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WELCOME TO ISSUE No.40

FOREWORD

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A new year calls us to be of two minds. First, looking back to assess where we've been, and second, facing forward to see where we're headed. So, too, our latest edition of *Performance* embraces this duality.

In issue 40, our contributors take a closer look at the regulatory landscape and its impact for sustainable finance, digitalization and changing business models. Whether you are just beginning a transformation or in media res, use this issue to help set your agenda.

Sustainability reporting requirements are creating ripples across private equity, according to Deloitte Germany's Dr. Maximilian Tucher and Carsten Auel. They share the impacts of sustainability reporting with a closer look at how SFDR and CSRD's reporting requirements might work together – and a clear-eyed look at implementation challenges.

Deloitte Luxembourg's Benoit Sauvage and Marijana Vuksic have their eyes on the digital regulations around the corner. Stemming from the EU's comprehensive strategy, these new regulations will cover retail payments, machine learning, artificial intelligence – and more. Firms should anticipate and embrace these changes, as the topics hail a new era in the EU financial services regulatory landscape.

The Financial Action Task Force (FATF) has spent years trying to improve reporting guidance for declaring AML tax offenses, leading the CSSF to publish its own indicators for the fund sector. Deloitte Luxembourg's Julien Lamotte and Antoine Liénard share the country's progress, but only the next FATF visit to Luxembourg will truly show if the CSSF has succeeded.

The journey to net zero should not be a solitary one; Investment Management firms must transform collaboratively across all axes. Our colleagues from Deloitte UK and the EMEA Centre for Regulatory Strategy outline how Risk and Compliance functions can aid the transition to net zero and avoid pitfalls, such as greenwashing, along the way.

Marc Van de Gucht, Director-General, Asset Management & Private Banking, BEAMA, also looks ahead to portend an Asset Management paradigm shift in three key areas: the changing macroeconomic environment, regulatory changes driven by ESG objectives, and the war for talent. Despite these challenges, the industry is forging ahead – adjusting in real time.

In a conversation between Deloitte Belgium's Tom Renders and Marie Lambert, Professor of Finance at HEC Liège, we uncover an academic assessment of SFDR classification impacts for asset managers and investor expectations – and changes emerging in the risk-return performance ratio.

It's clear that regulatory frameworks are a key driver for industry change in Europe and beyond. This issue of Performance showcases how the Investment Management sector is braced for continued impact while balancing necessary transformations with business transformations.

We hope you find insights to animate your year in this 40th edition of *Performance*.

EDITORIAL

Despite recent upheavals and changes that have affected the economy in recent years, the Eurozone economy has steadily grown with an increase of 0.7% in the first quarter of 2022, followed by an increase of 0.8% during the second and 0.2% in the third quarter. The primary driver behind this growth is the domestic demand, particularly a surge in tourism.

In this Performance edition, we tackled with the environmental future of our world. Many investment managers have made commitments to reach net zero greenhouse gas (GHG) emissions by 2050, and the financial services industry plays a crucial role in the implementation of such commitments. The regulatory challenge – the most significant and arduous challenge in this area – involves the implementation of numerous new Environmental, Social, and Governance (ESG) obligations. The European Union has made the development of sustainable finance a priority, and investor expectations are sky high.

Sustainable regulation is an active driver of the finance industry, but it has been only a year since the Sustainable Finance Disclosure Regulation (SFDR) came into effect. And yet, EU regulators and financial market participants (FMPs), including private equity firms, still face significant challenges in implementing SFDR. In this edition, we focus on how regulations are re-structuring, reshaping and innovating the market.

As the digital world continues to expand exponentially, developments in the digital finance regulations are creating momentum for tokenized assets. Innovations in retail payments, machine learning and artificial intelligence will be a major focus in the coming years. Despite this, financial institutions will still need to address operational challenges stemming from regulations in this new era.

The relationship between tax and AML mean that they must play in the same field and same team. Luxembourg's financial center has had to renew its game and approach to the fight against tax fraud laundering, as solidified on 3 July 2021 when the CSSF targeted the Luxembourg investment fund sector with a second list of indicators specific to collective investment activities.

Due to the confluence of risks, ranging from the COVID-19 crisis to the energy crisis and the war in Ukraine, it is of utmost importance to keep in mind that we only have one world. We, as humans and as institutions, are responsible for protecting it and keeping it alive.

It's our pleasure to have you as a reader and to keep you well informed! We are looking forward to what 2023 will bring.

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Major challenges ahead for the Asset Management industry

A PARADIGM SHIFT IS ANTICIPATED IN THE COMING YEARS

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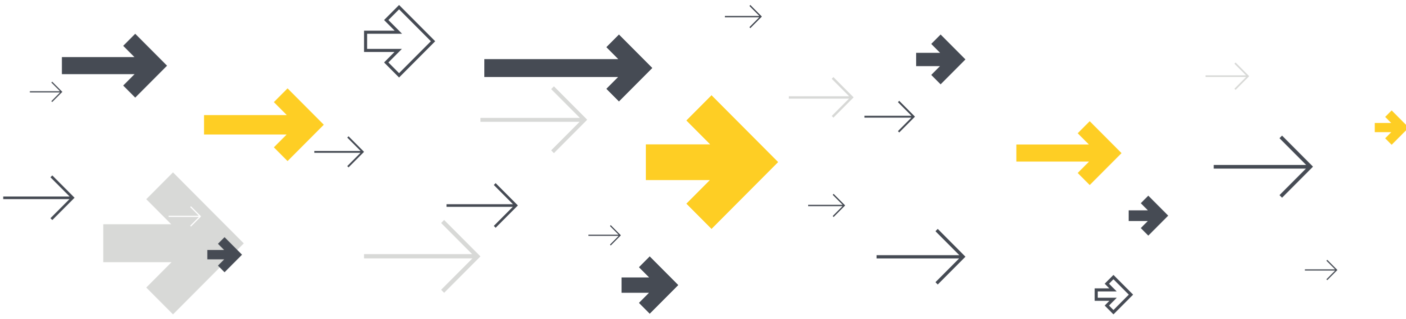
INTRODUCTION

Winter is coming... The unprecedented gas and electricity crisis has led to a surge in energy prices. The joint effects of the crisis have led us all to turn down the heat by at least one degree. When we go shopping, we are shocked that our weekly groceries have become that much more expensive again. “For the times they are a-changin’,” Bob Dylan’s song echoes through the speaker.

These words are more relevant than ever, certainly for the financial sector and particularly for the asset management sector. I try to remember the importance of looking at the big picture rather than every individual detail. Connecting each element to another and placing them in a broader context is crucial in today’s environment of complex challenges. That is why I am not listing every challenge of the asset management sector here, but instead, give you a helicopter view.
Of course, things move fast, and this article represents just a moment in time.



What types of challenges does the fund industry face?

A changing and uncertain macroeconomic environment

We are all familiar with the changing macroeconomic environment that asset managers must consider: we are evolving from a period of low inflation to one of high inflation (due to high energy prices, among other things); rising interest rates; political instability and fear of recession resulting in volatile stock markets where the investor (including the so-called defensive investor) is put to the test.

Since the income of the asset management companies is largely determined by assets under management (AUM), falling AUM (mainly caused by the falling stock markets) means falling income. However, at the same time, costs, such as for purchasing data from data suppliers, are rising.

Government intervention of all kinds are creating budget deficits. Various fiscal measures are considered to cover these deficits. Savers and investors are entitled to tax certainty and stability. The sudden abolition or major changes of a well-established tax framework can always undermine investors’ confidence in their government.

Therefore, the asset management industry must deal with macroeconomic consequences that is more uncertain than ever.

The regulatory challenge

A second major challenge relates to the legal and regulatory environment in which asset managers must operate. Those who think that most legislative changes are behind us are wrong. There is still a tsunami of new regulations floating toward the industry that need to be processed.

The most crucial challenge in this area is the one related to the implementation of numerous new ESG obligations. The European Union made the development of sustainable finance a priority. Investor expectations in this area are also high. If, as a professional association, we fully support the approach and the objectives it pursues, in the interest of a sustainable economy and society, the challenge for the actors is no less significant. They must adapt quickly, despite many uncertainties, considering short implementation timelines. In particular, the lack of reliable data to assess the sustainable nature of an investment is one such challenge. This could expose asset managers to the risk of being accused of greenwashing. ESG developments are part of a major transformation that will profoundly impact the financial services industry and more generally our entire economic model. We are only just starting.

The evolution of ESG regulations (going from SFDR to CSRD, ESG Ratings, CSDD, Deforestation regulation and global sustainable reporting standards) is one of the biggest projects that the sector has had to carry out, since the UCITS. This requires real understanding. Member states must be careful to prevent distortion of meaning when transposing EU-level directives into national law.

The legal rules have not yet been properly published and some still require clarification, as they can be in conflict with each other. This challenge is recognized by regulatory bodies, such as the European Securities and Markets Authority (ESMA). ESMA's Executive Director Natasha Cazenave recently reinforced their intent "to focus on supervision, enforcement and consistency application of the sustainable finance rules.[1]

In the second half of 2023, a Common Supervisory Action (CSA), coordinated by ESMA, will be launched concerning sustainability risks.

Financial education of consumers

A third major challenge relates to the financial education of consumers.

