good deal to be excited about. In this article, Deloitte shines a spotlight on "sustainable investment."

We talk to State Street Global Advisors, one of the world's largest investment companies, to find out how they integrate socially responsible perspectives into their strategies and portfolios. Then to capture the exciting opportunities being unlocked by digitization, FusionATCM gives us an overview of the first-of-its-kind cloud-native portfolio management solution that they offer. The solution promises asset managers instantaneous portfolio construction functionalities integrated with real-time compliance and post-trade management processing to "supercharge" the sustainable portfolio management process.

Part 01

Sustainable investment: Setting the context

As the head of the FNG's board of directors noted, the growth of the broader SRI market—of which sustainable investment forms a part—has been even more impressive.[4]

First, what do we mean by "sustainable investment"?
Sometimes referred to as "Socially Responsible Investing" (SRI), sustainable investing is an investment strategy that values companies on their environmental, social, and governance (ESG) credentials in addition to traditional financial metrics. Investors typically seek both financial returns as well as positive environmental and social results when making their investment decisions. However, different investors will place varying degrees of importance on these objectives.[1]

How significant is the sustainability market?
In what its authors rightly view as a sign of heightened investor interest, a study by the University of Oxford and Arabesque Partners noted that by March 2015, an impressive 72 percent of S&P 500 companies were integrating sustainability metrics into their reporting.[2] Morgan Stanley's research found that in 2014, US$1 out of every US$6 of US assets that were being professionally managed were invested in sustainable assets—up from US$1 out of every US$9 in 2012.[3]

The trend is certainly not limited to the US. In May 2016, citing the findings of industry group FNG, the European Sustainable Investment Forum (Eurosif) reported "above-average growth" in the sustainable investment market across Germany, Austria, and Switzerland. As the head of the FNG's board of directors noted, the growth of the broader SRI market—of which sustainable investment forms a part—has been even more impressive.[4] In under ten years, the CFA Institute points out, the number of those signing up for the United Nations' Principles for Responsible Investment (PRI) Initiative has increased more than twelve-fold.[5]

What are the market drivers?

At a high level, we see three main drivers behind the sustainable investments trend:

- In a number of countries, the public sector's need for financing for social and environmental projects has resulted in a regulatory environment and incentive structure that encourages socially responsible investment (in the green bonds space, for example).

1 See Epstein, M.J.; Yuthas, K. 2014. Measuring and Improving Social Impacts: A Guide for Nonprofits, Companies and Impact Investors. Canada: Berrett-Koehler Publishers, Inc., especially Part 1, Chapter 2 "Understanding the investor"; www.monitorinstitute.com/downloads/what-we-think/impact-investing/Impact_Investing.pdf

2 www.arabesque.com/index.php?tt_down=51e2de00a30f88872897824d3e211b11, p.8

3 www.morganstanley.com/sustainableinvesting/pdf/sustainable-reality.pdf

4 www.eurosif.org/wp-content/uploads/2016/05/2016.05.11-PR_Sustainable_Investment_Market_Report_DACH.pdf

- There has been a heightened awareness of the risk to companies' bottom line posed by social and environmental challenges, and a growing perception that it makes financial sense to invest in entities that integrate social and environmental considerations into their operations.
- A broader global trend towards conscious capitalism has emerged, not least as a reaction to the global financial crisis. Terms like "triple bottom line", "shared value", and "profit with purpose" have become ubiquitous—and reflect the growing emphasis on ensuring that financial markets yield measurable benefits on a broader range of dimensions than pure profit. Conscious capitalism is a reminder that markets should also be directed toward making a positive impact on society and the environment—and that this impact should be both measurable and transparent. With infectious enthusiasm, the leader of Morgan Stanley's Institute for Sustainable Investing, Audrey Choi, put it nicely in a recent TED talk "...change your mind, vote with your small change, invest in the change you want to see in the world, and change the markets."[6] In their contribution to Deloitte's Business Trends 2015 series, Eggers and Muoio cite the 2014 Net Impact survey (Net Impact is a not-for-profit organization that advocates for sustainable business). The survey revealed that a striking 83 percent of MBA candidates enrolled in business schools across the world were prepared to be paid 15 percent less if it meant being able to have a positive social and environmental impact through their work—an increase on the previous year.[7] It is a finding that resonates with Deloitte's own research about millennials, which highlights the increasing importance that "purpose" holds in career decisions for this demographic.[8]

The source of investor demand: study overview

Eurosif study: legislative pressures and materiality

In its 2014 survey,[9] Eurosif asked respondents (asset managers and self-managed asset owners) to rank a number of potential drivers for future growth of the SRI market in the subsequent three years (2014-2017). The chart below illustrates the results. The survey was carried out in both 2012 and 2014 with the graph below showing the results in comparative terms. In both 2012 and 2014, the survey used a relative scoring method (i.e., each driver was calculated relative to the least significant driver—in the case of 2014 that would be "demand from retail investors").

That institutional investors are identified as key drivers of growth is unsurprising—this certainly remains the main source of investor demand. What is interesting, however, is that asset managers cite legislative pressures and materiality as important drivers.

5 https://blogs.cfainstitute.org/marketintegrity/2015/08/17/cfa-institute-survey-how-do-esg-issues-factor-into-investment-decisions/

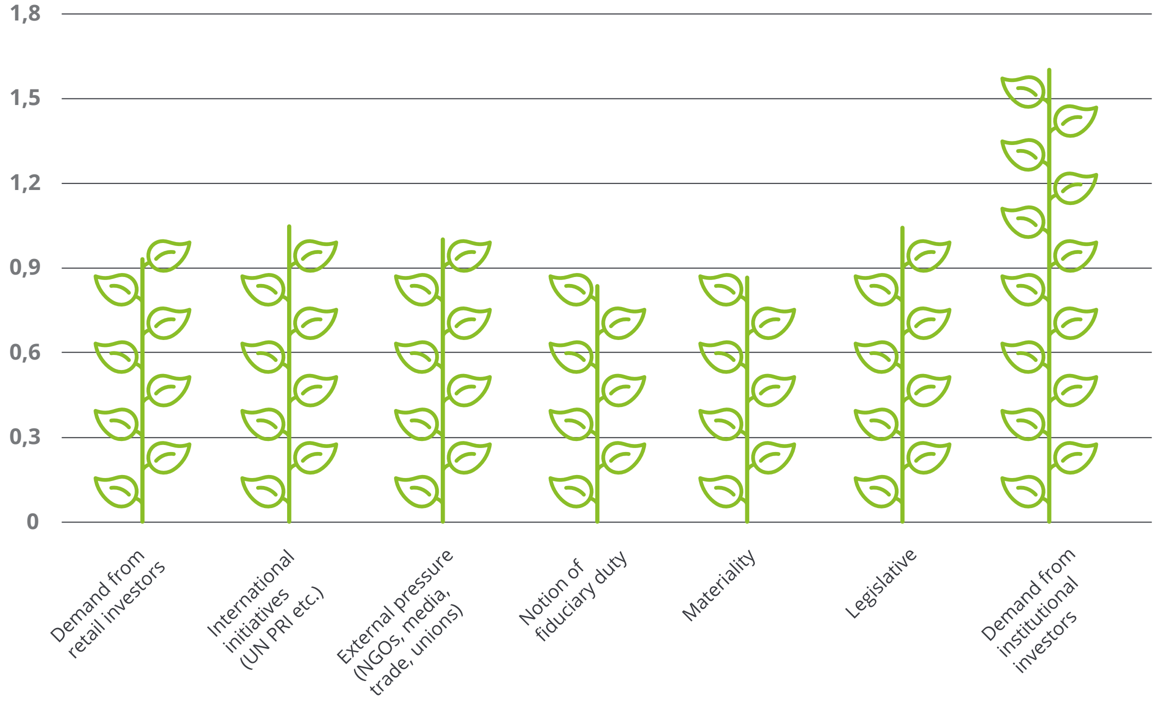
6 www.morganstanley.com/articles/audrey-choi-ted-talk-sustainability

7 Net Impact, 2014 Business as Unusual Report, 2014, https://netimpact.org/sites/default/files/documents/business-as-unusual-2014.pdf, accessed March 12, 2015, cited in Eggers, W.; Muoio, A. 2015. "Wicked opportunities", in Business ecosystems come of age: http://dupress.com/articles/wicked-problems-wicked-opportunities-business-trends/#end-notes

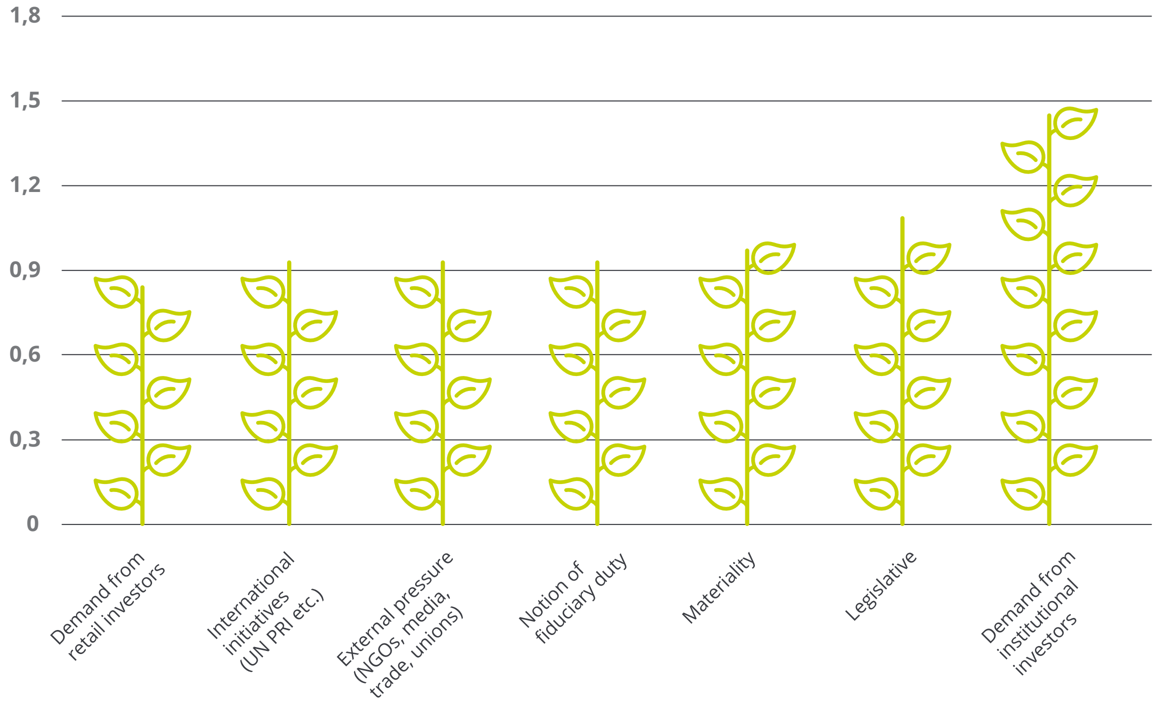
8 www2.deloitte.com/content/dam/Deloitte/global/Documents/About-Deloitte/gx-millenial-survey-2016-exec-summary.pdf

9 Eurosif (2014). European SRI Study. p. 33

Factors driving Socially Responsible Investing demand: FY 2012



Factors driving Socially Responsible Investing demand: FY 2014



Source: Eurosif (2014). European SRI Study, p.33

10 GIIN (2016): Annual Impact Investor Survey: https://thegiin.org/assets/2016%20GIIN%20Annual%20Impact%20Investor%20Survey_Web.pdf
11 GIIN (2016): Annual Impact Investor Survey: https://thegiin.org/assets/2016%20GIIN%20Annual%20Impact%20Investor%20Survey_Web.pdf, p.34
12 https://blogs.cfainstitute.org/marketintegrity/2015/08/17/cfa-institute-survey-how-do-esg-issues-factor-into-investment-decisions/

GIIN survey: investors' and stakeholders' aspirations

The "Annual Impact Investor Survey 2016," recently released by Global Impact Investing Network (GIIN), captured the voice of 158 organizations across the US, Europe, and emerging markets that are putting "impact" and sustainability at the heart of their investment strategies. These organizations' impact investments (covering a more focused, smaller subset of "impact first assets") totaled upwards of US$15 billion in 2015, with investors indicating a willingness to increase that figure by 16 percent in 2016.[10] In the GIIN survey, respondents who indicated "climate change mitigation" or "climate change adaptation" as important elements of their investment strategies were then asked to apply a ranking order to a range of possible motivations.

The result? "Alignment with my environmental impact goals" was ranked first, followed by "alignment with my social impact goals," "client demands," and "financing opportunities," respectively. " To mitigate risk in my portfolio" was ranked lowest.[11] This is interesting because it suggests that, for these investors, it is their own socially and environmentally oriented goals and those of their clients that are mainly driving their sustainability strategies.

Nevertheless, the risk management element should not be underestimated. In 2015, the CFA Institute surveyed its over 40,000 members (portfolio managers and research analysts) about ESG.[12] The results were striking, with a significant 73 percent of respondents indicating that they incorporate ESG into their decision-making process. Geographically, the number of respondents incorporating ESG is highest in Asia-Pacific, followed by the Europe, Middle East, and Africa (EMEA) region and, lastly, the Americas. What was their motivation for incorporating ESG? For a majority (63 percent), the key value lies in risk management, while 38 percent indicated that they believed ESG performance was a good measure of a company's management quality.