It is important to note that, in Europe, the population holds a huge volume of savings in bank accounts. In an inflationary environment, sitting on cash, when interest rates on bank deposits remain close to zero, is not the most prudent way to manage finances. The growth potential of the fund industry in Europe, therefore, remains significant. The point is to reinforce the consumer's financial education (so that they understand how money works and can make informed investment decisions) and regroup all relevant initiatives with the aim of increasing accessibility to the markets and improving consumer skills. Without further financial education, we are unable to significantly increase the number of private investors, which is a major objective of the European Commission supporting the sector.

Let's not forget that, in the long term, the first pillar of the pension system (managed by the public sector) will no longer be enough to meet the basic needs of retired people. This is another vector of growth for our industry, which can offer long-term investment solutions that should allow everyone to maintain a certain standard of living once they retire For investments (whether it be in a pension savings fund or through another fund), it's important to note that the earlier you invest and the more you stay consistent, the more capital you will make.

The significance of training both applies to people who do not invest today and to those who are already active in the financial markets. For example, as a sector we are required to explain sustainability concepts (taxonomy/SFDR/PAI) to clients. This ensures that there is no misunderstanding between the client's expectations and the offering they are given. The necessity of financial education is an essential area that cannot be over emphasized.

Finally, let us mention that the European Commission plans to take further initiatives (I refer here to its "retail investment strategy") to further protect investors, either by introducing new concepts and/ or changing existing ones. The concept of "value for money" is closely followed and supported by the sector. Thus, the sector emphasizes that these concepts should look beyond the cost aspect for the client and rather look at the qualitative aspect (e.g., what service is provided).

War for talent

The last major challenge I would like to mention is the war for talent and the need for skills. Advancing on the subjects of sustainability, the digital transformation of our businesses, the development of new products or the democratization of alternative asset classes implies innovating and having new skills. Skills development is a key issue. We must, therefore, strengthen the attractiveness of the sector and invest in the current and future workforce. Collaboration with universities and continuing education centers will help.

CONCLUSION

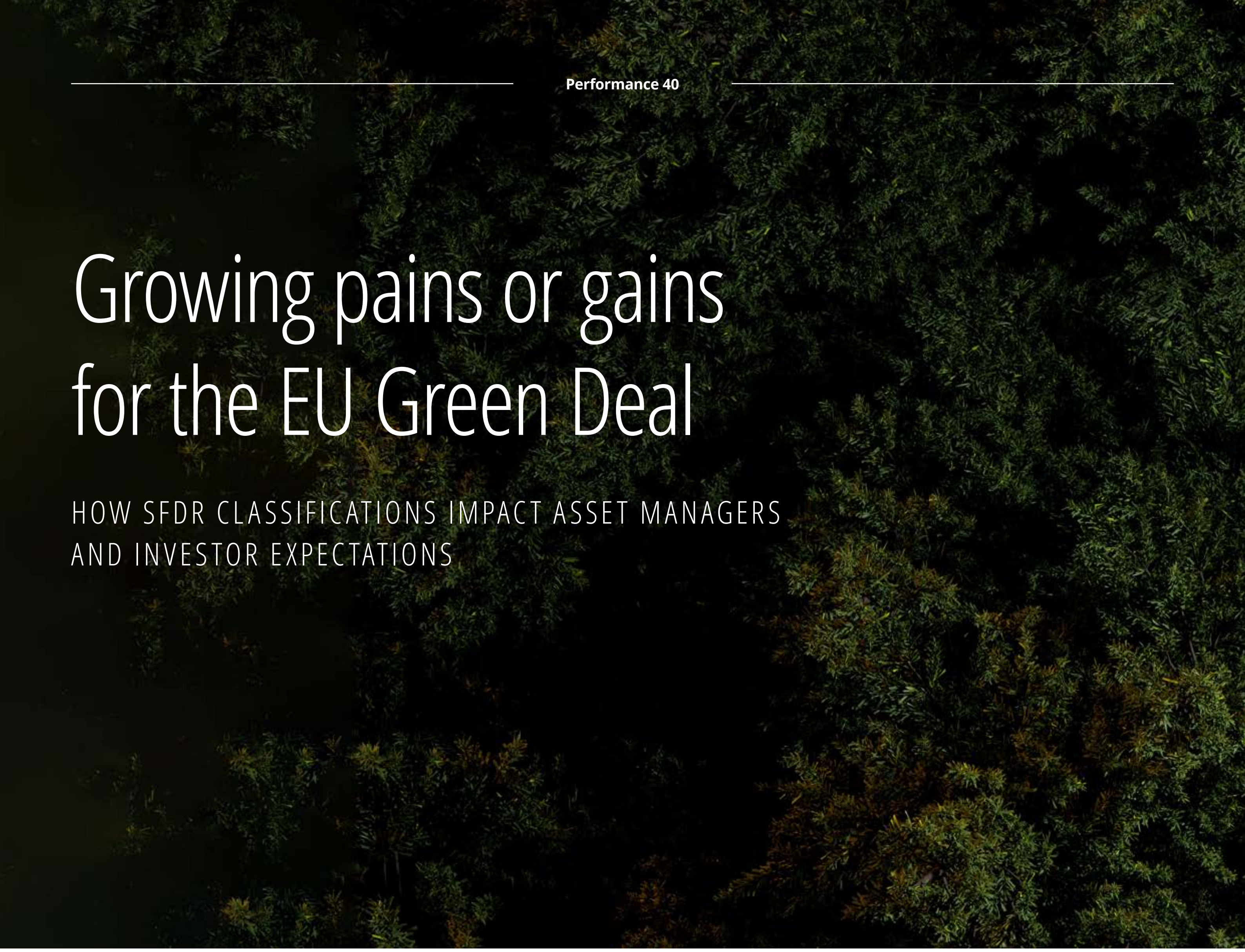
With sustainable finance, we are witnessing a paradigm shift. The challenges, beyond the investments necessary to adapt the systems and implement new operational processing, are particularly related to the lack of data concerning the sustainable performance of investments. Regulatory texts are still being aligned and adopted while technical clarifications are ongoing. However, the industry is already moving forward and is aware of the imperfections and risks. We are at the forefront of a transition that will necessarily involve adjustments.

The asset management industry is built on solid foundations with a broad diversification of investors and AUM. This is not the first challenge that we have gone through. We can be confident about the future.

1. The companies in which the funds invest are not yet required to report on their degree of sustainability. This obligation will only come into effect in 2024, and then only for large European companies. In 2025, this will be extended to smaller companies. But these obligations apply to European companies and not to US- or emerging market companies in which funds also invest. International rules are being worked on, but it will take some time before they come into effect. The question is also to what extent the European rules will be compatible with the international ones. Fund houses are therefore faced with the major challenge of mapping out the sustainable DNA of their funds in a standardized manner.

TO THE POINT

- What types of challenges does the fund industry face?
- A changing and uncertain macroeconomic environment - Government intervention of all kinds are creating budget deficits. Various fiscal measures are considered to cover these deficits. Savers and investors are entitled to tax certainty and stability.
- The regulatory challenge – the most important challenge in this area – involves the implementation of the numerous new Environmental, Social, and Governance (ESG) obligations. The European Union has made the development of sustainable finance a priority, and investor expectations are also high.
- The war for talent – skills development in sustainability, digitalization and innovation – is a key issue. We must, therefore, strengthen the attractiveness of the sector and invest in the skills in place. Collaborating with universities and current education centers will help.



Growing pains or gains for the EU Green Deal

HOW SFDR CLASSIFICATIONS IMPACT ASSET MANAGERS AND INVESTOR EXPECTATIONS

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INTRODUCTION

The financial industry has undergone significant changes since March 2021, particularly with the implementation of the EU's Sustainable Finance Action Plan. This plan aims to redirect capital toward sustainable investments, mitigate ESG risks in financial markets, and increase transparency and long-term thinking. To move sustainable investing forward, it's important for more companies to report their sustainability efforts consistently.

Tom Renders, partner from Deloitte Belgium spoke with Marie Lambert, Professor of Finance at the University of Liège, to talk about these changes and the ways that the industry has responded to them.

Tom Renders: Hi Professor Lambert, first of all, many thanks for your collaboration on this interview. Over the past two years, the investment management landscape changed drastically, often driven by regulatory changes and, to a large extent, by the European Union's increasing focus on sustainability. How would you summarize this evolution?

Marie Lambert: Since March 2021, the financial landscape has indeed profoundly changed. The EU's Sustainable Finance Action Plan, which is part of the EU Green Deal, has established a series of actions to reach three objectives: (i) redirect cash flows to sustainable investments, (ii) protect financial markets from environmental, social or governance (or ESG) risks, and (iii) promote information transparency and long-termism. To support these actions, new regulations and directives were designed and implemented in 2021-2022.

First, since March 2021, financial market participants have classified their financial product offerings to better inform investors about the sustainable objectives of their product (the so-called Articles 6, 8 and 9), the management of ESG risks and the due diligence carried out to avoid adverse impacts on society.

Second, since 1 January 2022, the EU Taxonomy was implemented, which establishes a dictionary of green activities related to six environmental objectives. Financial and non-financial companies under the scope of the Non-Financial Disclosure Directive (NFRD) need to disclose the proportion of eligible activities on climate objectives. Full reporting regarding alignment has been postponed to 2023 for financial undertakings. Additional information on taxonomy-aligned investments is also required for financial products classified as "sustainable".

Last but not least, the future Corporate Sustainability Reporting Directive (CSRD) should extend the number of companies required to report sustainable information in a more standardized way.

You mentioned the Sustainable Finance Disclosure Regulation (SFDR) and its related product classifications. How important is the increase in 'green' investments compared to, let's say 3 years ago?

According to the Global Sustainable Investment Alliance (GSIA), sustainable investments had reached $30.7 trillion at the end of 2017. In 2019, three years later, the value increased to $35.3 trillion. This represented one-third of the global assets under management. If we assume the same proportion in 2025, given the expected growth in global AUM from various professional sources, we could expect global sustainable investments to increase to above $50 trillion.

In Europe, we observe, in the same period, some downward corrections in anticipation of the new regulatory framework, which has clarified the scope for sustainable investment funds.

Between 2018 and 2022, HEC Liège's own research observes five times more dollar flows for funds classified in Article 9, than for those classified in Article 8. Compared to unclassified funds under SFDR, Article 9 funds receive $2.75 million more investment flows, while Article 8 funds attract only $0.5 million more capital. Regarding SFDR classification, in December 2022, MSCI categorized 25% of funds in one of the three SFDR Articles, which is 5% higher from 6 months prior. Of the classified funds, more than 70% of investment funds marketed in EU are classified as either Article 8 or 9 (with Article 9 representing less than 10%). The Morningstar database counts Article 8 and 9 funds as more than 50% of the market share. Yet, the average ESG ratings do not significantly vary among the different groups of funds. For instance, considering the global ESG rating, on a scale from 0 to 10, we observe average values of 7.86, 8.27, 8.76 for funds classified in Article 6, 8 and 9, respectively.

Performance and risk-return are often the determining factors in the selection of investment products. It is precisely this relationship that is often questioned in sustainable investments? Is this a fair observation?

Recent academic studies have shown that although sustainable ratings are used by investors, the main criterion remains the risk-return performance ratio. The utility function of investors, which – in the academic jargon – describes the investor level of satisfaction regarding an investment, has traditionally relied exclusively on the expected return and risk from the investment. Studies have shown that some (but not all) investors exhibit preferences regarding sustainability that should be integrated as an additional criterion in the function. Because of the heterogeneous preferences among investors, we observe pressures for the demand of "sustainable" assets, which results in higher pricing and a drag in return. The lower demand for so-called sin stocks could lead to their underpricing, with opportunities for making abnormal return. Another explanation could be that investors require a premium to keep those assets out of institutional portfolios.

Yet, we have recently experienced two very particular periods: First, the period of 2020 2021 has shown very strong performance achieved by high ESG assets, mostly due to a shock in the demand for investments and products that hedge climate or social concerns. Second, the energy crisis of 2022 has benefited the energy sector.

Both examples remind us that the market price is determined by the law of supply and demand. Pricing pressure can come from either high demand or limited supply.

You made an interesting point about sin stocks. What can be said about the recent hype around sin-funds?

The first complete academic study focusing on sin stocks was published in 2009 in the Journal of Financial Economics by Hong and co-authors[1].

It documents an average outperformance of sin stocks (i.e., stocks of firms active in the beer, smoke or gaming industry) of 26 bps per month in the US market from 1962 to 2006. The main argument to justify this outperformance proposed by the authors, is that these stocks are neglected and face litigation risk. Thus, this additional risk should be compensated by higher returns.

At HEC Liège, we reproduced their methodology in the period of 2007-2022 and we find that the alpha is no longer significant.

Still, we can see a hype around sin-funds. This can be illustrated, for instance, in the launch of a "bad ETF" in 2021 that allowed investors to get exposure to industries related to gambling, alcohol, drugs or ETFs. Another example is the tendency for some funds to overweight their investment in the energy sector, which has outperformed in this energy crisis. As explained earlier, one explanation could be that high pricing in the ESG assets can create opportunities for the sin market. The energy crisis of 2022 reminds us that fundamentals in market pricing are still driven by laws of supply and demand. And currently, the energy sector is generating strong returns, as it has become a very expensive and scarce good.

1. Hong, H., & Kacperczyk, M. (2009). The price of sin: The effects of social norms on markets. *Journal of Financial Economics*, 93(1), 15-36.

Going back to SFDR, we can observe that the largest increase in sustainable funds in Article 8 or 9 is the result of an adjustment of the investment policy of existing funds. How reliable are the track records of such funds? How should investors navigate this area?
The attribution of past performance to the fund SFDR classification must be made with caution. Two problems limit this performance analysis. First, one year after the classification, we observed many upgrades and downgrades. As an example, Amundi has recently downgraded most of their Article 9 funds to Article 8 funds. Given the different interpretations around the SFDR classifications, it is not surprising to see these adjustments and I expect more adjustments once the second level of the SFDR regulation including quantitative reporting on principal adverse impacts and taxonomy-alignment indicators will be released for Articles 8 and 9 funds. Secondly, according to Becker et al. (2022)[2], European funds have recently increased their ESG efforts as a way to attract new inflows and to comply with new regulations. However, the classification does not tell us which strategy the funds were performing before the classification and that can cause problems to measure performance across categories.

There is some talk about an ESG bubble. To what extent is this a realistic fear today and when looking towards the future? Are we already seeing signs of this in the market today?
In efficient markets, all information should be integrated in the price and so we should not observe any under- or overpricing. We are currently in the transition phase where information on ESG is limited to a selected small sample of companies. This might create an imbalance between offer and demand and push valuations to abnormal levels. This abnormal situation should get resolved over time, as we get access to more information and investor preferences get more homogenous. If we compare the valuation of companies in the Stoxx 50 to those in the Stoxx 50 ESG, the (EBITDA, EBIT and revenue) valuation multiples of stocks included in the ESG group are not significantly different from those in the other group of stocks.

Investors, and certainly institutional asset owners, are becoming increasingly cautious about their investment portfolios. If an ESG approach is applied, it usually consists of a combination of best-in-class approach and exclusion. As a result of the latter, the most controversial companies and sectors are increasingly losing support from investors and the communication between investors and companies is declining. In short: Are the biggest 'culprits' not being robbed of their opportunity to improve themselves? Is the regulation falling short here?
Corporate engagement and shareholder action remains a third sustainable investment strategy (GSIA, 2020)[3]. While we acknowledge that asset owners, such as pension funds and insurance companies might represent minority shareholders and, therefore might either not play an active role or might delegate the task, then there is probably a paradox with regard to the current situation. Some of these institutional investors are afraid of being accused of greenwashing, and prefer to exclude some sectors. However, investing in the polluters might be justified if the goal is to use shareholder proxy voting rights to encourage them to change their practices. Regulation is not falling short, but the problem is rather coming from the pressure that public opinion might impact how asset managers will choose to react.

TO THE POINT

- The EU's Sustainable Finance Action Plan, which is part of the EU Green Deal, has established a series of actions to reach three objectives: (i) redirect cash flows to sustainable investments, (ii) protect financial markets from environmental, social or governance (or ESG) risks, and (iii) promote information transparency and long-termism.
- Since March 2021, financial market participants have classified their financial product offerings to better inform investors about the sustainable objectives of their product (the so-called Articles 6, 8 and 9), the management of ESG risks and the due diligence carried out to avoid adverse impacts on the society.
- Recent academic studies have shown that although sustainable ratings are used by investors, the main criterion remains the risk-return performance ratio. The utility function of investors, which – in the academic jargon – describes the investor's level of satisfaction regarding an investment, has relied exclusively on the expected return and risk from the investment.

2. Becker, M. G., Martin, F., & Walter, A. (2022). The power of ESG transparency: The effect of the new SFDR sustainability labels on mutual funds and individual investors. Finance Research Letters, 102708.
3. GSIA Global Sustainable Investment Alliance. (2020). Global Sustainable Investment Review 2020. Retrieved from http://www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf

How the SFDR is changing the dynamics in Private Equity

IMPLEMENTATION CHALLENGES FOR GENERAL PARTNERS AND LIMITED PARTNERS

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INTRODUCTION

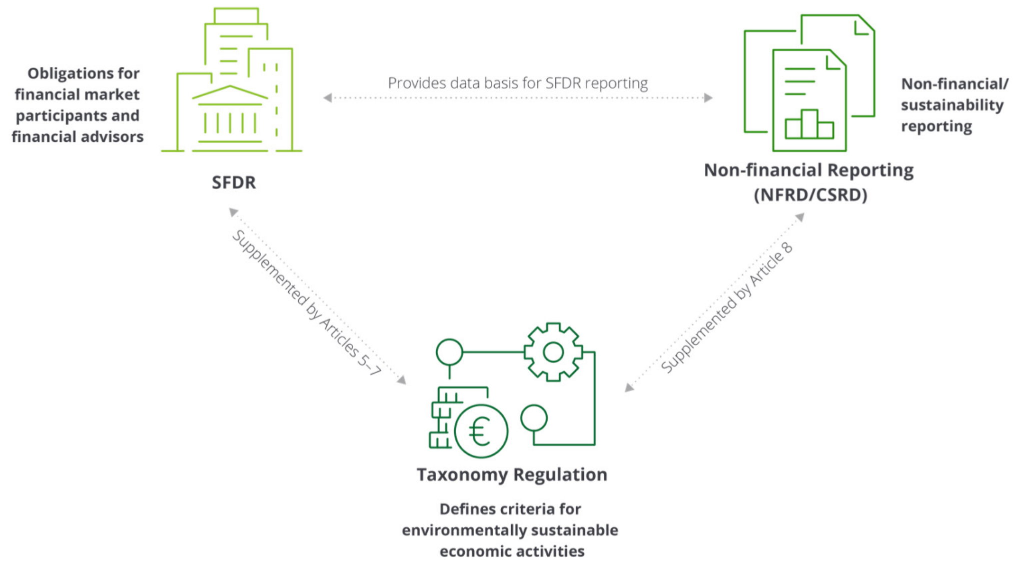
It's been one year since the Sustainable Finance Disclosure Regulation (SFDR) requirements came into effect. And yet, EU regulators and financial market participants (FMPs), including private equity firms, still face significant challenges to implement the SFDR.