Does sustainability pay?

As previously indicated, our view is that the broader shifts toward conscious capitalism and triple bottom line thinking should not in any way be discounted as motivating factors behind the rise in sustainable investing. That being said, there is some relatively strong evidence out there that sustainability pays off in pure financial terms.

The authors of the aforementioned study by the University of Oxford and Arabesque Partners scoured more than 200 academic papers, industry publications, journalistic sources, and books, and produced some striking findings, a few of which are reproduced in the graphic below.

How sustainability pays off

90 percent of the studies looking at the cost of capital indicated that sound sustainability standards reduced companies' cost of capital

88 percent of the studies found that robust ESG practices boosted firms' operational performance

80 percent of the studies indicated that "good" sustainability practices had a positive impact on the performance of companies' stock prices

Even in cases where the focus is economic impact, investors and corporate managers would be well-advised to consider the sustainability dimension when making decisions

Source: University of Oxford and Arabesque Partners 2015. "From the stockholder to the stakeholder: How sustainability can drive financial outperformance," p.9

These impressive findings notwithstanding, there remain doubts around the financial benefits of responsible investing. Might that skepticism be a good thing? London Business School finance professor Alex Edmans thinks so. He makes the interesting point that, in fact, somewhat paradoxically, socially responsible investing pays off from a financial perspective because many people think that it doesn't! The vast majority of investors, according to Edmans' argument, focus on tangible assets, which are reflected in a company's stock price, whereas they do not focus on the intangibles like social and environmental credentials until those are reflected in a company's stock price, by which point it is "too late" because the stock price of those companies then increases. Edmans argues that this allows clever investors who focus on companies' intangibles to capitalize during the period when socially responsible companies are still being undervalued.[13]

Business and the bottom line

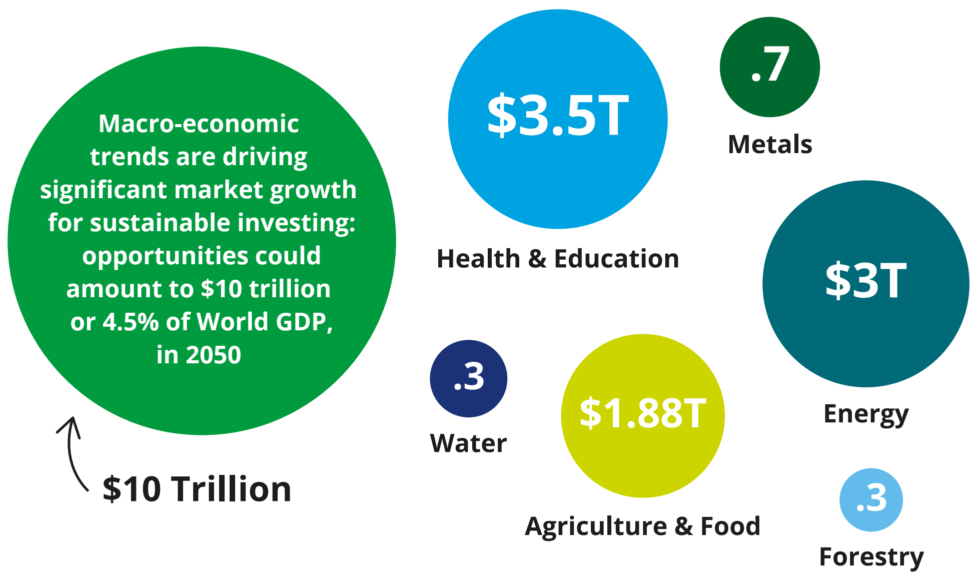
Edmans' reasoning aside, there is a "common sense" business argument for why sustainability will have to be a key concern for investors in the coming decades. Simply put, the mammoth sustainability challenges that we are facing mean that the businesses that are able to address those challenges in a scalable way will be most likely the ones that will thrive.[14] Indeed, in its 2013 survey, Deloitte noted the increased involvement of Chief Financial Officers (CFOs) in the sustainability strategy of their companies. Approximately 73 percent of CFOs who responded to the survey claimed that they had played a greater or somewhat greater role in the sustainability strategy of their firms over the year leading up to the survey—an increase from the 53 percent who said the same in 2012.[15]

Wicked opportunities

The diagram below, cited in Morgan Stanley's 2015 report "The Business case for sustainable investing,"[16] provides a striking illustration of the dovetailing between sustainability challenges and business opportunities.

When it comes to measurement, there is no single set of metrics that will be suitable for all investors.

New sustainability-related business opportunities in Key Sectors in 2050



Source: "Vision 2050: The new agenda for business," World Business Council for Sustainable Development, 2010 cited in Morgan Stanley 2015 "The Business Case for Sustainable Investing."[17]

13 Wall Street Journal (Feb 2016): Does Socially Responsible Investing make financial sense?

14 http://www.morganstanley.com/ideas/business-case-for-sustainable-investing

15 http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Risk/dttl-risk-Deloitte-CFOs_and_Sustainability-2014.pdf, p.8

In what Deloitte's Bill Eggers and Anna Muoio describe as the business translation of "wicked problems" into "wicked opportunities," we are seeing increasing incentives and possibilities emerging for big business to team up with non-profit organizations, governments, and other actors within the social sector to make scalable investments that could have real financial but also social and environmental returns.

What challenges does this entail?

For starters, there is the thorny issue of measurement. Professor Dr. Vogel at the Haas School of Business is skeptical about claims that investing in socially responsible companies yields better financial returns than investing in their non-responsible counterparts precisely because, he argues, the lack of a common position around how to measure impact makes it impossible to agree on the distinctions between a responsible and non-responsible company. If you cannot even describe such a distinction in clear terms, then comparative analyses of which one yields better returns break down because the terms of the argument are themselves open to debate.[18]

This lack of agreement is compounded by the fact that different investors will have different measurement needs. In 2013, Deloitte's Monitor Institute conducted a research study with the support of B Lab and Rockefeller Foundation, tapping into the views of 30 organizations that included investment funds, portfolio management companies, family offices, foundations, and investment banks. What they found was significant variation in terms of what type of data was considered most valuable. For example, detailed data on "beneficiary-level outcome" (e.g., the actual number of people affected by a specific action) might be more relevant for foundations than other investors who might find it sufficient to have "output" data (e.g., the number of aid packages distributed).[19]

In addition, the measurement needs of investors, the study found, change throughout the investment lifecycle: *"What an investor wants to know when evaluating a potential investment is different than what that investor wants to know as she tracks the performance of the investment."* The general conclusion of this research is simple: when it comes to measurement, there is no single set of metrics that will be suitable for all investors—no single approach that can be adopted across the board. And it is precisely this challenge that makes a tailored portfolio management approach, which fits the needs of individual investors, particularly critical.[20]

Information needs by ecosystem segment

	Third party evaluation	Accepted standard	Verified data	Benchmarking and reporting	Integration and customization	Greater efficiency	Education/ technical assistance	Access to investment opportunities
Large scale financial institutions	●●	●●●	●	●●●	○	●●	○	○
Small private funds	●●	●●●	●	●●	●	○	●	●●●
Investment managers and advisors	○	●●	●	○	○	●●	●●●	○
DFIs/ multilaterals	○	●●	●●	○	○	○	●●●	○
Large foundations	●	●●	●	●●●	●●	●	●●●	●
HMMs/ family offices	○	●	●	○	○	●●	○	●
COFIs	●●●	●	●●	●	●	○	○	●●●
Academics	●●	●●●	●●	○	○	○	○	○

●●● ●● More important ⟷ ● Less important ○ Not mentioned

Source: Sesfield, T. "The Measure of a Promise." Monitor Institute

16, 17 www.morganstanley.com/ideas/business-case-for-sustainable-investing

18 Wall Street Journal (Feb 2016): Does Socially Responsible Investing make financial sense?

19,20 www.monitorinstitute.com/downloads/what-we-think/measure-of-a-promise/Monitor_Institute-The_Measure_of_a_Promise.pdf, p.3, 4

Part 02

A leading provider of ESG investments: State Street Global Advisors

The ESG investment thesis of State Street Global Advisors (SSGA) is informed by ongoing research and direct experience with investors around the world as well as a body of academic and industry study. Their investment approach is grounded in the belief that value creation is influenced by more than financial capital alone, especially in the longer term. Mounting evidence demonstrates that ESG issues can affect the performance of investment portfolios and have implications for a company's earnings, future prospects, and broader economic functioning. Today, investors can allocate to funds and strategies with positive ESG characteristics *and* strong risk-adjusted return potential. SSGA describes this comprehensive view of ESG investing as "meaningful performance".

In 2015, State Street completed a study of 400 institutional investors in 20 countries and asked survey participants about their ESG investing habits.[21] The survey found that 83 percent of respondents anticipated high-to-moderate interest going forward in ESG investments. Moreover, 76 percent of respondents also reported being more likely to appoint a manager with ESG capabilities. These research findings reflect a growing desire among investors to align investments with values or to shape environmental or social outcomes.

Despite these market trends and increasing investment in ESG strategies, broad standards for sustainable investment do not exist yet. To navigate this challenge, SSGA created solutions that reflect prevalent themes and areas of interest. They continue to develop investment solutions across the continuum of ESG approaches as well as the risk and return spectrum. SSGA has access to and experience with ESG tools that can be deployed for strategies that:

- Avoid investment in companies that are not compatible with an investor's values; yet, still seek best possible performance within those constraints
- Take a "second generation" approach whereby ESG factors are integrated into investment decisions and portfolios are tilted toward better ESG performers and/or away from weaker ESG performers
- Adopt a "third generation" approach using ESG factors to seek enhanced performance or reduced risk

The fact is that ESG investing is not a one-size-fits-all proposition, despite investors sharing common interests. In order to serve the needs of diverse investors around the world, SSGA continuously researches the relationship between ESG performance and investment performance.

SSGA describes this comprehensive view of ESG investing as meaningful performance.

21 State Street 2015 Asset Owner Survey conducted by Longitude Research in October and November 2015

At a high level, SSGA believes that, when a company does well in ESG areas, it should be an indication that the firm is well-managed overall; the shares of well-managed companies tend to outperform over time. On the other hand, sceptics argue that these benefits are already priced in by the market, or that a company may incur an unnecessarily high cost structure to achieve ESG goals.

SSGA focuses empirical examination of ESG performance on five dimensions, namely:

1. **Quality:** Are ESG rankings representative of the quality of a company?
2. **Risk:** How beneficial is ESG in terms of minimizing downside investment risk?
3. **Return:** Does good ESG performance contribute to superior investment returns?
4. **Correlation:** How does ESG correlate with other sources of alpha?
5. **Dependencies:** How are these relationships likely to evolve over time?

One constant in this dynamic market is that active ownership plays a prominent role in SSGA's duty to act as stewards of investors' assets. As one of the world's largest managers of index equity assets, SSGA is a significant stakeholder in thousands of companies globally. The nature of index investing epitomizes long-term investing, and active ownership represents a tangible way in which investors can seek to positively impact the value of the underlying assets. Their approach to proxy voting and company engagement is fueled by the belief that firms with robust and progressive governance and sustainability practices should be better positioned to generate long-term value and manage risk.

SSGA expects strong governance standards from investee companies, and their direct engagement with investees focuses on advocating change where poor ESG practices place investor value at risk.

SSGA is one of the leading providers of ESG investments in the world with approximately US$168 billion in ESG assets (as of 31 March 2016). They are a signatory to the United Nations-supported Principles for Responsible Investment (PRI), which they point to as a reflection of their commitment to integrate ESG into their investment process, asset stewardship activities, and throughout the organization.

Since 1986, SSGA has worked to develop internal ESG experience covering portfolio management, investment research, proxy voting and engagement, as well as strong relationships with third-party research providers. With that history in mind, SSGA believes now is the time for investors to incorporate ESG factors into their investment beliefs and processes.

Part 03

ESG investments at the core of a start-up: FusionATCM

Investment methodologies based on responsible social impact perspectives face an even more distressing situation.

FusionATCM's broad understanding of the financial industry, coupled with an in-depth focus on the investment management sector, made them realize that the market has fundamentally changed. Demographic transformation, changing market environments, and new technological developments combined with increased investor demands for sustainable investments require continuous and instant adaptation on the part of investment managers.

This is a challenge for asset managers with their existing operational legacy. Current and available well-known software vendors seem to be finding it extremely difficult to anticipate the required transformation and to adapt their off-the-shelf solutions accordingly. Vendors can be reluctant to change or adapt their "standard" product offerings and thus the investment management organization must find their own specific solution(s). And even when the investment manager is able to configure the information system to execute ESG-based strategies, the system often only supports a small part of the trade cycle, resulting in significant integration challenges.

Investment methodologies based on responsible social impact perspectives face an even more distressing situation. This rapidly growing investment strategy is relatively new within the asset management sector. Available trade management cycle systems are not able to build, evolve, and scale new sustainability functionalities and requirements in an agile, modular, and accelerated manner. Currently, the huge financial and time-consuming investments required for supporting efforts distract investment managers from their primary goal of achieving sustainable returns.

Most asset managers therefore implement complex and unmaintainable Excel sheets that have been connected with core trade cycle management systems and market data providers. This situation is far from optimal and distracts portfolio managers' attention away from strategic portfolio construction and towards operational data processing tasks. In addition, the lack of functionalities within this approach puts the portfolio manager at a disadvantage in terms of allowing the individual a dedicated focus to improve investment methodology, thereby affecting long-term results.

This is highly problematic given the fact that the asset manager who is most capable of combining sustainability factors with more traditional financial and quantitative analysis is likely to be the one best equipped to generate alpha. Such success requires the portfolio managers' dedicated focus.

This is where FinTech (or investTech) startups challenge established investment managers. One of them is FusionATCM: a startup that prides itself on having developed a SaaS-based trade management cycle solution that is fundamentally fast, real-time, scalable, flexible, and customizable in a matter of hours. All functionalities have been designed based on forward-thinking that more effectively empowers the investment manager toward the future. All modules and functionalities have one goal in mind: strengthen investment managers' alpha.

To achieve this, the sustainability investment functionalities are integrated as a core functionality within the platform as a whole. This enables investment managers to incorporate their sustainability perspectives into other investment philosophies such as low volatile or conservative investment strategies.

Furthermore, ATCM's sustainability investing functionalities are configurable in the sequence that the asset manager requires, as there is no one-size-fits-all sustainability investing philosophy.
If portfolio managers developed an investment strategy based on the first generation of SRI investments, they are capable of applying only the company ESG ratios in their portfolio construction process. It is also possible for portfolio managers to combine these company ESG ratios with other ESG ratios at other levels, for example in relation to ESG ratios for the country of domicile. Examples of the more complex investment philosophies supported by FusionATCM include portfolio construction processes based on ESG ratios in relation to ratios found on risk reduction, involving proxy voting and in combination with enhanced performance.

When it comes to impact and sustainability investment strategies based on the portfolio manager's input, FusionATCM believes that there are four steps in the investment decision-making process:

- The first step is identification, which is based on analyzing several overarching trends. The ATCM platform allows portfolio managers to instantly analyze markets by industry or sector, currency or region. ATCM facilitates the identification of companies, sectors, and countries based on negative screening/exclusions or from a positive identification angle in order to support the relevant impact investment philosophy.

FusionATCM's platform aims to allow users to include different investment strategies during the creation of an investment model.

- The second step is quantification, which is based on the overall assessment of applied ratios and key figures. Every single company can be monitored and inspected depending on what is required or compared with companies within the same sector. Ratios available on the platform are based on ESG dimensions and can be retrieved by multiple data vendors.
- The third step is ranking, which is based on ranking mechanisms that reflect sustainability ratios for countries and companies. The ATCM platform enables the performance of well-regarded ranking calculations and may be configured in accordance with investment managers' specific philosophies at this stage. Aside from investment philosophies based on sustainability perspectives, other factors can be included. Investment strategies built on risk models, low volatility, or thematic strategies can also be integrated.
- The fourth and last step is the creation of the investment model. The ATCM platform allows investment managers to construct an investment model and implement their philosophy. This investment model facilitates real-time comparison with a sustainability index or can be rebalanced in case thresholds are reached with a strong overall risk-based focus. ATCM pro-actively informs the responsible portfolio manager and supports the individual in making the optimal decision.

FusionATCM's platform aims to allow users to include different investment strategies during the creation of an investment model. This paves the way for the realization of optimal asset allocation by enabling the investment manager to also include investment philosophies based on low-risk methodologies, low volatilities, or duration strategies.

Future trends

ESG considerations are already a prominent component of SSGA's investment management business. Their ongoing research reflects both increasing investor demand for ESG insights and the evolutionary relationship between ESG factors and investment performance.

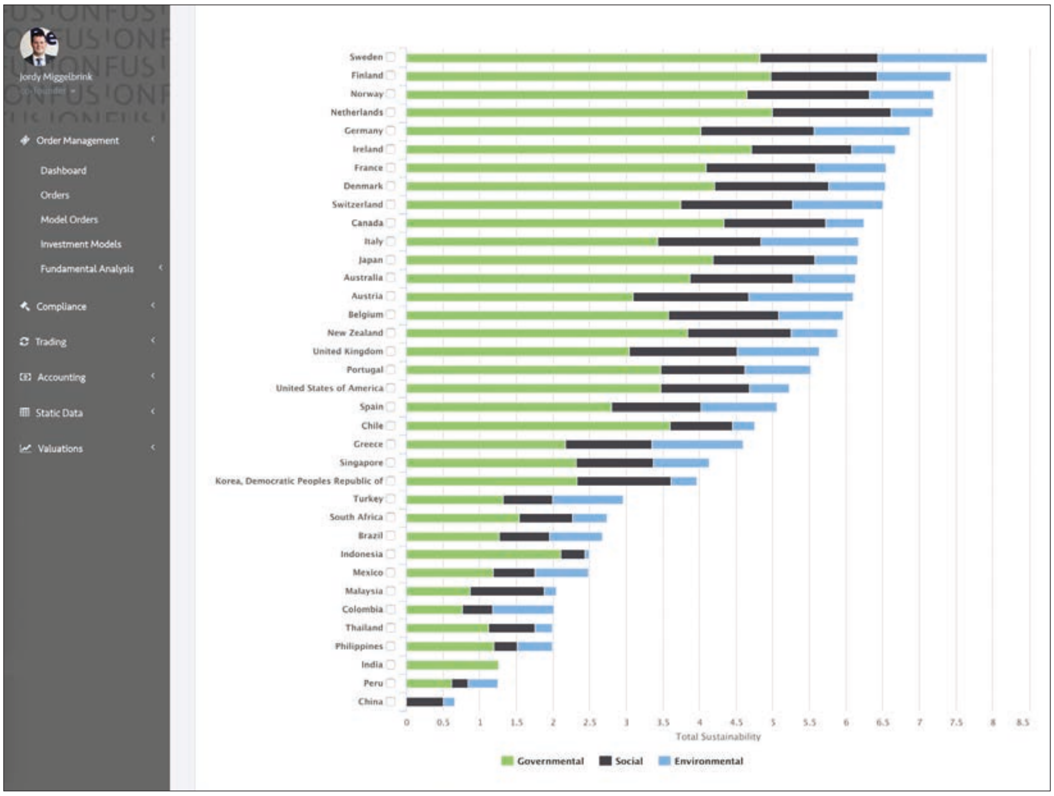
Past is not prologue, of course. In SSGA's long-term view, they expect to see more attractive returns for environmentally efficient, socially responsible, financially stable, and well-governed firms—especially as this dynamic evolves and ESG factors and themes get priced in. Investors look set to increasingly consider ESG factors in preparing for economic change.

With all indications pointing to an increasingly vibrant and dynamic SRI ecosystem, and ever more demanding investors, portfolio managers will face a host of new challenges. Gaining a deeper understanding of the SRI investor class, with all its nuances and diversity, will remain as important as ever, as will continuing to develop deeper insight into the ways that ESG factors drive investment performance.

During this fast-paced journey, the continued development of tools to support portfolio managers in responding to investors' varied and evolving needs will be critical. It is highly unlikely that the legacy information systems currently in use can sustain the pace of innovation required. When it comes to implementing ESG ratios into the portfolio construction functions, well-known system vendors currently find it tremendously challenging to anticipate required transformations and adapt their solution accordingly. This situation is likely to remain as long as the core of these information systems is not migrated towards today's technology. Dynamic players like FusionATCM pride themselves on leveraging the kind of cutting-edge technology that enables investment managers to seek to optimize their business model by regaining full control of their investment cycle.

Conscious capitalism most certainly does not sit still. Watch this space.

Country sustainable ranking

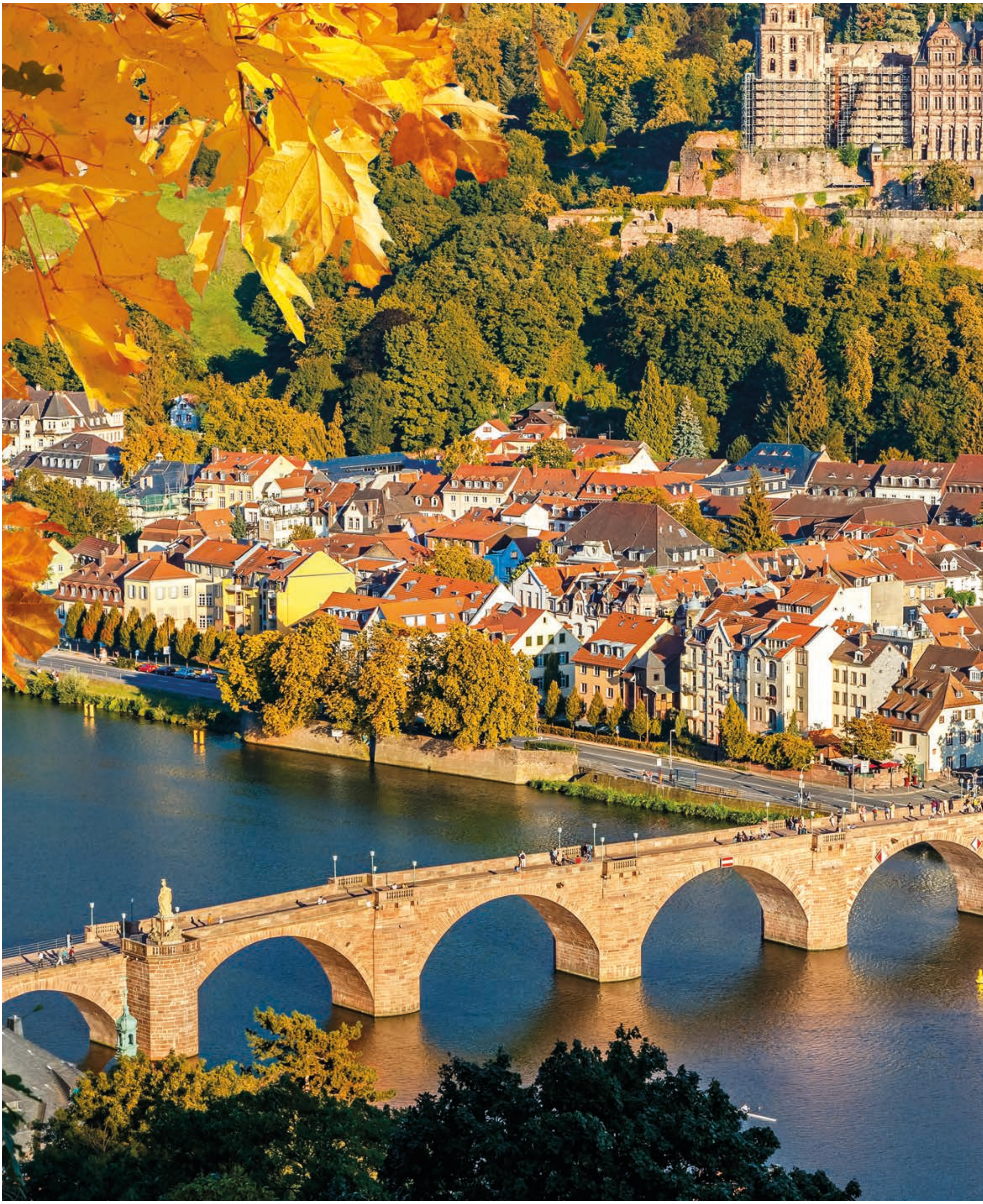


Source: Alpha Trade Cycle Management Platform.

In summary:

- All indications point to an increasingly vibrant and dynamic SRI ecosystem, and evermore demanding investors
- This raises new challenges for portfolio managers
- Gaining a deeper understanding of the SRI investor class, with all its nuances and diversity, will remain as important as ever, as will continuing to develop deeper insight into the ways that ESG factors drive investment performance
- During this fast-paced journey, the continued development of tools to support portfolio managers in responding to investors' varied and evolving needs will be critical

Gaining a deeper understanding of the SRI investor class, with all its nuances and diversity, will remain as important as ever.



The reform of the German Investment Tax Act

Main content and impact for Asset Managers

Alexander Wenzel
Partner
Financial Services
Deloitte

On 8 July 2016, the German Investment Tax Reform Act passed the Federal Council of Germany. As a consequence, the act will basically take effect on 1 January 2018 with a wide-ranging impact on the taxation of income realised through an investment fund. The reform implies a significant challenge for Asset Managers but also present new opportunities to gain additional market shares. Now is the right time to focus on the reform and to take action in order to make the most of the new legal environment.

It will be important to cope with the new requirements of a special investment fund already before 1 January 2018 given that a change from an investment fund to a special investment fund is excluded after that date.

Basic content of the reform

The reform fundamentally changes the taxation of investment income by introducing two separate taxation systems for investment funds on the one hand and special investment funds on the other hand. While an opaque taxation system will apply to investment funds where both the fund and its investors are subject to tax, the principle of tax transparency can be continued for special investment funds with however fundamental modifications.

Scope of application

The reformed German Investment Tax Act ("GITA 2018") is applicable to investment funds which are defined as investment asset pools within the meaning of the German Capital Investment Code. In addition, so-called "fictitious investment funds" are in scope of the GITA 2018 even though they do not qualify as investment asset pools. In practice, the most relevant case from a practical point of view will be so-called single investor funds, i.e. investment vehicles which limit the number of possible investors to one single investor but are in line with the remaining requirements for an investment asset pool. Furthermore, a company which must not unfold an active entrepreneurial activity under the laws of its home country and which is not subject to tax or exempted from tax will be deemed an investment fund.