What's the purpose of the SFDR?

The new regulation aims to foster the integration of ESG factors into investment and advisory processes and to make investment products more transparent. The rules shall enable investors to compare sustainable funds more easily and prevent greenwashing. The SFDR is the disclosure tool in the EU's broader sustainable finance framework, along with the EU Taxonomy Regulation and the Corporate Sustainability Reporting Directive (CSRD). The disclosure obligations in the SFDR are divided into three main areas:

1. **Integration of sustainability risks** in the investment decision-making and advisory process
2. **Consideration of Principle Adverse Impacts (PAIs)** in investment decisions and investment advisory on sustainability factors
3. **Transparency** when products either promote ESG characteristics (Article 8) or target sustainable investments (Article 9)

The close relations between the EU regulations: CSRD, SFDR and EU Taxonomy



Source: Deloitte.

The challenges one year on

Since 10 March 2021, the SFDR (without the Regulatory Technical Standard or RTS) leaves significant room for interpretation and therefore often leads to generic and qualitative disclosures and ample room for interpretation. Implementation of the RTS, which includes more detailed quantitative disclosures, has also been postponed several times and will now start to apply on 1 January 2023. In order to comply with the SFDR, we are still lacking accessible, definitive guidance and industry agreement on comprehensive quality data related to environmental, social and governance (ESG) investments. The complexity of the legislation, as well as the difficulty of gathering the required data means private equity firms are facing a lot of uncertainty with regard to SFDR reporting requirements of their Limited Partner (LP) firms.

ESG data struggles

Extensive ESG reporting is already essential for many LPs, despite the changing timeline and lack of alignment. SFDR's quantitative PAI disclosures require larger LPs to report on 18 mandatory PAIs (including 9 environmental, 5 social, 2 sovereign and 2 real estate indicators) for direct and indirect investments for the year 2022. The reporting is based on quarter ends and must be published by 30 June 2023, requiring PAI data to be already gathered from private equity funds for FY 2022. If funds do not integrate PAI considerations in their investment approach, and while collecting and managing standardized data from a diverse range of portfolio companies, LPs face significant challenges with SFDR data compliance.

For FMPs with fewer than 500 employees, the SFDR allows them to choose between a "comply" or "explain" basis to publish a PAI statement on the due-diligence policies outlining the PAIs of their investment decisions on sustainability factors. Given most private equity companies have fewer than 500 employees, a significant proportion of the sector can opt out of the regime and disregard PAI issues altogether. Based on Deloitte's analysis, most private equity companies have issued a negative PAI statement, i.e., "no consideration of PAI," which suggests sustainability is still relatively low on their agenda, or they do not have the processes in place to gather the relevant data to consider these impacts. Complying with SFDR is vital for private funds

to protect their reputation, attract investors who want to allocate their money sustainably, and meet the data demands of their LPs.

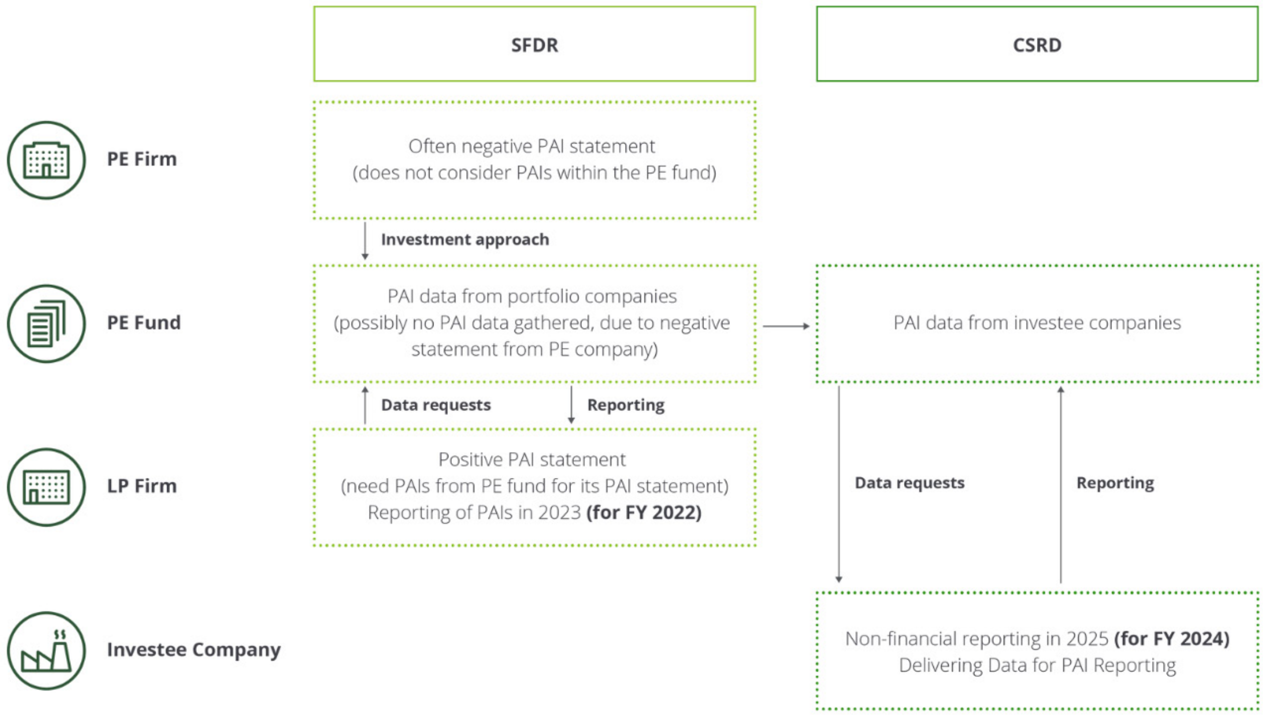
By contrast, most institutional investors (like LPs) employ more than 500 people and are therefore obliged to issue information on adverse impacts, leading to a positive PAI statement, i.e., "consideration of PAIs." In the case of insufficient data, LPs must conduct "best efforts" to ensure that the data is made available, using sources such as engagement with investee companies themselves, their own research, third-party data providers or reasonable assumptions. One common misunderstanding that we observe is that PAI data only apply to sustainable funds. However, as the PAI reporting applies on entity levels, it aggregates all sustainable and non-sustainable products. As a result, private equity companies will face multiple requests for fund PAI data from LPs who are obliged to collect and aggregate the information. ESG has become an integral part of the investment decision-making process for LPs, and it is unsurprising that General Partner (GPs) routinely receive extensive questions focusing on various ESG-related themes. Adding to the complexity, GPs actually attempt to answer these questions while many LPs are still working out what exactly they are looking for and why it is important to them.

Entities use different approaches to sourcing the data, causing significant discrepancies in the PAI indicators reported by similar funds. Without easily available and comparable data and appropriate guidance from regulators, private equity firms may be using different information based on unrelated criteria, making it difficult for investors to rely on and compare the data disclosed.

Companies' sustainability reporting under CSRD could serve as a potential data source for investor PAI reporting under the SFDR. The new directive (first draft published in April 2021) will amend and enhance the existing sustainability reporting requirements stipulated by the Non-Financial Reporting Directive (NFRD). It will not only significantly expand the companies in scope but also introduce harmonized reporting standards developed by European Financial Reporting Advisory Group (EFRAG). However, the timelines of the SFDR and the CSRD are not aligned: ESG reporting for the latter is not required until 2025 (for FY 2024) for most portfolio companies.

> "[...]LPs face significant challenges when trying to comply with the data demands of the SFDR"

The CSRD is a source of data for SFDR reporting



1. Due to the **lack of alignment of timelines**, extensive ESG reporting is already required for the **majority of LPs (SFDR)**
2. LPs require **PAI data** from **the PE funds** in 2023 (for FY 2022) for their investments (PE Funds)
3. PEs need to **integrate PAI consideration in their investment approach** in order to comply with the **data demands of LP companies**

Source: Deloitte.

"Private equity firms' challenge in sourcing ESG data from private holdings is further exacerbated by a lack of clarity in the regulation's language."

Regulation complexity and uncertainty

Private equity firms' challenge in sourcing ESG data from private holdings is further exacerbated by a lack of clarity in the regulation's language. Ambiguities and uncertainties remain, whether it is how products are classified (using Articles 6, 8 and 9) or the way the regulation applies to some firms and products.

While the SFDR is a disclosure regulation and shall provide greater transparency about ESG factor integration, discussions about potential minimum requirements for sustainable products (i.e., for Article 8) are ongoing. Without a clear definition, we see a wide range of interpretations and further confusion among investors. SFDR requirements are complemented by reporting requirements from the EU Taxonomy, but neither provide clear criteria, definitions for eligible investments or minimum strategies for so-called "light green" financial products. Even the regulator pointed out that the effectiveness of the strategies varies significantly among "light green" financial products.

It is essential for private equity firms to implement sufficient processes that will allow them to determine where they can access all necessary ESG data and navigate data costs and how to integrate scoring into their portfolio systems. That said, non-financial portfolio companies must also embrace a more professionalized approach to ESG data management to satisfy investor demand for SFDR-compliant data. Including comprehensive ESG data in the due-diligence work has gone from being a "nice-to-have" to more of a "must-have for both GPs and LPs. Now it is up to private equity firms to implement the necessary processes, frameworks, systems, and data to meet these requirements. This is especially vital, as the private equity sector has a pivotal role in the transition to more environmentally and sustainable economy.

CONCLUSION

Private equity managers need to ensure sufficient plans are in place to implement meaningful ESG strategies, such as sustainable product design, structural sustainability integration, reporting workflows and ESG due diligence. Such measures will help to mitigate the challenges faced at the entity, fund and portfolio company levels, as the regulations governing sustainable finance continue to evolve.

TO THE POINT

- While most Private Equity firms have issued negative Principle Adverse Impacts statements, their institutional investors, i.e., limited partners (LPs) require respective data to meet their SFDR reporting obligations.
- Complying with the SFDR is vital for private funds to protect their reputation, attract investors who want to allocate their money sustainably, and meet the data demands of their LPs in 2023 (for FY 2022).
- Private Equity firms' challenges in complying with the SFDR lie in lacking accessible, definitive guidance and industry agreement on what comprehensive quality data related to ESG investments.
- The CSRD could serve as a potential data source for the PAI reporting of investors under the SFDR. However, ESG reporting for the CSRD is not required until 2025 (for FY 2024) for most portfolio companies.

Regulatory agenda and trends

DIGITAL OPPORTUNITIES AND CHALLENGES

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INTRODUCTION

Financial industry stakeholders continue to face five-sigma events: the 2007-2008 financial crisis and its regulatory wave, COVID-19, and the Russian invasion of Ukraine's pressure on the supply chain, inflation, and talent scarcity. As the relentless pace of regulatory publications briefly slowed during the summer break, Deloitte took stock of the challenges ahead.

First, the financial sector has experienced a full regulatory cycle since the 2007-2008 crisis, from initiation to application. This cycle will be reviewed from this year until 2025/2026.
Alongside this review, the ESG and sustainability agenda will also be a major topic over the next 2 years. In the next 12 months, the Sustainable Finance Disclosure Regulation (SFDR) and EU Taxonomy will fully apply. They are followed by publications on the principle adverse impacts by June 2023, quickly followed by Corporate Sustainability Reporting Directive (CSRD) reporting from 2024 for larger institutions.

In parallel, Deloitte has observed two other major trends. The first is the review of the AML-CFT framework and creation of an unprecedented review of EU sanctioning regime. These texts, currently in discussion by EU institutions, will lead to substantial operational

challenges, including compliance with requirements pushed by the new EU-level authority (AMLA) alongside the EBA. Establishment of AMLA will increase the spotlight on the most exposed financial institutions (notably those with more cross-border activities and consequently, perceived as of higher AML risk) that will be put under its direct supervision.
The second regulatory trend, and probably the whale in the ocean, is digital regulation.

From a practical and business perspective, these regulatory trends can be split into two camps:

1) Familiar regulatory texts re-vamped to adapt to the current market conditions and digital age, for which there is already a broad market knowledge. These include amendments to the Markets in Financial Instruments Directive (MiFID), the European Market Infrastructure Regulation (EMIR) and the Capital Requirements Directive and Regulation (CRD/CRR) regime.
2) New regulations that could shape the markets in unexpected ways, requiring a shift in strategic positioning of business and activities, such as ESG and digital regulations. These newcomers will unleash yet unknown opportunities but also demands that would be complex to implement. The digital finance regulatory package will especially require a change in behaviors for the more traditional financial sector players if they want to stay relevant and provide value to their its clients.

From previous experience, the biggest regulatory challenges do not arise from known-unknown areas but unknown-unknown ones, delivering unanticipated change and maximum disruption.

ESG adaptations are unknown-unknown, potentially transforming products, services and behaviors. However, while these changes are complex to introduce, there is a widespread understanding of the challenges.

Instead, we anticipate the most disruptive risks and opportunities to arise from digitalization. It will not only revolutionize the way services are provided, but also create an entirely new regulatory playground for cryptoassets, payments, data, and artificial intelligence. Existing challenges could be tackled with new solutions and current business models disrupted by new ones.

Of the upcoming EU regulations, digitalization will have the biggest and most far-reaching impact, from client interactions to the governance or operations of financial institutions. This challenge is compounded by the pace of these texts, materializing over the next 36 to 48 months.

Consequently, banks, asset managers, insurers and all financial intermediaries should stand ready and consider how they will tackle these systemic changes looming right around the corner.

Snowball effect of digital finance and digitalization of services:

A digital regulatory milestone was the "MiFID quick fix" of February 2022, imposing a "digital first, paper second" approach to client communications. This was the first client engagement rule to formally abandon paper since EU regulations began.

Encouraged by this small step, EU legislators jumped on the digitalization train with accelerating speed and to stay competitive on a global market and came up with several transformative legislative acts that will apply starting next year: the Distributed Ledger Technology (DLT) Pilot Regime, the Digital Operational Resilience Act (DORA), and the Markets in Crypto-assets (MiCA) Regulation.

These regulations will help create a fully digital asset universe, from traditional financial instruments that can be issued and governance rules in excess circulated by means of the current General Data Protection Regulation (GDPR), digital platforms and DLT (DLT PR) to issuers of crypto assets and crypto-asset service providers (CASPs). Then all players can finally function in a regulated environment that will provide much needed legal certainty (MiCA) and be emersed in a secured and resilient cyber environment (DORA).

Another milestone recently introduced by EU legislators is a new regulation aiming to modernize EU payments by obliging payment service providers to offer mandatory instant payment services. This will complete the EU framework for payments and help render mainstream instant payments on a pan-EU basis, as already seen under the Payment Services Directive (PSD2). The regulation is also in line with ECB instant payment evolution, which further enables this project.

Together with the upcoming Artificial Intelligence Act (AI) and machine learning (ML) regulations and strategies, these rules will profoundly transform the financial markets as we know them and announce a new digital future.

Regulatory adoption will be layered, as with all new technologies. and reluctance has a disruptive potential. First, financial services will increasingly be offered digitally. Then, the market will need to adapt to the demand for digital assets and forward-thinking financial institutions could reap rewards by moving first. As these digital solutions mature, they will spread to payments, trading and loans, and then to financial institutions' own structures.

It will take time, but the DLT and its sub-category better known as "blockchain" will eventually become mainstream, especially once we have central bank digital currencies (CBDCs) that will allow a complete financial ecosystem to fully function in a digital way.

Practical digitalization for my institution

Financial institutions may ask why these digital regulations are important to them and their clients.

First, society is increasingly embracing digitalization in all aspects of life, largely thanks to smartphones, and finance is no longer immune. Second, digital technology is sufficiently advanced, robust and available to allow new players to enter the game, and banks need to stay competitive amongst digitally mature peers. Finally, an EU-wide regulatory regime will soon apply, bringing eagerly anticipated legal certainty and potential for economy of scale.

Therefore, we advise financial institutions to confront these challenges and take the lead, or risk their clients jumping ship to a competitor's digital alternative.

A successful digital journey begins by understanding what is coming, designing a response, and implementing it on time and with enthusiasm. You can embrace this challenge by contemplating your digital strategy, what products and services to provide and how digital assets interact with your existing strategy and the role you would like to play in the ecosystem.

With this in mind, let's look at the upcoming digital regulations in order of appearance.

DLT Pilot Regime: unique regulatory framework to test new technologies

It is vital to look beyond the DLT Pilot regime's go-live deadline of 23 March 2023. This regulation is a canary in a coal mine, allowing the issuance, trading and post-trading of fully digitalized financial instruments issued through this new technology. One can imagine that, as a start, the regime will act alongside the traditional market infrastructures and will have its own processes, as custodian, private or retail bank intervention is not foreseen. In theory, an issuer could create shares, make them accessible via a DLT platform, and allow for trading and custody on this platform with direct retail access.

Let's imagine 2028, where the DLT Pilot's size constraints are removed (currently it's limited to illiquid instruments). A big EU issuer can offer shares to any investor on a trading facility run by an authorized party without intermediary, by putting investors in contact via its open DLT. Tokenized assets, for AML and security purposes, might be traded versus CBDCs held in ECB accounts at a later stage.

DORA: cyber resilience

While the DLT Pilot impacts entities in the investment value chain, DORA will directly affect all stakeholders in the financial world, barring a few exceptions.

DORA aims to ensure DLT and MiCA can work efficiently in a safe and protected environment, from a cyber and IT security perspective. It is a pan-EU safety net that allows the digitalization of finance based on common rules and streamlined processes across all EU entities. DORA requires third-party IT providers to have an EU physical presence, so that responsible bodies can regulate and supervise them.

Therefore, for large firms, DORA will be akin to the introduction of MiFID I. While these firms already have cyber-resilience, efficient processes, a head of cyber/IT, and governance, they may not be DORA-compliant. Therefore, firms may need to thoroughly review their existing framework's adequacy to comply.

Smaller institutions will need to adapt to this new cyber and resilience world, for example, by designing and setting up IT and cyber capacities, building Threat Intelligence-led Penetration Testing, defining high-level compliance and governance, investing in training, and becoming audit ready.

DORA will be published later in 2022 with a go-live date of 24 months. However, given the stakes, firms should ready themselves earlier rather than later.

MiCA: unleash crypto asset potential

If you've heard of MiFID, you might already know what to expect from MiCA. MiCA, no doubt, is inspired by MiFID rules regarding licensing, organization, governance and client relationships and will be a complex and enjoyable ride to implement.