The GITA 2018 is not applicable in the following cases:

- If the certain exceptions of the German Capital Investment Code are applicable (e.g. securitisation special purpose vehicles and holding companies)
- If the investment asset pool is established in the legal form of a partnership, provided that it does not qualify as UCITS; investment funds of a contractual type (Sondervermögen) are however not considered to be partnerships

- In the case of participation companies pursuant to the German Participation Companies Act and REITs which are subject to the German Real Estate Investment Trust Act

In order to qualify as a special investment fund, an investment fund must comply with certain additional requirements which are comparable to the criteria to be fulfilled by all types of investment funds under the law currently in force. In other words, those requirements relate to regulation, redemption rights, eligible assets and investment limits. In addition, the number of investors must not exceed 100 whereby private individuals are basically prohibited. Unlike under the current rules, individual investors may however invest even directly into a special investment fund if they hold the fund units as part of their business assets. On the other hand, a look-through approach in relation to partnerships as investors will take place resulting in the fact that private individuals can basically no longer invest indirectly into a special investment fund.

It will be important to cope with the new requirements of a special investment fund already before 1 January 2018 given that a change from an investment fund to a special investment fund is excluded after that date.

Investment funds
One of the key points of the GITA 2018 is that investment funds will be subject to German corporate tax to the extent they receive German sourced dividend and rental income as well as capital gains from German real estate. These items are fully taxable at a rate of 15% including solidarity surcharge in the case of income subject to German withholding tax. In the case of income where no deduction took place, i.e. where the investment fund needs to file a corporate tax return with the German fiscal authorities, the tax rate amounts to 15% plus solidarity surcharge thereon. All other income (e.g. interest income, capital gains from the sale of stocks and other securities) is tax-free.

An application for exemption from corporate tax is possible to the extent that certain eligible investors are invested in the investment fund. Also, an entire exemption from corporate tax is possible if the constitutive documents of the investment fund necessitate that only certain eligible investors must hold a participation.

The objective of the pre-determined tax base is to make sure that at least the risk-free market yield is taxed in the hands of the investors.

Finally, German trade tax may become due at the level of the investment fund. An exemption does however apply if the objective business purpose is limited to the investment and management of the assets for the joint account of the investors and if an active entrepreneurial management of the assets to a substantial extent is excluded.

In addition to the investment fund, also the investor is subject to tax based on a very generalising system. Under the GITA 2018, the following items will trigger a taxation:

- Distributions regardless of their composition (e.g. even a repayment of capital will be taxable)
- Pre-determined tax bases
- Capital gains realized upon the disposal of investment fund units

The objective of the pre-determined tax base is to make sure that at least the risk-free market yield is taxed in the hands of the investors. It is therefore due if the distributions remain under the so-called base proceed. The base proceed in turn has to be determined by multiplying the first redemption price set in the calendar year with 70% of the base interest rate (long-term yield on public bonds published by the German Central Bank). The base proceed is capped by the actual increase in value of the investment fund unit plus any distributions. The pre-determined tax base is then deemed to be received by the investor on the first business day of the following calendar year.

On principle, special investment funds are subject to German corporate tax to the same extent like investment funds.

Any investment income (distributions, pre-determined tax bases and capital gains from the disposal of investment fund units) can generally be subject to a partial exemption provided that the respective investment fund qualifies as equity fund, mixed fund or real estate fund:

- equity funds are investment funds that invest continuously at least 51% of their value in equity participations according to their constitutive documents. The partial exemption amounts to 30% for private individuals. For individuals holding the investment fund units as part of their business assets, the partial exemption increases to 60%. For corporate investors, 80% of the investment proceeds are tax-free.
- mixed funds are investment funds that invest continuously at least 25% of their value in equity participations according to their constitutive documents. In this case, half of the partial exemption rates applicable to equity funds is available.
- real estate funds are investment funds that invest continuously at least 51% of their value in real estate and real estate companies according to their constitutive documents. The partial exemption rate amounts to 60%. If the relevant investments are made in non-German real estate and non-German real estate companies, the partial exemption rate increases to 80%.

Special investment funds

On principle, special investment funds are subject to German corporate tax to the same extent like investment funds. They can however opt for tax transparency, i.e. the tax system known under the prevailing law can be continued depending on the choice of the special investment fund. In other words, the tax liability is dropped and the income of the special investment fund is deemed to be received directly by the investors. It should though be noted that significant amendments have been made to the principle of tax transparency.

As under the current GITA, investors are taxed on distributed income, deemed distributed income and on capital gains from the disposal of special investment fund units. The modifications mentioned above primarily concern the determination of the income at the level of the special investment fund and the attribution to the investor:

- The income needs to be grouped depending on the tax effects at the level of the respective investor;
- with regard to distributed income, a new distribution order is to be taken into account;
- the equalisation methodology will not be accepted for tax purposes any longer; instead, an attribution of income and expenses to the investor on a pro rata temporis basis takes place:
  - in the case of a distribution of income which has been generated during a time period where the investor was not invested in the special investment fund, a repayment of capital is simulated
  - in the case of a reinvestment, only income and expenses actually generated during the holding period of the investor are attributed to that investor; in addition, the income is deemed to be received by the investor at the end of the fiscal year of the special investment fund regardless of a prior sale of the special investment fund units
- The extent of the deemed distributed income has been newly defined, i.e. inter alia it does not include capital gains from the sale of bonds whereby a distinction between DDI-bonds and plain vanilla bonds is not necessary any longer; an exception only applies in the case of swap contracts to the extent that the swapped payment flows are determined by dividend or interest income;
- Any income which is not part of the deemed distributed income is deemed to be distributed with the expiration of the fifteenths fiscal year of the special investment funds following the collection.

As under the current GITA, investors are taxed on distributed income, deemed distributed income and on capital gains from the disposal of special investment fund units.

Transitional rules

The GITA 2018 will basically enter into force on 1 January 2018 regardless of the fiscal year of the investment fund and of the acquisition date of the investment fund units. Investment funds with a fiscal year differing from the calendar year have to form a short fiscal year as per 31 December 2017 for tax purposes.

Investment fund units, units in corporate investment companies and in investment vehicles falling into the scope of the GITA 2018 on 1 January 2018 for the first time are deemed to be sold on 31 December 2017 and re-acquired on 1 January 2018. The capital gain will however only be taxed at the time of the actual disposal of the units.

Investment fund units acquired before 2009 are currently grandfathered in such a way that capital gains are not taxable. This protection will end on 1 January 2018, i.e. any changes in value taking place from that date onwards will become taxable to the extent they exceed a tax exempt amount of €100,000.

Impact for Asset Managers

The GITA 2018 will completely change the way of how investment income is taxed and particularly Asset Managers should undertake immediate action in order to prevent outflow of funds. Particularly business investors are balancing pros and cons at the moment regarding the question whether they should shift their investments from investment funds to special investment funds.

As far as investment funds are concerned, the main points are that Asset Managers need to make sure that the fund is taxed correctly in Germany which may include the filing of corporate tax returns. Equally, it may be necessary to re-structure investment funds in order to avoid any tax disadvantages for the fund as well as for its German investors. This includes amendments to the constitutive documents as well as an appropriate flow of information and communication. Finally, an adequate management of withholding taxes is vital to remain competitive and processes need to be implemented for the purpose of benefitting from a partial or even full exemption from German corporate tax in the case of eligible investors.

In relation to special investment funds, the challenges go even beyond. In particular, Asset Manager should engage themselves with the question whether or not it is necessary to launch special investment funds specifically for the German market in order to retain their German business investors. The usual business where an investment fund is structured in such a way that the units can be distributed on a cross-border basis will not work any longer due to the specific requirements of the GITA 2018. In the case a special investment fund has been founded, the new provisions dealing with the determination of the income means an enormous challenge for Asset Managers.

This particularly holds true with respect to the attribution of income and expenses on a pro rata temporis basis as a result of the omission of the equalization method for German tax purposes. Broadly speaking, the new investor reporting will no longer follow a "one-size-fits-all-approach". Instead, the reporting need to be individualised taking into account the specific position of each and every investor.

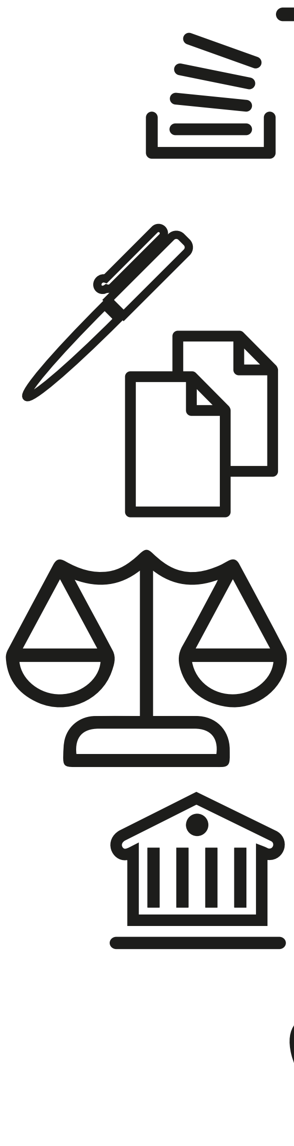
To the point

- On 8 July 2016, the German Investment Tax Reform Act passed the Federal Council of Germany. As a consequence, it will basically take effect on 1 January 2018 with a wide-ranging impact on the taxation of income realised through an investment fund
- The reform implies a significant challenge for Asset Managers but also present new opportunities to gain additional market shares. Now is the time to concentrate on the reform and to take action in order to make the most of the new legal environment
- For investment funds, the principle of tax transparency will be dropped resulting in the fact that both the fund and its investors will be subject to German tax
- By way of contrast, special investment funds can opt for tax transparency meaning that the taxation known under the prevailing law can be continued; the legal modifications are however significant
- Asset Managers need to make sure that the investment fund is taxed correctly in Germany which may include the filing of corporate tax returns. Furthermore, care has to be taken that investment funds are optimised from a German tax perspective, that withholding taxes are managed in the most efficient way and that processes are implemented in order to benefit from a potential exemption from German corporate tax
- As far as special investment funds are concerned, Asset Manager should consider to establish special investment funds exclusively for the German market in order to retain German business investors. The complexity of the investor tax reporting will increase considerably, because it needs to be individualised taking into account the specific position of each and every investor

The GITA 2018 will completely change the way of how investment income is taxed and particularly Asset Managers should undertake immediate action in order to prevent outflow of funds.

Conduct of business rules in the Belgian insurance sector

From AssurMiFID to the Insurance Distribution Directive



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The Belgian insurance sector has been subject to the MiFID I[1] conduct of business rules since 1 May 2015.

This roll-out of MiFID to the insurance sector, commonly known as AssurMiFID, was one of the objectives of the Twin Peaks II Law of 30 July 2013, by which the Belgian legislator wanted to create a level playing field for the selling practices of all investment products and for consumer protection rules. As such, the Law of 2013 and its implementing Royal Decrees (see text box), expand the scope of the MiFID I conduct of business requirements to insurance companies (including their tied agents) and insurance intermediaries acting in Belgium.

It was clear from the start that the impact of this legislation on the strategy, products and operations of insurance companies and intermediaries would be very high (see further). The impact in practice was increased by the very challenging timeline through which the new regulatory framework was imposed on the insurance sector (i.e. implementation of the new framework by 30 April 2014, merely a couple of months following the publication of the Royal Decrees). This also led to a decision[2] of the Constitutional Court delaying the entry into force with one year (to 1 May 2015).

1 Directive 2004/39/EC of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC and repealing Council Directive 93/22/EEC

2 Decision of the Consitutional Court of 11 June 2015, Role number 5871, Arrest nr. 86/2015

The AssurMiFID regulatory framework:

- The Twin Peaks II law (TP II), dated 30 July 2013
- Part IV of the Insurance Law of 2014
- The three implementing Royal Decrees, dated 21 February 2014
- The Circular Letter of the Financial Services and Markets Authority (FSMA), dated 16th of April 2014, and revised in September 2015, to include additional guidelines with regard to record keeping requirements.

Following an appeal of a sector association against the AssurMiFID regulation, the Constitutional Court delayed the entry into force with one year to 1 May 2015.

On the date of this article, we are awaiting the finalisation of the regulatory framework, as certain aspects, included in AssurMiFID, relating to reporting and cost and charges transparency, still have to be implemented further. For these areas, the legislator aims to align with other European regulatory initiatives like PRIIPs.

AssurMiFID rules of conduct are based on MiFID I

Scope

All insurance companies (including their tied agents) and independent insurance intermediaries, i.e. brokers and non-tied agents acting in Belgium, need to comply with the AssurMiFID rules. Insurance companies are fully and unconditionally responsible for their “tied” agents, as is also the case for insurance agents and insurance brokers working with sub agents.

Application of the rules

The extent to which the different rules of conduct apply, depends only on the type of insurance products and services offered:

Products

The MiFID suitability and appropriateness regime only applies to life savings and investments contracts. Some partial exemptions exist e.g. for large risks. Pillar 2 (occupational) pension plans are not in scope of AssurMiFID.