Specifically, MiCA addresses crypto assets that currently fall outside the scope of financial services legislation (whether the DLT Pilot or MiFID). These crypto assets exchange digital utility tokens forward and are further clustered by MiCA into three sub-categories so-called asset-referenced tokens ("ARTs"), E-money tokens ("EMTs") and other crypto assets that represent those that cannot be categorized upfront and in a straightforward way.

If today's crypto market is limited to "initiated" parties, once MiCA steps onto the scene (likely early 2025), it will be an open pan-EU market by 2024 or 2025, with a demand for crypto assets and an EU-wide regulatory regime. To enter this market, financial institutions, unlike currently regulated players (FinTechs), will not need a specific licence; however, they must still abide with the most MiCA requirements from organizational point of view to properly govern and conduct engagement demands with clients and authorities.

CONCLUSION

There are many ways financial firms will have to adjust to stay compliant with various and fairly complex requirements stemming from these legislative texts. On top of the upcoming digital finance regulatory package, some well-known rules will also be substantially amended to adjust to the tech-driven environment. Hence, if you are reluctant to embrace innovative ways and read this article thinking that you shouldn't be bothered by the above text, think again. At the very least, AML requirements will catch up to you. If you wish to have nothing to do with crypto or blockchain, you still very well might find yourself in a crypto asset transfer that will require you, as an intermediary, to do your part on KYC and pass the information further down the chain. In increasingly interlinked financial markets and cross-border nature of crypto assets transactions, no one will be spared of their due diligence checks. The sooner you get cosy with digital assets, the less painful your compliance efforts will be.

Don't be surprised if, in the process of opening what might be perceived as a "can of worms," you end up in the world of opportunities with a great potential that crypto assets, digitalized way of working and new technologies have to offer.

TO THE POINT

- Financial institutions will face **substantial operational challenges from upcoming regulations**.
- Various **digital finance regulations** currently under development will help create a fully digital universe for tokenized assets that will be ripe for distribution across the entire value chain. This, followed by the regulatory texts stemming from the **EU's comprehensive strategy for data**, plus sweeping **initiative on retail payments, machine learning and artificial intelligence**, will mark a new era in EU financial services regulatory landscape with digital topics as a top priority in years to come.
- Deloitte is raising awareness of the **opportunities and challenges** of the upcoming regulatory wave through a series of articles to help the financial ecosystem anticipate this evolution.

Fight against tax fraud laundering put to the test in next FATF visit

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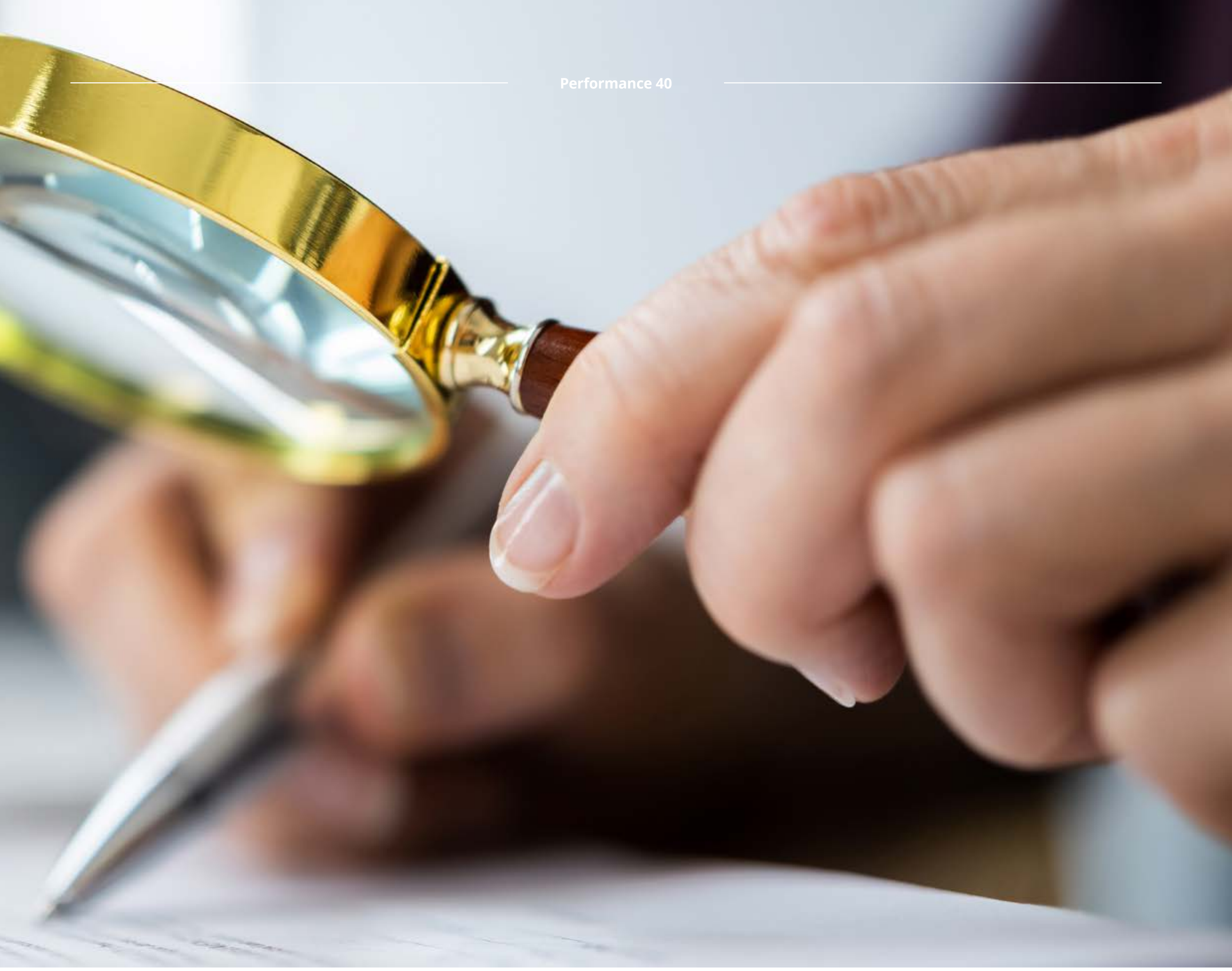
INTRODUCTION

Initially postponed due to the pandemic, the next visit of the Financial Action Task Force (FATF) to Luxembourg should take place in the fall of 2022. While its 19 February 2010 mutual evaluation report included recommendations to strengthen certain aspects of Luxembourg's anti-money laundering (AML) and combating the financing of terrorism (CFT) system, the last 10 years have undoubtedly seen the Grand Duchy develop its regulations and practices in this area.

On their 2009 visit, FATF emissaries specifically targeted the relative uncertainty of declaring tax offenses to the financial prosecutor's office, pointing out that they were not considered offenses that could contribute to money laundering (ML).

Although the Anti-Money Laundering Act did not restrict the reporting of suspicious transactions that could also have a tax dimension,



a Commission de Surveillance du Secteur Financier (CSSF) Circular nevertheless stated that “The professional must ask himself whether the funds [...] are likely to arise from one of the primary offences.” This effectively excluded tax evasion from any AML declaration.

Moreover, the FATF emissaries found that, in practice, some financial institutions did not go further than required to investigate these tax offenses for fear of being prosecuted for bank secrecy breaches. In fact, the penalty for banking secrecy breaches was greater at the time than the penalty for failing to report suspicious transactions, which discouraged financial institutions from going down this road as a result.

Finally, although the regime regarding requests for mutual legal assistance in criminal matters allowed Luxembourg to carry out a multitude of acts, FATF emissaries pointed out that cooperation was not possible concerning tax matters, even ancillary ones.

Based on these findings, the FATF made numerous recommendations to address hardware failures.

In the past decade, the Luxembourg financial center has completely changed its approach to the fight against tax fraud laundering.

By abolishing banking secrecy and introducing the automatic exchange of information on 5 November 2014, the Chamber of Deputies took the **first legislative response** to the FATF's recommendations. As banking secrecy breaches could no longer be sanctioned and the fear of prosecution was no longer justified, the first reports of suspicious transactions regarding tax offenses were made.

The second block was removed by introducing **two new tax offenses** by the law of 23 December 2016 that implemented the 2017 tax reform; (i) aggravated tax fraud and (ii) tax swindle (whether committed or attempted) regarding direct taxes, registration and inheritance duties, and value-added tax.

Adding these two offenses to the list of primary offenses of Article 506-1 of the Criminal Code led to the concept of **money laundering and tax fraud being recognized**. At this point, only simple tax fraud remained only punishable administratively and does not constitute a primary offense of laundering tax evasion as such.

This legislative reform was followed by CSSF Circular 17/650 of 17 February 2017, which set out **professionals' obligations in the fight against tax fraud laundering**. This Circular's scope was not limited to institutions regulated by the CSSF but to all professionals subject to and listed in Article 2 of the amended law of 12 November 2004 on the fight against ML and terrorist financing, as confirmed by the Financial Intelligence Unit's circular of 31 March 2017.

CSSF Circular 17/650 lists 21 indicators of possible tax-related ML offenses, and is specifically used by institutions to **set up their control and risk assessment procedures**. It has also enabled certain actors to reduce their risks exposure to money laundering tax fraud. For example, by abandoning their poste restante service, or requiring tax compliance documentation drawn up by a leading independent firm to avoid any conflict of interest risk between the person who issued this opinion and the institution's client.