Services

The duty to care obligations differ depending on the nature of the service i.e. whether advice is being provided to the client or not. The execution only regime, included in MiFID, can however not be applied under AssurMiFID.

Intermediaries

No derogations from or tailoring of the rules for (specific types of) insurance intermediaries are foreseen. Some proportionality principles are however taken into account by the regulator in relation to the practical application of the rules.

Clients

Unlike MiFID, AssurMiFID does not make a difference between retail clients/ professional clients or eligible counterparties. All requirements apply to all clients in the same way.

	General loyalty duty	Inducements & conflicts of interest	Assessment of client's needs	Suitability & appropriate-ness	Inform Your Customer	Reporting obligations	Record-keeping (incl. client file)
Life insurance contracts, savings and investments	Fully applicable	Fully applicable	Fully applicable	Fully applicable	Fully applicable	Fully applicable	Fully applicable
Life insurance contracts, 2nd pillar	Not applicable	Not applicable	Not applicable	Not applicable	Not applicable	Not applicable	Not applicable
Life insurance contracts, other	Fully applicable	Fully applicable	Fully applicable	Not applicable	Fully applicable	Fully applicable	Fully applicable
Non life insurance contracts, small risks	Fully applicable	Fully applicable	Fully applicable	Not applicable	Fully applicable	Fully applicable	Fully applicable
Non life insurance contracts, large risks	Fully applicable	Fully applicable	Partially applicable	Not applicable	Partially applicable	Fully applicable	Fully applicable

Fully applicable **Partially applicable** **Not applicable**

Conduct of business rules

The MiFID I rules on inducements and conflicts of interest have been copied into AssurMiFID and apply to all types of insurance contracts and insurance distribution services. As such, the conditions for inducements paid by or to a third party other than the client, include the application of the enhancement test and transparency towards clients. Inducements are only allowed if they enhance the quality of the service to the client and the client must receive upfront full disclosure of the inducements paid or received (i.e. type, circumstances, calculation methodology and, if known, the amount).

The conflicts of interest rules require insurance companies and intermediaries to identify all potential conflicts of interests, and put in place adequate mitigating measures to prevent and/or manage these conflicts. Clients have to be informed upfront of the nature and the sources of conflicts of interest and the mitigating measures taken. A register of conflicts of interest has to be kept (usually by the compliance officer).

The AssurMiFID suitability and appropriateness requirements are based on the MiFID I requirements, but tailored to the insurance context. These requirements come on top of the existing obligation – arising from IMD[3] - to assess the needs of clients. As already mentioned, the MiFID execution only regime has not been copied into AssurMiFID. The suitability and appropriateness rules only apply to life savings and investments contracts, including 3rd pillar pension products (life insurance contracts that under Belgian law are recognized as having a primary purpose of providing for an income at retirement).

It was clear from the start that the impact of this legislation on the strategy, products and operations of insurance companies and intermediaries would be very high.

3 Directive 2002/92/EC of 9 December 2002 on insurance mediation

The MiFID I information and reporting requirements have also been tailored to the insurance sector. The information requirements are largely the same for all types of insurance contracts, with some exemptions for insurance contracts related to large risks. Further regulatory guidance is expected in relation to information on costs and charges. For life savings and investment contracts, reference will most likely be made to the PRIIPs regulation, whereas for insurance contracts other than life savings and investment contracts, a proposal is being discussed that aims to align the level of transparency with the rules that currently apply to mandatory mobility insurance contracts.

With reference to reporting requirements, the FSMA announced that in the course of 2016 a regulation, detailing the reporting requirements, would be finalised. Finally, under AssurMiFID, insurance companies and intermediaries are also required to maintain a client file. This client file must include all documents that contain the rights and obligations of both parties, such as the contract, and the terms and conditions under which services will be provided to the client as well as all other information provided to the client.

AssurMiFID impacts on the Belgian insurance sector

Given the relatively recent date of the regulatory framework, Belgian insurance companies and intermediaries are still learning from the day to day practical application of AssurMiFID and are fine tuning processes, procedures and controls. This exercise will certainly continue until the regulatory framework has been fully stabilized (i.e. the sector is awaiting further guidance and regulation, as well as possible changes might arise due to decisions in relation to appeals filed with the Constitutional Court[4]). Further clarification on concepts and obligations is also expected from a feedback report that the FSMA will publish in the near future on the recent awareness reviews that it has performed.

The conflicts of interest and inducement requirements have significantly impacted the remuneration flows and hence, the business model, of insurance companies and (non-tied) intermediaries. Together with other drivers like margin pressure, digitalisation and other challenges, insurance companies are fundamentally rethinking their way of doing business. The Belgian insurance distribution landscape has also changed. The number of intermediaries has substantially decreased in the Belgian market (over the last 2 years, minus 10% per year). Without any doubt, AssurMiFID has contributed to this decrease.

> The conflicts of interest and inducement requirements have significantly impacted the remuneration flows.

Another tough nut to crack was finding the right solution to fulfil the record keeping requirements. This solution obviously depends on the existing operating model, but a lot of organisations were still operating in a highly paper driven way, with often decentralized archiving. Not all organizations already had a sophisticated scanning and archiving solution in place, linked to a central CRM system.

Comparison with IDD

AssurMiFID – a forerunner of IDD?

The Belgian legislator had every intention of moving ahead of the European legislation, when introducing AssurMiFID. AssurMiFID entered into force, with a one year delay, on 1 May 2015, whereas the Insurance Distribution Directive (IDD[5]) was only adopted on 20 January 2016 with implementation date 23 February 2018.

4 (1) The pending regulations relating to reporting and cost and charges have not yet been published. The FSMA is also reviewing the insurance distribution landscape (definition of intermediaries, possible collaborations between intermediaries, etc.). (2) A recent decision of the Constitutional Court (of 9 June 2016, Role number 6078, Arrest nr. 89/2016) concluded that the difference in approach between AssurMiFID and MiFID I in the field of client categorisation and execution only are not in favour of the aimed level playing field

5 Directive (EU) 2016/97 of 20 January 2016 on insurance distribution (recast)

In the table we recap the most important differences between the AssurMIFID framework and IDD:

Applicability	All insurance products	Only life savings and investment products	Non-life insurance products	Insurance-based investment products	Comment
Needs analysis	✓ ✔				(+) Provide client with a personalised recommendation
Suitability and appropriateness regime		✓		✔	**No execution only – always appropriateness test** (+) Execution-only regime foreseen including definition of "non-complex" products (+) Suitability statement on advice given
Conflicts of interest	✓			✔	**Full MiFID I regime for all insurance products** (-) MiFID I regime only for insurance-based investment products
Inducements	✓ ✔			✔	**Strict regime from MiFID I applicable with enhancement test and full pre-contractual transparency** (-) General transparency (nature) - No amount/calculation method (-) Lighter regime (detrimental impact) - No enhancement test
Information to clients	✓		✔	✔	**Detailed guidance will be tailored** (+) Product Information Document (+) Whether a periodic suitability assessment is provided (+) All costs and associated charges (+) Guidance on and warnings of the risks

✓ AssurMiFID ✔ IDD

The insurance sector will need to comply with the enhanced product oversight and governance requirements

When comparing the AssurMIFID regulations – and as such the MiFID I rules - with the IDD, it appears that some IDD rules are less strict. Mostly in the field of conflicts of interest and inducements, the final IDD text seems to be softened when compared to the MiFID I/AssurMiFID regulatory framework. The MiFID I specific conflicts of interest regime under IDD only applies in relation to insurance based investment products whereas the Belgian legislator has made it applicable also for non-life insurance products[6]. With respect to inducements, the pre-contractual transparency requirements applicable to all products are limited to a general disclosure of the nature of the remuneration (no amount – no calculation methodology).

The additional inducement criteria only apply to insurance based investment products. An important difference is also that the enhancement test under IDD has been transformed into a lighter enhancement check, i.e. verify that the inducement does not have a detrimental impact on the quality of the service. It remains to be seen how this verification will be further defined in the final Level 2 rules to come.

Required catch up

Given the AssurMiFID existing regulatory framework, the impact of IDD on the Belgian market will most likely be more limited than in some other Member States; nevertheless with IDD, a number of important additional requirements will become applicable. The insurance sector will need to comply with the enhanced product oversight and governance requirements (e.g. the identified target market) and produce a "Product Information Document" for non-life insurance contracts, in order to provide clients with relevant information about the insurance product (to be compared with the KID for PRIIPs).
Also several new requirements, inspired by MiFID II, have been introduced in IDD applying to insurance based investment products. Insurance companies or intermediaries will need to provide clients with a pre-contractual suitability statement when providing advice, specifying their advice and how it meets the client's needs. Additional information will need to be given when a periodic suitability assessment is offered. Clients will also need to receive appropriate guidance on and warnings of the associated risks, as well as information on costs and associated charges, including information on the cost of distribution (if not already included in the key information document).

Not withheld from MiFID II is the stricter inducement regime with reference to independent advice, i.e. the ban on inducements. However, IDD explicitly allows Member States to impose stricter inducements requirements.

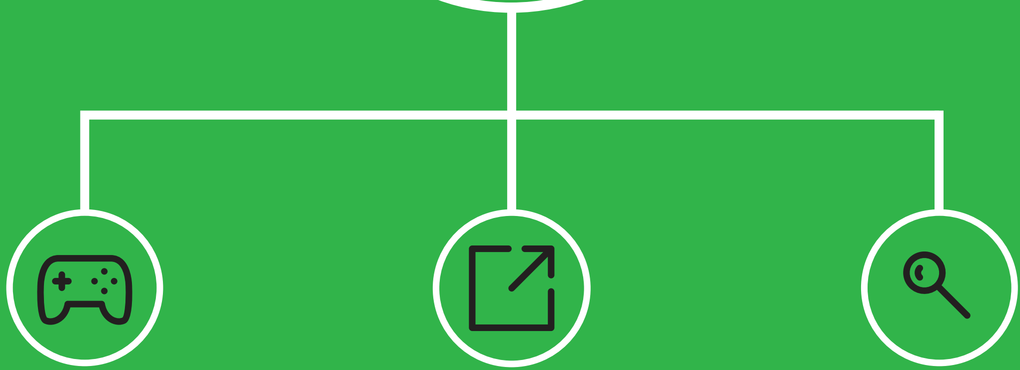
To the point:

- Belgium has moved ahead of European Insurance Conduct legislation
- Non-finalized regulatory framework and future alignment with IDD and MiFID II currently not yet clear
- Level playing field remains difficult
- Strong decrease in the number of insurance intermediaries

6 Without prejudice to the general conflict of interest rules as determined by the Solvency II framework

The MiFID I rules on inducements and conflicts of interest have been copied into AssurMiFID and apply to all types of insurance contracts and insurance distribution services.

What about MiFID II?



Although the ultimate intention of both **AssurMiFID and IDD is to create a level playing field in the investment space,** differences remain between the different sets of rules (AssurMiFID, IDD, MiFID II).

IDD is a minimum harmonization directive which **allows member states room to take own initiatives** and set their own accents.

The position of the Belgian legislator in relation to the transposition of IDD is at this stage not fully clear, more particularly, will the legislator aim to raise the bar to the full level of MiFID II?

Ensuring your business's successful future
The investment management compliance framework

Clive Laurence King
Director
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Deloitte

An overview of the investment management compliance framework, as seen from the perspective of Deloitte Financial Services IM.

Investment management companies often feel challenged by the term "compliance." In this arti-cle, we aim to promote an understanding of the importance and relevance of the compliance function for investment management companies in general. We have also taken into considera-tion some of the additional compliance obligations resulting from unique developments on the German market.

The management boards of many investment management companies often only regard the compliance function as a regulatory obligation and therefore a necessary, but unproductive, expense. We believe that with the right approach, **an effective compliance organization can bring a real benefit to the business and prevent it from incurring unnecessary fines and penalties.**

Inefficient compliance organizations that either do not have access to all of the information they require to perform their function effectively, or do not establish effective controls across the whole company, are often unable to prevent excessive risks from being taken. This can result in severe consequences and reputational damage to the company. Recent prominent examples of compliance organizations that have not operated effectively in the performance of their duties and have failed to prevent reputation damage and substantial fines for the companies concerned can be seen in both the VW emissions scandal and the Deutsche Bank, Forex, and Libor manipulations.

Therefore, it bears repeating that **"the importance of the compliance framework and its added value to the business should not be underestimated."**

Accordingly, we would like to focus on the benefits the compliance function can bring to the company, as well as its importance in assisting the management board to find the most successful way to develop the business, within the boundaries set by the plethora of ever-changing regulatory guidelines.

Therefore, we believe it is first necessary to remind the management board that the ultimate responsibility for the compliance organization rests with them.
Under European regulations and specifically in Germany, according to the Securities Trading Act (WpHG) and the Kapitalanlagegesetzbuch (KAGB), the regulator (BaFin) has laid down a set of minimum requirements (including those set out in the MaRisk, InvMaRisk, MaComp) that it expects to be implemented within the compliance function by all financial institutions and investment management companies.

According to these requirements, management boards have the obligation to establish adequate policies and procedures and maintain appropriate resources (financial, human, and IT) to ensure that the company itself, as well as its employees, comply with all of the relevant regulatory requirements that are applicable to the company's business.