On 3 July 2020, due to the Luxembourg investment fund sector's importance and its different exposure to laundering tax evasion risks compared to the traditional banking and insurance sectors, **the CSSF published a second list of indicators specific to collective investment activities**. By taking these new indicators into account, stakeholders are encouraged to include elements regarding tax transparency in their investment controls.

The exchange of information in tax matters has been a true cornerstone of the fight against tax fraud laundering, being one of the criteria the most used by all market professionals to determine their clients' level of risk as part of a risk-based approach.

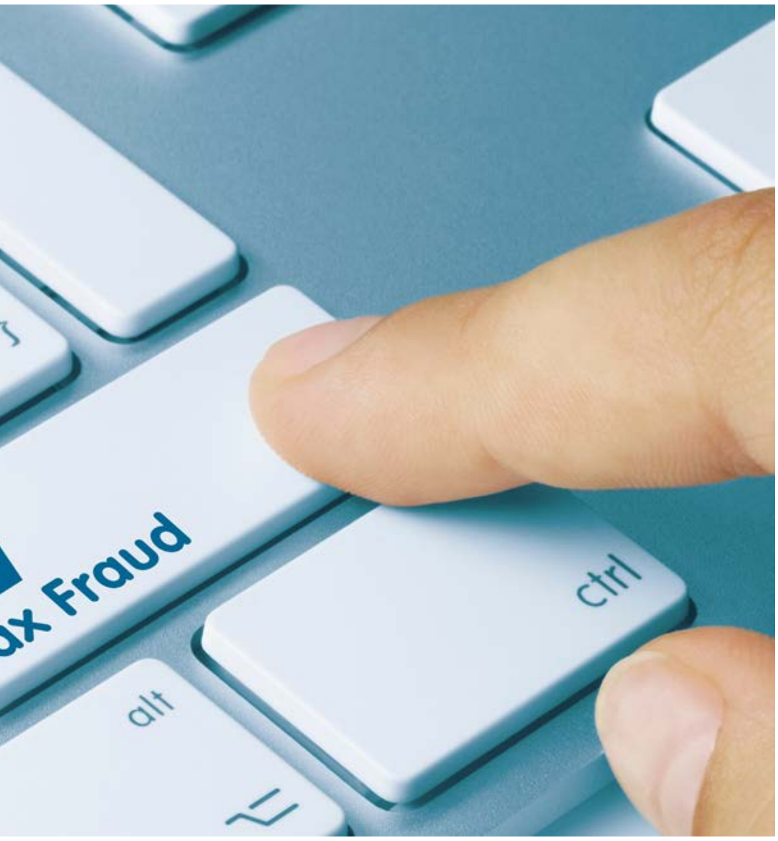
With this new arsenal, **the Luxembourg financial center has been put in proper working order**, and the vast majority of players have integrated tax fraud into their AML policies.

In practice, this evolution is illustrated in the **FIU's annual reports**, which have

included figures relating to tax offenses for each sector subject to AML obligations since 2017. The number of declarations of suspicions in tax matters, their typology and the FIU's follow-ups are recorded in these reports, making it possible to measure the importance of tax offenses in the volume of declarations made by professionals to the Luxembourg financial prosecutor.

In the traditional banking, investment fund and professionals of the financial sector (PSFs), criminal tax offenses rank third in the primary offense categories of suspicious transaction reports. For insurance sector players, these criminal tax offenses rank first, testifying to the good consideration of the fight against tax fraud and the proper functioning of professionals' controls.

In addition, Luxembourg was previously pointed out by the FATF that, given the financial



center's size and the fact that capital was attracted for tax reasons, the number of declarations for suspected tax offenses should be reflected in the total number of declarations made by professionals. Now, **the role of tax offenses in the number of declarations is more correlated with the market**.

Finally, the FIU's annual reports also highlight that since tax offenses were introduced into Luxembourg legislation as a primary ML offense, information exchanges have taken place both at the international and national levels. In tax matters, the FIU now carries out the required exchanges, either through the cross-border dissemination (XBD) system or through traditional international cooperation. In practice, XBD is typically used to share elements of a case where the suspicion of a tax offense is low but where information from another FIU could confirm or refute the suspicion. As an illustration, in 2018, 221 declarations were disseminated via this system with several Member States.

When the FIU confirms a reported suspicion or when the exchange is made with non-EU countries, **traditional international cooperation comes into play**. In 2018, the FIU carried out 242 of these exchanges, most of them regarding suspicious transaction reports for cases where there was doubt about the tax residence of natural and legal persons, and for which the automatic exchange of information between tax administrations did not apply.

At the national level, it is also worth highlighting the increase in exchanges between the FIU and the direct and indirect tax Authority. These latter are generally asked to determine the allegedly evaded tax to confirm or refute a suspicion of a criminal tax offense. This increased from six exchanges in 2018 to 92 in 2020.

CONCLUSION

In view of the facts set out in this article, it can be seen that **Luxembourg has succeeded** in carrying out the necessary reforms to make the entire sector—both the financial center players and the professionals in charge of their regulation—aware of the importance in the fight against the money laundering of tax fraud.

In practice, we have seen **financial institutions' skills improve in this area** in recent years, with more and more tax experts appearing on client acceptance committees, and sometimes these experts being directly integrated into compliance departments. The same applies to control bodies that have included people specifically trained in combating tax fraud in their teams.

In view of the forthcoming FATF visit, these improvements could be highlighted to evaluators to **show the effectiveness of Luxembourg's measures to combat ML** in relation to tax offenses. As a result, it is hoped that the FATF's conclusions will be positive, given that the legislative and regulatory changes have led to an evolution in market players' oversight and the FIU's handling of these cases.

Nevertheless, despite the FATF's findings this autumn, all actors subject to AML obligations must continue to **review their exposure to tax infringement risks**, ensure their due diligence measures are up to date, and question the quality of their clients' documentation. Supervisory authorities are scrutinizing these areas actively communicate on the subject.

TO THE POINT

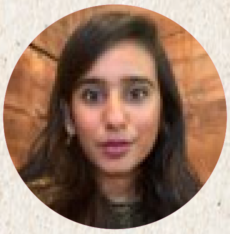
- Over the past decade, the Luxembourg financial center has changed its approach to the fight against tax fraud laundering.
- In 2009, FATF emissaries targeted the uncertainty around declaring tax offenses to the financial prosecutor's office, because they were not considered offenses that could contribute to money laundering at the time.
- In practice, it was found that some financial institutions did not go further than required to investigate these tax offenses, for fear of being prosecuted for bank secrecy breaches.
- On 17 February 2017 the CSSF has published a first list of indicators that should raise suspicion of money laundering of tax fraud. On 3 July 2020, given the Luxembourg investment fund sector's importance, and its difference in exposure to laundering tax evasion risks compared to the traditional banking and insurance sectors, the CSSF published a second list of indicators specific to collective investment activities.
- In view of the forthcoming FATF visit, these facts could be highlighted to the evaluators to show the effectiveness of Luxembourg's implemented measures to combat money laundering in relation to tax offenses.

How Risk and Compliance functions can support the net zero transition*

INVESTMENT MANAGERS AND NET ZERO

* This article is an abridged version of a report done by the EMEA Centre for Regulatory Strategy (assisted by colleagues in Risk Advisory), in conjunction with the Investment Association.





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INTRODUCTION

To mitigate the worst effects of climate change, action is needed now. The financial services industry has a crucial role to play, and investment managers are in a unique position to help channel investments to sustainable activities. Many investment managers have joined Governments and other corporates and financial services firms in making commitments to reach net zero GHG emissions by 2050.

Since COP26, regulatory expectations in relation to transition plans have evolved rapidly. To facilitate net zero commitments, regulators, supervisors, and wider stakeholders increasingly expect investment managers to develop, disclose and execute credible transition plans.

At the international level, the Task-force for Climate-related Financial Disclosures (TCFD) published guidance [1] on voluntary transition plan disclosure in October 2021. The Glasgow Financial Alliance for Net Zero (GFANZ) [2] and the International Sustainability Standards Board (ISSB) [3] also issued consultations in 2022, which included recommendations and standards respectively for the disclosure of credible net zero plans.

In the UK, the largest investment managers and all listed investment managers will be encouraged under guidance contained in Financial Conduct Authority (FCA) rules [4] aligned to the TCFD to disclose aspects of their transition plans in 2023, with the guidance applying to smaller investment managers above an exemption threshold the following year. The UK Government then intends to go further by requiring disclosure on transition plans under the forthcoming Sustainability Disclosure Requirements (SDR) [5].

Investment managers with operations in other jurisdictions, such as the EU, and to a lesser extent the US, may face similar local rules in relation to the disclosure of transition plans.

Investment managers which have made net zero or low carbon commitments should develop their transition plans and consider their related disclosures. All other investment managers should consider starting this work now to meet FCA guidance, where applicable, or other international guidance and standards, and in advance of regulatory deadlines.

Meeting net zero commitments and stakeholder expectations means new responsibilities for staff at investment managers, including Boards, senior managers, and across the three lines of defence. As part of this, Risk and Compliance functions will have an important role to play, particularly in relation to mitigating the reputational, conduct, regulatory and liability risks that may arise from failing to deliver against transition plan targets, poor plans, or poor disclosures.

1. TCFD guidance on metrics, targets and transition plans, October 2021
2. GFANZ recommendation and guidance on transition plans for financial institutions, June 2022
3. ISSB proposals on sustainability-related and climate disclosures, March 2022
4. FCA TCFD-aligned climate disclosure rules for asset managers, December 2021
5. FCA Discussion Paper on Sustainability Disclosures Requirement, November 2021

The Deloitte and Investment Association joint report sets out suggested actions Risk and Compliance functions can take across six key areas; this article summarises the salient points.