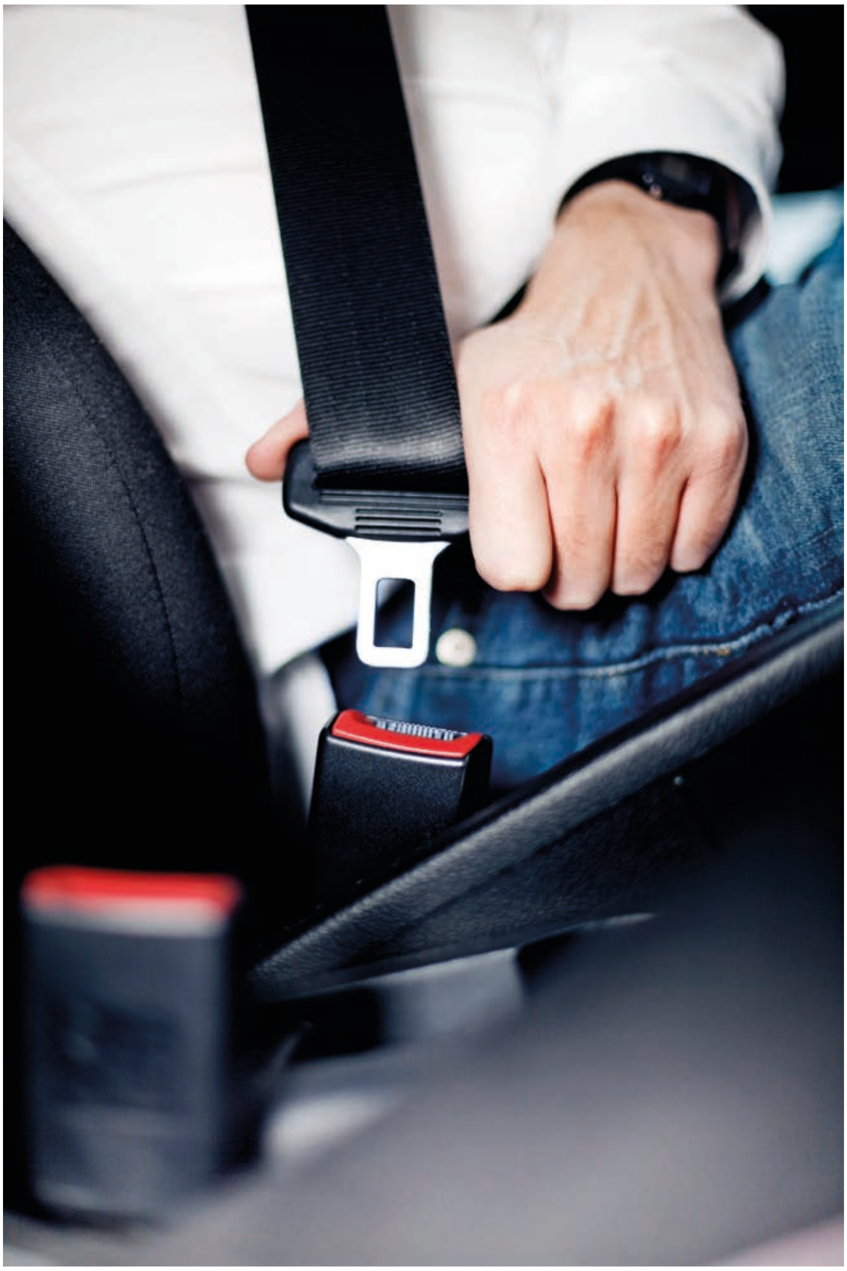
In particular, this responsibility requires the establishment of a permanent and effective compliance function, which is able to support not only the existing business processes, but also those required for business development, while at the same time acting to control and prevent excessive risks, as required.

To be able to perform properly, the compliance function must have access to all the information it requires to be able to ensure effective performance of the established controls within the company. It must also be able to conduct its duties independently.

The compliance function must ensure that the compliance framework is properly established within the organization to enable the compliance team to perform its function as a "second line of defense" validating the policies, procedures and controls put in place by the operative business units ("the first line of defense") and ensuring the effective performance of the necessary control activities. In fact, the operating business units are responsible for complying with the provisions of the law and performing the necessary required controls (internal controls).

The compliance framework must therefore be properly set up initially, in order to enable the compliance function to act in the most effective manner. The compliance function must ensure the operating business units comply with their day-to-day as well as any future legal obligations, and that they establish sufficient and adequate controls to ensure such compliance on an ongoing basis.

This requires an initial investment by the organization in the compliance function, both in terms of time and resources (human, IT, and monetary), in order to build an adequately qualified compliance team and a compliance monitoring organization, including controls and systems for monitoring and advising on the adaptation of policies and procedures as required.



The investment management company must ensure that the overall internal control system of the organization is functioning properly, at least on a random sample basis.

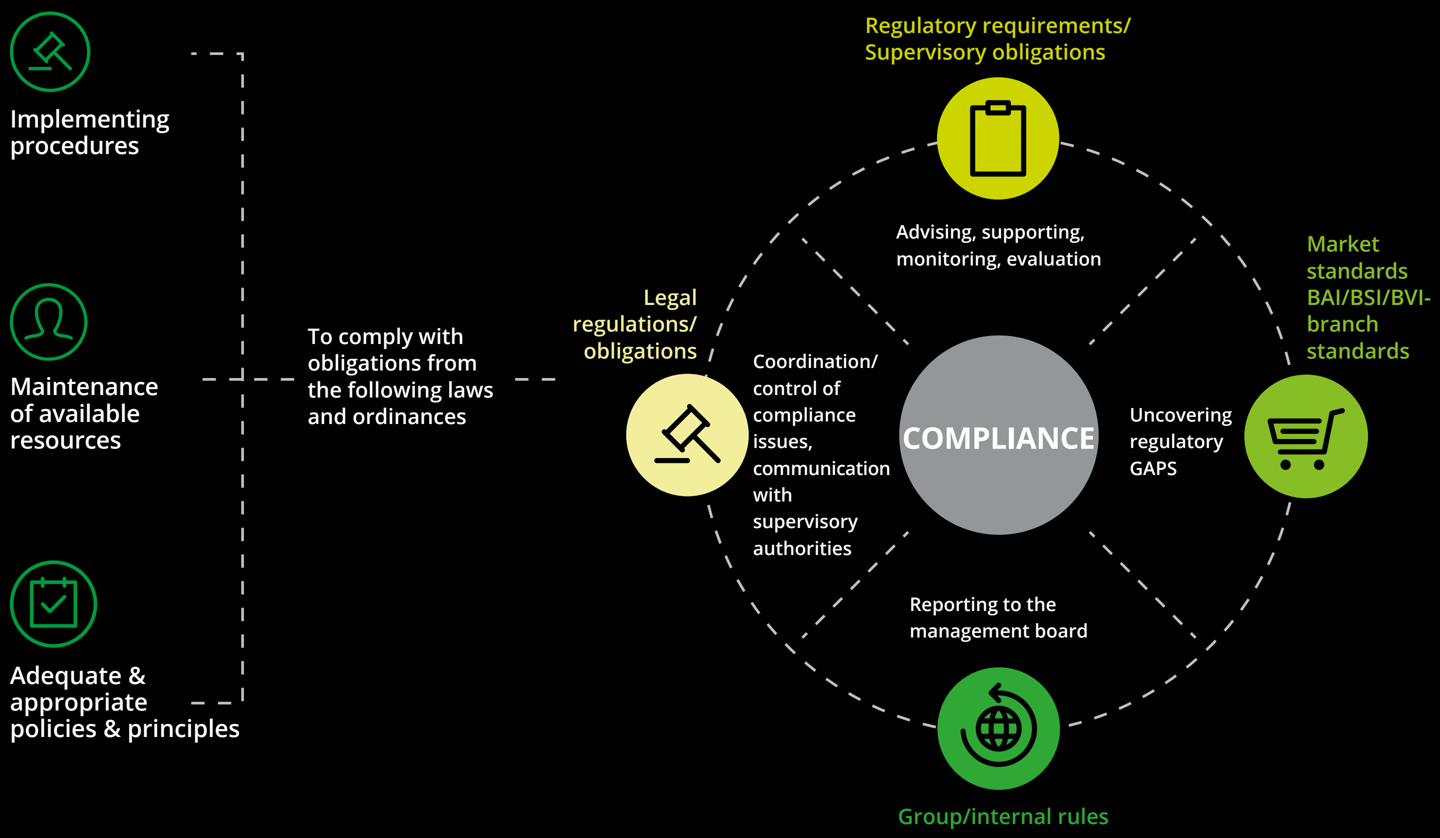
The initial investment in the compliance function can be significant, as it involves a lot more effort in the first year due to the requirement to set up all of the necessary controls, as well as the monitoring organization. Thereafter, efforts and associated costs should reduce dramatically since, once all of the initial controls are in place, the compliance function should become more involved in a control monitoring and advisory role for existing and future business, unless there are fundamental changes required to any critical processes.

Accordingly, the compliance function should first perform an annual compliance risk assessment on the activities of the entire organization, and from this determine both the necessary actions to take and/or projects to implement, with timelines to ensure compliance. This can then form the basis of the compliance audit plan for the year, enabling the compliance function to check and see if all of the controls put in place are functioning in the way they should, or if any corrective, remedial action is necessary.

In addition, the investment management company must ensure that the overall internal control system of the organization is functioning properly, at least on a random sample basis. Control/monitoring activities should be performed as well—if not by compliance, by operational risk and/or internal audit—such as monitoring of trading by the back office and/or other designated employees.

If properly implemented, the compliance framework should cover all of the items shown in Deloitte's Compliance Framework (including the obligation to cooperate with custodians in Germany).

Ultimate responsibility of the management board



Fields of action in compliance

General
- Validation of processes and procedures
- Record-keeping and documentation
- Establishing compliance-related criteria for employees
- Data protection officer
- Necessity/quality of training for employees

Risk Management and Outsourcing
- Control of regulatory risks
- Contents of outsourcing contracts
- Controlling outsourcing: regular inspection of outsourcing companies/ service providers

KYC: Know your Customer
- KYC checks for customers, asset managers and custodians
- Anti-money laundering and counter-terrorism
- Combating bribery and corruption (ABC)

Monitoring Trading/Fund Management/Reporting Obligations
- Best execution policy
- Employee trading
- Conflicts of interest
- New products/markets/reporting obligations (AIFMD, EMIR etc.)
- Voting rights and voting rights notifications and disclosures

Monitoring of Fund Regulations
- Investment limits and investment principles
- Promises made in prospectuses
- Investor profile and risk profile
- Valuation
- Leverage

Cooperation with Custodians
- Transactions requiring approval
- KVG's duty to cooperate
- General collaboration and SLAs

Governance and Integrity
- Code of conduct
- Avoiding conflicts of interest
- Compatibility of "KVG" incentive and compensation systems with business strategy, risk strategy and sales strategy
- Evaluation of incentives with business partners/service providers
- Establishing competency rules
- Fraud prevention
- Complaints management

Sales
- Inducements/conflicts of interest
- Sales principles/bonuses/combating bribery and corruption/gifts and other non-cash benefits
- Validation of and consultation on prospectuses, KIIDs, marketing and sales matters, PRIIPS
- Management and control of requests

In the worst-case scenario, compliance failures can lead to personally damaging effects for members of the management board.

The regulatory focus on compliance is rapidly gaining importance for all investment management companies.

With a vast number of new regulatory requirements being pushed through the European Parliament at the same time[1], along with the proposals, recommendations, and standards coming from the Basel committee, International Accounting Standards Board (IASB) and The International Organization of Securities Commissions (IOSCO)[2], there is an ever-greater need not only to implement these requirements, but also to ensure that a proper monitoring system is implemented through the compliance function.
The consequence of not performing compliance in a proper manner can result in significant reputational damage for the company, as well as in severe penalties and sanctions from the regulators. In our previously mentioned examples, VW and Deutsche Bank, both organizations had to make accounting provisions for billions of euros in expected fines due to non-compliance with the rules.
Furthermore, in the worst-case scenario, compliance failures can lead to personally damaging effects for members of the management board. For example, they could see a loss of the license for the responsible member of the management board permitting them to operate the business, with the subsequent automatic personal reputation loss and/or even the loss of their jobs (which happened to both the CEOs of VW and Deutsche Bank).

It is therefore imperative for compliance to find the right balance between monitoring day-to-day operations, ensuring conformity with the existing regulations, and informing management and the departments on how to adapt their procedures/processes for future requirements.

1 CRD IV, CRR, MAD/MAR, MiFID II/MIFIR, EMIR, UCITS V (OGAW V), CSDR and more
2 BCBS 239, FINREP, IFRS 9 and more

The compliance function also plays an increasingly important role in:

- Developing new products
- Acting as an escalation point for complaints
- Developing the company remuneration scheme, to ensure no conflicts of interest exist
- Advising on how to incorporate new regulatory requirements into necessary project implementation or into day-to-day operations, with the help of the finance and risk departments

The compliance function must not only ensure that the regulatory requirements are met, but also regularly report to senior management on compliance and operational risks, as well as on any breakdowns in procedures, complaints, and regulatory changes, advising them on the necessary next steps to be taken. Compliance should also serve as the main point of contact with the regulatory supervisors for all matters concerning compliance with regulatory and legal obligations by the investment management company. In addition, and in fulfilment of their independent role, they should also act as an early warning system alerting the regulators to any significant compliance issues that may exist at the company in order to try to prevent any reputational damage to the company.

Conclusion

If the compliance function operates as it is supposed to, then through the proper application of an annual compliance risk assessment program across the whole organization, potential compliance problem areas can be detected before they become issues. Thus, the compliance function serves as the right hand of the management board, providing it with timely warnings of the risk-bearing capacity of the company, areas where the company requires improvement of its compliance, as well as the risks arising from customer or product over-concentration, or the disappearance of target markets, among others.

An efficient compliance framework ensures proper control and monitoring, observance of all rules associated with running the existing business, as well as ensuring that new business is developed to its optimum capacity, by ensuring timely requests and setup of all necessary licenses, reporting, and procedures.

Such information should also enable the management board to proactively develop and adapt their business strategy as required. **An effective compliance function is therefore imperative for ensuring not only a successful continuation of the existing business, but also for enabling successful future business development.**

In summary:

- A properly implemented compliance organization can bring real benefit to the business and prevent it from incurring unnecessary fines and penalties.
- The application of a compliance risk assessment program across the whole organization can help detect and mitigate potential compliance problem areas before they can become issues.
- An effective compliance organization ensures that regulatory requirements are met; compliance and operational risks are monitored for breakdowns in procedures and the compliance team advises senior management on changes affecting the organization and any necessary next steps to be taken.
- An effective compliance function is imperative for ensuring a successful continuation of the existing business, as well as for enabling successful future business development.

The UK's vote to leave the EU
How will investment managers be affected?

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The UK's vote to leave the European Union has created significant uncertainty for investment managers, with implications for their investment strategies, their cross-border business, and potentially their ability to retain and attract staff. Firms will need to think ahead and be prepared to take some decisions in an uncertain environment.

The Brexit referendum has negatively affected some asset classes in the UK, such as open-ended property funds.

The UK's widely unexpected Leave vote has introduced uncertainty over the country's economic growth prospects and has resulted in both tactical and strategic challenges for investment managers. Preparing for Brexit will be complicated by considerable uncertainty over the timing of the UK's invoking Article 50, the negotiating stances of both the UK and the EU, and the ultimate outcome.

The UK's most likely options range from: staying in the European Economic Area (EEA), which would mean the UK would retain access to the free trade area and the so-called "passporting" regime; joining the European Free Trade Area, which would mean staying in the free trade area but losing automatic access to passporting; to going it alone on a World Trade Organization (WTO) basis, which would mean both leaving the free trade area and losing automatic access to passporting. Given the wide range of outcomes as well as the potential negative impacts on UK (and possibly EU) growth from a long drawn out negotiation process, irrespective of the outcome, firms should start making some detailed preparations now.

UK and global financial markets have (so far) been resilient post-Brexit vote, after an initial stumble. US stock markets have reached new highs and the main UK and European indices have recovered from their post-Brexit losses, with a fall in Sterling particularly helping UK multinationals to outperform relative to domestic companies. A £170 billion stimulus package from the Bank of England, together with a cut in interest rates, has seen UK government and corporate bond yields fall sharply, while expectations of more central bank stimulus in Europe and a more benign interest rate outlook in the US have combined to boost the value of many fixed income instruments across the globe.

Nevertheless, the Brexit referendum has negatively affected some asset classes in the UK, such as open-ended property funds. These witnessed sizeable redemptions and sparked a number of fund suspensions. Similarly, shares of many domestically focused UK businesses, such as housebuilders and banks, remain well below pre-referendum levels. Sterling has taken the brunt of the impact of the uncertainty of the UK's economic prospects, down more than 10 percent against the dollar and the euro. There is a concern that slower economic growth could also lower fund sales in the UK.[1] Following the Leave vote, investors in Europe switched into "risk-off" mode with equity funds hardest hit with redemptions.[2] Investment managers experiencing sizeable redemptions may see margin pressures, as well as those with Sterling-based fees and international costs. Conversely, those with international fees and Sterling costs are likely to benefit. Investment managers also need to be alert to pressures on fund liquidity in the event of significant client redemptions.

The medium and long-term implications of Brexit are unclear. While financial markets have been resilient, uncertainty during the renegotiation period will probably weigh on economic growth prospects both in the UK and the wider EU, as well as spark periods of market volatility. Brexit could also lead to similar referenda in other Member States, and raise questions about the future of the EU. If other Member States decided to leave, this could have a significant impact on global economic activity and ultimately hurt asset values, given Europe's role as the largest trading bloc in the world. In such an uncertain environment, investment managers will need to update their contingency plans with a renewed focus on potential future impacts on revenues and on fund liquidity, as well as considering the potential impact on their operating model and staff.

Foremost among operational challenges is uncertainty over passporting, which allows EEA investment managers to provide services in any EEA country through a branch or without a physical presence. While the potential loss of access to EEA passports could be a very significant problem for many UK financial services firms, many investment managers are comparatively well placed if they needed to access the EEA without the passports. Nevertheless, the impact would be far from insignificant.

Under the current regulatory regime, UK investment managers can market UCITS[3] retail funds across the EEA without needing to have a UCITS management company or UCITS funds outside the UK. In practice, many UK investment managers already have an EEA UCITS management company or companies and EEA UCITS funds, with appointed local depositaries. Luxembourg and Ireland have typically been the preferred non-UK fund domiciles of UK investment managers in part due to the substantial asset servicing and funds infrastructure businesses in these countries. Firms typically delegate the portfolio management back to a UK entity, which is similar to the model of many global investment managers. Under this setup, firms need to ensure that their EEA management company can provide sufficient oversight of the UK portfolio manager.

As an illustration, the Luxembourg investment funds industry does not expect UK investment managers to shift asset management divisions out of the UK. Rather, the objective is to provide UK investment managers with pragmatic solutions, avoiding disruption to the operating model, and mitigating additional cost as much as possible. For example, asset managers could be looking to set up or re-domicile fund structures to continental Europe working with third-party providers in an initial stage.

1 In August, the Bank of England cut its GDP forecast for 2017 from +2.3% to +0.8%.

2 Morningstar DirectSM Asset Flows Commentary: Europe, Morningstar, July 2016

3 Undertakings for Collective Investment in Transferable Securities

While the potential loss of access to EEA passports could be a very significant problem for many UK financial services firms, many investment managers are comparatively well placed if they needed to access the EEA without the passports.

If the UK loses access to the UCITS passport, firms marketing UK-domiciled funds to EEA retail investors will need to set up a UCITS management company and funds in the EEA (or expand their existing setups) if they want to continue marketing to these investors. Where EEA investors in UK funds move to non-UK funds, or where UK funds re-domicile, there are a number of issues to consider, including whether there could be a tax impact for investors. For EEA investment managers who want to market to UK retail investors, they could set up UK funds or apply for their non-UK funds to become "recognized" by the FCA under the existing UK rules. For the latter option, they would need to demonstrate equivalent consumer protection to the FCA through its funds authorization process.

For non-retail funds, the loss of the AIFMD[4] passport would mean that UK funds, or funds managed by UK alternative investment fund managers, could only be marketed in the EEA where this is allowed under country-specific rules (so-called "national private placement regimes"). EEA countries vary significantly in the extent to which they allow non-EEA funds to be marketed. The UK is relatively open, but some countries are very restrictive. To access the existing AIFMD passport, UK firms would need to have funds and an alternative investment fund manager based in the EEA, although portfolio management could still be delegated to a UK entity. However, in the future, the UK could be granted an AIFMD third country passport if the EU considers that the UK regulatory regime poses no significant obstacles regarding investor protection, market disruption, competition, and the monitoring of systemic risk. The EU is currently considering extending passports to five jurisdictions (Switzerland, Canada, Jersey, Guernsey, and Japan). If the EU were to grant an AIFMD passport to UK firms, it would allow them to access professional investors across the EEA directly, provided they obtain authorization in the EEA and fully comply with the AIFMD.

UK firms managing institutional mandates currently benefit from a MiFID[5] passport, which allows them to access clients across the EEA. If UK firms lose this passport, they will only be able to manage individual mandates for EEA investors where this is allowed under country-specific rules, so may need to establish a greater EEA presence. However, MiFID II, which is due to be implemented in January 2018, introduces an equivalence regime for non-EEA countries. If the UK is deemed by the European Commission to have equivalent prudential and conduct regulation, UK firms will be able to obtain a "third country passport" to provide investment services to professional investors across the EEA without a branch or subsidiary following registration with ESMA. To obtain equivalence, the UK will need to provide an equivalent level of access to the UK for EEA firms. Currently, the UK allows third country investment managers to provide certain services to some types of UK clients under its "overseas persons exclusion.[6]

Investment managers will also need to consider their distribution networks, as UK-based distributors will only be able to sell funds to EEA retail clients where this is permitted in the relevant country, and MiFID II does not provide any third country passport for distributing to retail investors. UK-based distributors may need to set up EEA branches (if this is allowed in the relevant countries) or an EEA subsidiary (which could access retail clients across the EEA through a MiFID passport). It is also possible that EEA-based distributors serving UK clients may need to set up a UK branch or subsidiary.

4 Alternative Investment Fund Managers Directive
5 Markets in Financial Instruments Directive
6 The overseas persons exclusion is set out in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001

If the UK loses its existing passporting rights, investment managers will need to re-evaluate their current EEA and UK footprints. UK firms will need to ensure they have a sufficient EEA presence, with appropriate levels of capital and staff to support any planned expansion of their EEA businesses. The operational restructuring required will vary significantly between firms, depending on the extent of their existing EEA presence. For non-retail business, the operational impact will be reduced if the UK is granted third country passports under MiFID II and AIFMD. However, there could be a time gap between the UK leaving the EU and the passports being granted, and the EU would be able to withdraw the passports in the future if the UK no longer met the criteria. European firms seeking to access UK clients will also need to review the extent of their UK presence. Currently, the UK is more open to non-EEA business than many EEA countries are, so it is possible that European firms seeking to access the UK market may face fewer barriers than UK firms seeking to access the EEA market. However, the UK is likely to want to push for reciprocity as part of its negotiations.

Talent management is another critical operational challenge for UK firms. Workforces in the investment management sector tend to be very international, reflecting in part the globalization of markets. Since the Brexit vote, firms have been reassuring EEA staff based in the UK (and indeed UK nationals based in the EEA) and they will need to continue to do so to the extent that they can. For the UK to retain its central role in the European investment management business and for UK-based investment managers to thrive, access to top-level talent, including that from the EU, will be vital. Firms will no doubt continue to lobby the UK authorities for this cause.

Finally, there will also be operational challenges with respect to taxation for both the corporate group and fund vehicles. Historically, there has been increasing harmonization of tax rules across Member States, resulting in both the benefits and drawbacks of establishing an entity in a particular EEA state being reduced. The impact of EU law, treaty freedoms, and potential domestic law changes could increase tax drag on both corporate entities and funds.

In the face of the operational and strategic challenges that Brexit has raised, firms will need to be forward thinking and consider all the possible scenarios. They will need to be prepared to make some decisions in an uncertain environment, as the details of the UK's future relationship with the EU may not be known for some time and any changes to the business may take time.

Firms will also need to review and update their longer-term strategy and positioning. For example, the post-Brexit impacts of their current product and client exposure can reveal relative strengths and weaknesses within their respective business models as well as highlight some product opportunities or strategic gaps.

To the point:

- The UK's Leave vote creates significant uncertainty, which could weigh on economic growth prospects for the UK and the wider EU. Indeed, the UK's future relationship with the EU, and the extent of barriers to cross-border business, will not be known for some time. Against this uncertain backdrop, firms will need to make some important decisions.
- The impact on cross-border business will be most significant for firms providing services to retail clients. For non-retail business, the impact of Brexit is likely to be partly mitigated if the UK is granted third country passports under MiFID II and AIFMD. To achieve that, the UK regulatory regime must be deemed sufficiently robust compared to that in the EU. If these passports are not granted, UK firms may need to establish a greater presence in the EEA to continue providing services to EEA clients.
- Given that the UK is relatively open to international business, EEA-based investment managers may face fewer barriers accessing the UK market than their UK counterparts face accessing the EEA markets, if passporting rights are withdrawn. However, the UK government is likely to push for reciprocity as part of its negotiations.
- Firms will need to continue to reassure existing employees about their futures, to the extent they can. UK investment managers will want to do as much as they can to ensure access to top-level talent, both from within the UK and globally.

Sustainable and Smart Beta

Both are here to stay, why not take advantage?

Bruno Monnier
Fund Manager
Ossiam

Smart Beta and ESG Investing have earned their respective places in the asset management landscape. While stemming from different investment philosophies, those two commercial successes need not work at cross purposes. Would an approach combining the two be a worthy addition, beyond its marketing appeal?

The idea of applying an ESG screening comes naturally as we have seen the advent of "values investors" alongside the economic minded "value investor".

The fact is ESG[1] investing and Smart Beta are not just commercial successes, nor mere happenstance. Both result from a broad evolution of the financial industry towards increased transparency and accountability. This dual demand could surely be attributed to defensive reactions specific to current financial markets but can also be considered from the larger standpoint of changing service expectations in any industry: accessibility, comparability, personalization and the possibility to give a feedback.