1) Credible net-zero plans

The credibility and business implications of transition plans will face increasing stakeholder scrutiny - not just from supervisors and shareholders, but also from special interest groups and Non-Governmental Organisations (NGOs), which might bring class actions or otherwise seek to highlight poor ambitions, performance or disclosures.

Investment managers will need a Board-approved transition plan, with a detailed and resourced plan of actions. Commitments should be underpinned by targets, using robust, science-based, and standardised methodologies.

Investment managers will need to focus on reducing emissions across investee companies, derived from their assets under management (scope 3 emissions), while maintaining diversified portfolios and delivering risk-adjusted returns.

Actions for risk and/or compliance

- Inform and advise relevant Committees and the wider firm on regulatory, supervisory and industry expectations and guidance on transition plans and their interaction with the broader sustainable finance regulatory landscape.
- Engage actively with policymakers, regulators, standard-setters, and industry bodies.
- Support the development of the transition plan and create policies, procedures, and controls to monitor adherence to the plan on an ongoing basis, escalating concerns pro-actively.
- Consider reviewing the policies and controls put in place by the business on the use of carbon offsets.

2) Governance, culture, and incentives

Robust governance, with an aligned culture and incentives, will be essential in facilitating the execution of net zero plans. There should be a clear sense of purpose and alignment across the transition plan, climate strategy, business strategy, product range, risk appetite, risk management, culture, and incentives.

Firms' governance structures and culture should be effective in cascading the transition strategy and plan horizontally and vertically throughout the firm, with responsibilities allocated clearly across the three lines of defence.

Actions for risk and/or compliance

- Ensure that the CRO and CCO have a seat on relevant Committees, to give them a voice in developing the transition plan, and in providing second line oversight on adherence to the plan.
- Be alert to the potential for a culture to develop where staff seek to ignore or circumvent transition plan actions, for example, where they do not support constraints placed on investment decision-making.
- Provide the Board and relevant Committees with robust management information (MI) on delivery of net zero plans and performance against KPIs, metrics and targets.

3) Climate risk management

Investment managers are required to manage and/or disclose their risks which arise from climate change, for example, under the Financial Conduct Authority's TCFD-aligned rules and the EU's Sustainable Finance Disclosures Regulation (SFDR).

A credible transition plan will help investment managers with their work on climate risk management by reducing exposure to transition, liability, litigation, and reputational risks. Investment managers can also leverage their existing risk management frameworks to support the net zero transition.

Actions for risk and/or compliance

- Support the business in identifying climate risks, including from the transition to a low-carbon economy, and in integrating climate risks into the risk management framework.
- Ensure the strategy on climate risk management is aligned with the transition plan outcomes and is consistent with the risk appetite statement. For example, this might cover appetite to invest in certain markets, or concentration limits.
- Support the business by providing oversight of climate-related scenario analysis and stress testing. Scenario analysis should be done both at the entity level and the fund level.
- Support the business to develop policies to identify where actions to integrate climate considerations into investment decision-making result in a change to fund or mandate objectives and to make sure that the necessary internal and regulatory processes are followed.
- Identify gaps in knowledge, skills and experience on climate change and related risks within Risk and Compliance and put in place a plan to address them, for example, through periodic training sessions.
- Engage with relevant industry groups to understand best practices in relation to climate risk management.

4) Greenwashing

Greenwashing is high on regulatory agendas, with regulators around the globe carrying out regulatory enforcement in this area. Greenwashing is often seen as a deliberate act of misconduct. However, when faced with incomplete ESG data and unfamiliar terminology, investment managers also need to address the risk of greenwashing inadvertently.

To support the net zero transition and reduce liability, litigation and reputational risks, investment managers should ensure accurate and compliant disclosures on net zero transition plans, firm-wide climate policies, emissions, and products.

Disclosures will need to be underpinned by a robust climate data strategy, data governance and target operating model.

Actions for risk and/or compliance

- Support the development of a robust climate data strategy, data governance and target operating model to source varied, current and forward-looking data on climate risk and emissions across own operations and investee companies.
- Ensure the business considers regulators' concerns when using ESG ratings and data providers. Risk and/or Compliance can also assist with creating procedures in relation to the governance and oversight of data obtained from third parties.
- Gain access to all data needed, both from internal and external data sources.
- Consider conducting periodic reviews of whether the requirements in firm-wide sustainability data policies are being observed.
- Ensure disclosures on the transition plan, firm-wide policies, and products are consistent and meet regulatory requirements and supervisory expectations.
- Leverage existing control frameworks to ensure that there are processes, policies and controls in place to monitor funds which promote or target climate characteristics across the product lifecycle.

5) Treatment of customers

Investment managers have a pivotal role in supporting their institutional clients and retail customers with their climate ambitions and/or preferences.
Investment managers must ensure that they communicate clearly with their customers about how transitioning to net zero might affect the value of their products. They will also need to monitor complaints, particularly in relation to greenwashing, and have a clear escalation process.

Actions for risk and/or compliance

- Ensure customer and client communications are clear, fair and not misleading.
- Ensure customers are treated fairly as investment managers' product offering changes and that any material changes to the investment strategy or to management fees are disclosed.
- Assess how changes in product affordability and/or availability might affect vulnerable customers.
- Where required under the EU Delegated Acts amending MiFID II and IDD ensure that ESG considerations are incorporated into product governance and, where investment managers have in-house advisers, ensure that suitability reports capture adequately clients' sustainability preferences and the reasons why certain products have been matched to the preferences.
- Ensure the distribution team and financial advisers in the value chain receive adequate training on funds which promote or target climate characteristics.
- Ensure that, where they have responsibility for complaints handling, Risk and/or Compliance are trained in relation to funds which promote or target climate characteristics. This will require Risk and/or Compliance to have a good understanding of sustainable investing, interpretation of climate data and non-financial performance metrics so that they are able to determine whether a fund has performed as expected and the reason for this.

6) Thinking about ESG holistically

As there are more funds which promote or target sustainable or ESG characteristics than solely climate characteristics and many regulatory requirements or supervisory expectations include broader environmental or ESG considerations in their scope, investment managers will need to think about ESG holistically.

Actions for risk and/or compliance

- Consider how to integrate nature considerations into the risk management framework, product range, and investment decision-making processes.
- Ensure that fund documentation and client disclosures are clear on how they will treat trade-offs between "E", "S" and "G".

CONCLUSION

Meeting net zero commitments will require a transition to a fundamentally different and more sustainable economy. With the recent findings of the Intergovernmental Panel on Climate Change that we have a "brief and rapidly closing window to secure a liveable future"[6], the impetus for investment managers, as stewards of investor capital, to move from ambition to action is more urgent than ever before.

Investment managers will need to transform their entire organisation across their business strategy, products and services, investment decision-making, risk management, and operations. Alongside the Board, senior managers and those in the business and internal audit, Risk and Compliance functions can play an important role in supporting their firm's net zero transition and ensuring their firm is positioned for the future in terms of competitiveness and resilience.

Please see our **report** for further details.

6. Climate Change 2022: Impacts, Adaption and Vulnerability, IPCC, February 2022

TO THE POINT

- Many investment managers have made commitments to reach net zero greenhouse gas (GHG) emissions by 2050 amid growing stakeholder expectations that they will develop, disclose and execute credible transition plans.
- Meeting these commitments will require investment managers to transform their entire organisation across their business strategy, products and services, investment decision-making, risk management, and operations.
- Risk and Compliance functions, working with colleagues from across the organisation, have an important role in supporting the design and execution of the transition plan.
- **We have published a report in collaboration with the Investment Association: *How Risk and Compliance functions can support the net zero transition: Investment managers and net zero***, which considers regulatory developments and actions for Risk and Compliance functions in relation to the net zero transition.
- This article summarises the key themes discussed in the report: (i) credible net zero plans; (ii) governance, culture, and incentives; (iii) climate risk management; (iv) greenwashing; (v) treatment of customers; and (vi) thinking about ESG holistically.

Webinars
Programme 2022-2023

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Alternative Investments

- **22 March 2023**
  INREV NAV / reporting

Banking

- **29 March 2023**
  Future of Banking: Chief Strategic Officer survey
- **14 June 2023**
  Regulated Banking: Data Governance Act / ePrivacy Regulation

Investment Funds

- **8 February 2023**
  Cross-border distribution of foreign funds: latest trends, new opportunities, and Brexit
- **17 May 2023**
  Fund Tax update: update on latest trends
- **28 June 2023**
  Asset management survey results 2023

Regulatory

- **22 February 2023**
  Regulatory Landscape for 2023 – focus on Sustainable Finance
- **8 March 2023**
  Key Elements of an effective AML/KYC compliance regime

Risk & Asset management

- **1 March 2023**
  Distribution and Product lifecycle management – The ManCo as a key stakeholder!
- **5 April 2023**
  Digital processes for improving the evaluation and monitoring of risk
- **19 April 2023**
  Principles for sound Liquidity Risk Management and Supervision

Sustainability

- **7 June 2023**
  Sustainable Investment - What is the impact of your portfolio on the real world?

Technology & Innovation

- **1 February 2023**
  Overview of AI and its top use cases in Banking
- **26 April 2023**
  ManCo Tech: This time it is for real!

For access to the sessions do not hesitate to contact
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