Smart Beta is but the transfer of a know-how previously kept in the active management industry to the front row of indexed investments. By disclosing the methodology and the details of their investments, the portfolio managers are not only giving away data, they are also empowering the end investors to challenge their process and their implementation. This provides in turn a rich toolbox of allocation techniques and experience that can be leveraged upon to address specific needs.

The drivers of ESG investing are abundant. Heightened company accountability comes first in the form of correcting the information asymmetry through richer reporting, which then leads to higher shareholder involvement by way of proxy voting. On another note, the growth of ESG had been accompanied by the rise of investments tailored to different beliefs or themes, outside of the pure financial scope. Finally, analysts at large have discovered or rediscovered that non-financial data matter for the homo economicus and that the forthcoming global challenges warranted a more comprehensive framework.

Though they may have much in common in terms of their motivations, ESG and Smart Beta have matured into very distinct disciplines. This historical separation between both approaches creates all the more possibilities and value to what can be achieved by their combinations, if it can be achieved. A taxonomy of all possible interactions would be of scholarly interest, but for now it suffices to consider the most straightforward case: applying smart beta techniques to a selection of companies according to ESG criteria.

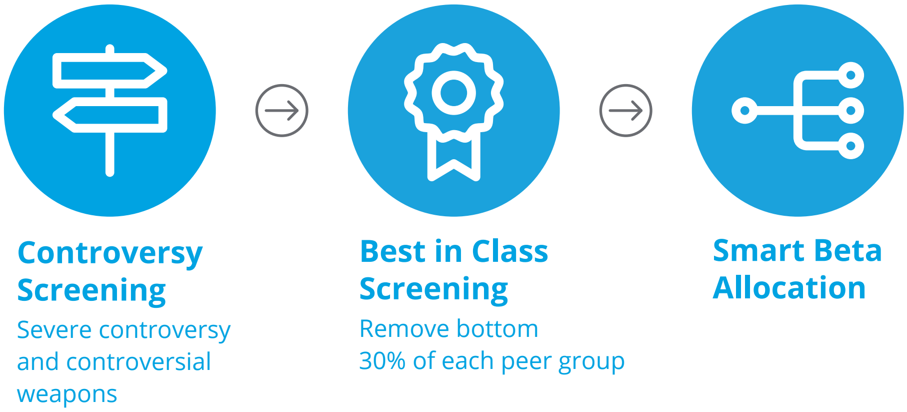
1 ESG : Environnemental, Social and Governance

The idea of applying an ESG screening comes naturally as we have seen the advent of "values investors" alongside the economic minded "value investor". As these values or beliefs cannot be compromised with, it clarifies the portfolio construction that they should be dealt early on in the process to mark their priority. Thematic investing, another ESG discipline, can also be considered along those lines: the theme prevails. It is also a prudent first step to account for the non-financial data input separately, as long as the trade-off between the utility that can be derived from them and from financial data is not clearly defined.

On the other hand, Smart Beta managers are familiar with offering their methodologies on various investment universes, or applying their processes to customer-defined selections for investment mandates. Because Smart Beta as a whole exploits stylized facts about financial markets, it can be expected to operate whenever the market segment in consideration displays those same characteristics in terms of risk and factor exposures. The proliferation of geographically segmented products results from this easy transposition of concepts.

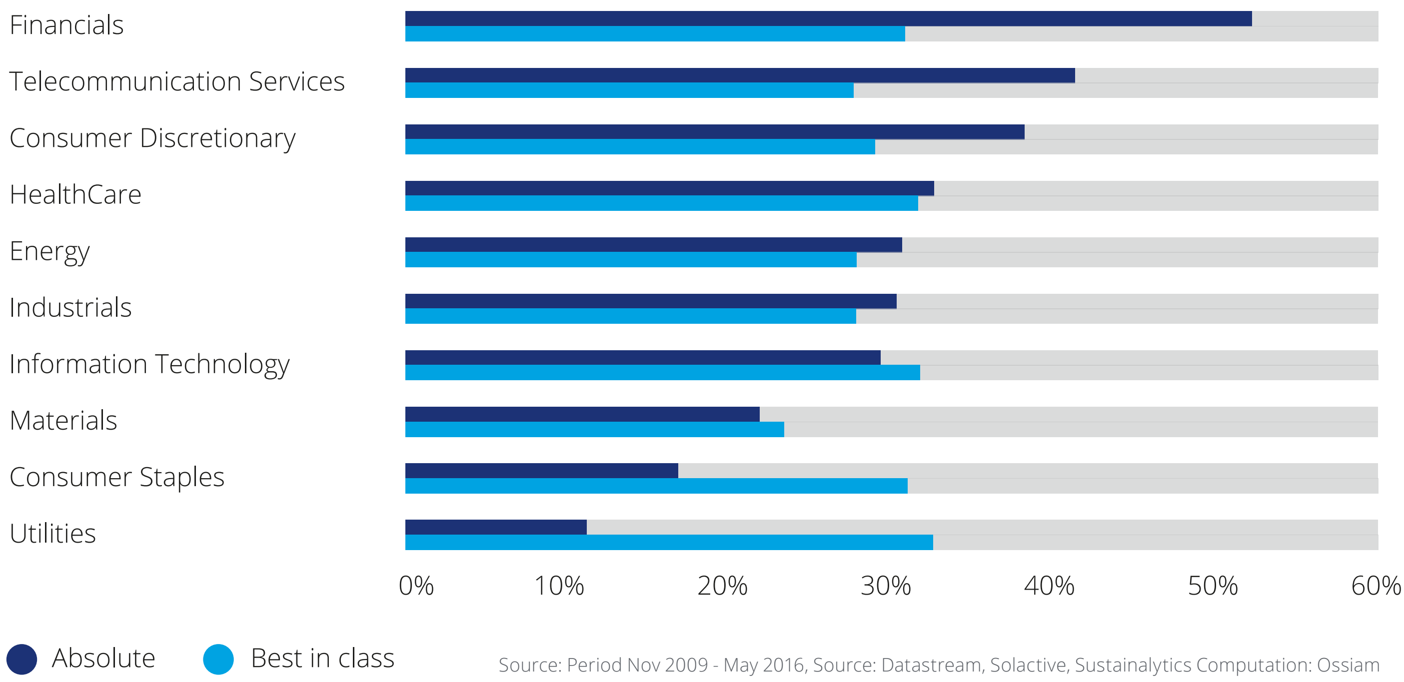
As an illustration, we will check for the presence of these facts after an ESG screening has been performed to assess beforehand the suitability of applying directly allocation techniques. We then perform these allocations to confirm their effects. Our numerical application considers the largest US companies from 2009 (when ESG data are available) to 2016. As for the actual selection, we consider a process that combines ethical screening with a positive "best in class" screening: this approach can be considered as a consensus approach for European investors. Removing companies subject to severe controversies aligns the portfolio away from averred contestable behavior and towards responsible management values. The best in class approach adopts a long term view by rewarding companies which are leading their peer group in terms of policies and strategies, as measured by their respective E, S and G scores.

Figure 1: Screening process for Smart Beta allocation of investments



Our first concern will be checking whether the screening we have defined does not deprive completely our investment pool from sectors or segment of the market. Preserving the economic mesh is the most efficient way of keeping intuitions about the structure of the market, risks and diversification intact. This is exactly what the best in class construction does: by implementing the selection group within groups of similar companies, we make sure that all groups are represented in our final selections, thus keeping the economic structure intact. As an illustration, we provide a comparison of the best in class approach with a selection that is performed on the ESG scores but irrespective of the peer groups. As shown in Figure 2, we see that the Best-in-class approach will remove 30% of the Financial sector, while an absolute approach would halve its weight.

Figure 2: Percentage of each sector removed by the ESG filter



Source: Period Nov 2009 - May 2016, Source: Datastream, Solactive, Sustainalytics Computation: Ossiam

Beyond compatibility, the value of a dual approach will arise where there can be synergies.

Indeed, different industries have different structural ESG scores. Their business might entail different exposure to environmental and social issues, and some may be further down the line of ESG alignment.
An absolute filter would have induced then a clear ESG bias towards specific sectors.

Additional tests yield results supporting the compatibility of the two approaches. For instance, the exposures to risk-factors (Fama-French) are not altered with any statistical significance. While the very best in each class tend to be the least volatile, the proposed screening process as a whole, does not act like a volatility screening. Company size however is affected, with favoritism towards the largest companies.

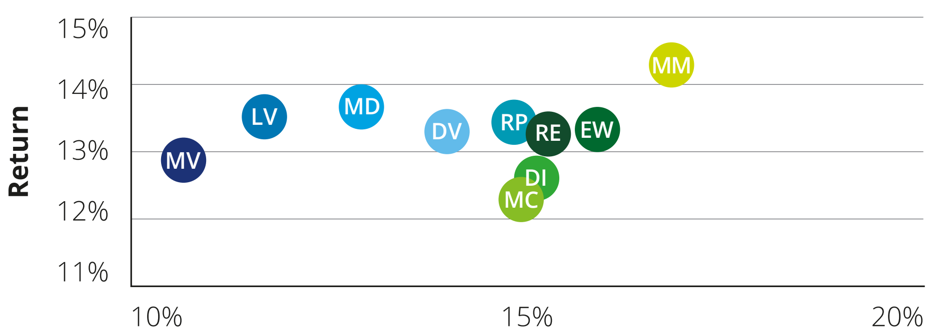
To conclude our experiment, we implement an array of Smart Beta strategies with or without performing the ESG screening (simulations go back to 2009).

Those preliminary results confirm Smart Beta allocations can provide similar improvements and the same diversity of risk profile to an ESG investor (Figure 3). Reversing the point of view, Smart Beta converts are also able to carry on with their investment methodology while taking on supplementary sustainability objectives (Figure 4).

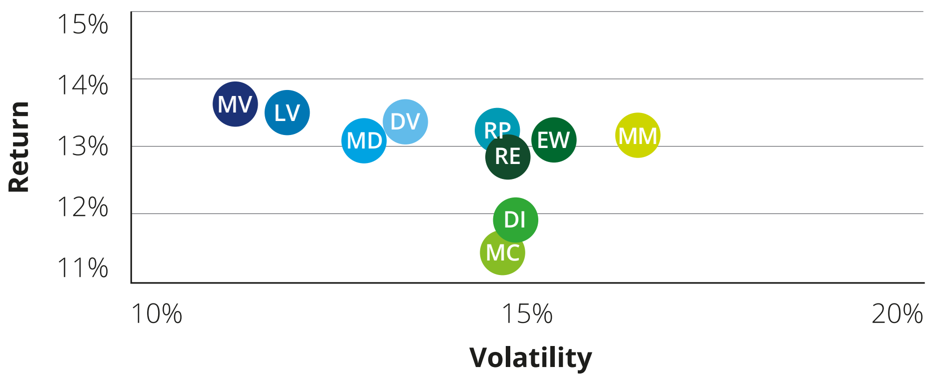
Beyond compatibility, the value of a dual approach will arise where there can be synergies. Finding these will depend on the particular objective of the investment process. Naturally, risk based smart beta allocation will be well complemented by the extra financial exposure assessment that an ESG analysis can provide. Fundamental based allocation can also benefit from these new valuation drivers, as an example, there is such a thing as carbon risk, how regulation will affect the industry, how it will impact analysts' forecasts. Uncovering and using those complementarities is what will make smart beta sustainable.

Figure 3: Risk-Return Profile

Smart beta strategies without ESG screening



With ESG screening



- **MC** Market capitalization, the benchmark
- **DI** Diversity Weighted, reduce market capitalization differences while preserving the relative order
- **LV** Low Volatility, selecting the least volatile and weighting them by their inverse volatility
- **MV** Minimum Variance, finding the portfolio targeting the lowest possible variance
- **DV** Dividend Weighted, selecting companies with the largest divident payout
- **RP** Risk Parity, weighting by the inverse of volatility
- **EW** Equal Weight, assigning the same weight irrespectively of the market capitalization
- **MM** Momentum, selecting companies that have performed well in the past
- **MD** Maximum Diversification, finding the portfolio maximizing the ratio of asset weighted volatilities over the volatility of the portfolio
- **RE** Risk Efficient, aiming at the reduction of downside volatility

Figure 4: Impact of the ESG screening on smart beta strategies

	EW	DI	RP	LV	MM	RE	DV	MV	MD
Correlation of excess returns	96%	95%	95%	98%	96%	93%	97%	98%	90%
ESG score improvement	11%	14%	11%	13%	14%	11%	13%	11%	10%

Source: Period Nov 2009 - May 2016, Source: Datastream, Solactive, Sustainalytics Computation: Ossiam

To the point:

- Smart Beta and ESG investing are two facets of larger evolution in investor demand
- A simple combination of the two - screening via ESG, allocating via Smart Beta - can satisfy both approaches
- Using a Best in Class process, we verify the value of this mixed technique:
  - ESG investors gain access to a range of risk/return profiles without overlooking their core values
  - Smart Beta investors can carry over their strategy of choice within the ESG space
- Beyond the simple combinations, synergies exist, particularly for risk management
- Other similar synergies are likely to emerge for existing strategies or through specific products as the state of the art progresses

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