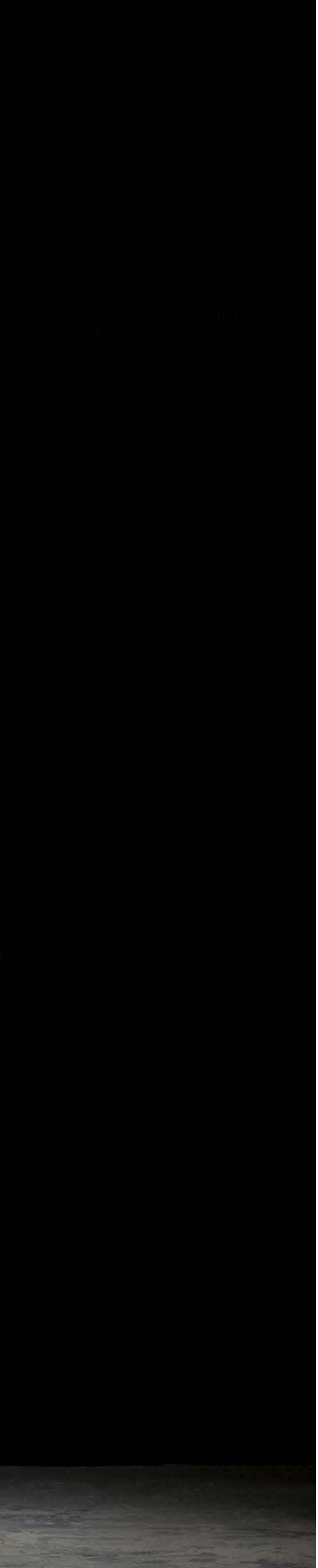
Performance Magazine

Issue 41
June 2023

Deloitte.



WELCOME TO ISSUE No.41

FOREWORD

With summer's arrival turning up the heat, our latest edition of *Performance* takes the temperature of the investment management industry and explores the top trends and opportunities of 2023. In issue 41, our contributors transport you to the golden shores of alternative assets and shifting investor demand—while helping you navigate the associated regulatory and cross-border turbulence.

VINCENT GOUVERNEUR
EMEA INVESTMENT MANAGEMENT
CO-LEADER
DELOITTE

TONY GAUGHAN
EMEA INVESTMENT MANAGEMENT
CO-LEADER
DELOITTE

An insightful discussion between **Nick Tabone and Hans-Jürgen Schmitz, Managing Partner of Mangrove Capital Partners**, reveals SICAR and RAIF's vital role in nurturing alternative asset management and venture capital growth and the hurdles asset managers must clear in Luxembourg.

Global warming, ESG and the race to net-zero stay top of mind as **Econopolis' Philippe Van Loock and Pieter Slegers** dig into the rocketing demand for climate solutions and the lush investment flows from state initiatives—and how climate stocks' outperformance is set to continue.

The bond market's historic crash of 2022 toppled its 50-year reputation as a safe haven. However, **Michaël De Man, CEO of Econopolis**, explains how interest rate hikes and outperforming emerging markets offer opportunities for savvy investors to diversify their portfolios.

As the EU's battle against money laundering and terrorist financing turns 10 this year, **Alice Lehnert and Andreas Schmitt** take a sneak peek at the upcoming EU laws tackling due diligence, beneficial ownership and cash payments.

Eager to heed the growing call for alternative products from well-informed investors and HNWIs, investment fund managers still encounter cross-border distribution challenges. **Guillaume Scaffe and Chloé Piquet** expose the current regulatory patchwork despite the EU's efforts to harmonize marketing rules.

Despite China dismantling many barriers to foreign investment, BNY Mellon's recent survey of 300 global asset owners and managers reveals enduring market friction. **Magdalene Tay and Sam Xu of BNY Mellon** explore foreign investors' burning priorities, high hopes and enduring headaches while exploring China's ever-evolving market.

Investment management firms have a deep well of data to draw from, but often fail to treat it as an asset. **Sylvain Crépin, Nicolas Griedlich and Kunalsingh Ramchurn** explain how a robust data strategy and governance can unlock a wealth of opportunities to propel trust, understanding and transparency to another level.

This summer issue distills the hottest priorities of investment managers today and demonstrates the sector's unfolding innovation in a vista of shifting demand, regulatory cacophony and emerging opportunities.

May this 41st edition of *Performance* inspire you.

EDITORIAL

With Luxembourg as the focus market of this 41st edition of *Performance*, the spotlight naturally falls on alternatives. One of the leading financial hubs for alternative asset management, Luxembourg's unique regulatory framework and central European location provide rich soil for this asset class to flourish. And, by the nature of the investment management market, Luxembourg's trending topics also translate into global megatrends.

The future is rosy for alternative assets. Despite their riskier reputation, these asset classes prove more tenacious in the face of turbulent economic factors, making them less volatile as a result. Amid the current financial turmoil, investors eager to diversify their portfolios favor real assets over a more traditional strategy. However, this interest will likely heighten the EU's formidable regulatory focus, especially the complex marketing material requirements for retail and professional investors.

An indispensable area of alternatives is venture capital; here Luxembourg also leads the pack. We invited Hans-Jürgen Schmitz, CEO of Mangrove Capital Partners, a Luxembourg-born and globally acting venture capital player, to share his unique insights into the drivers, opportunities and hurdles of Luxembourg's booming venture capital industry. While the Grand Duchy's regulatory framework has helped catalyze venture capital's snowballing growth—the number of managers in the space has exploded tenfold in 20 years—the weighty compliance burden can also stymie smaller asset managers, especially those marketing within the European Union.

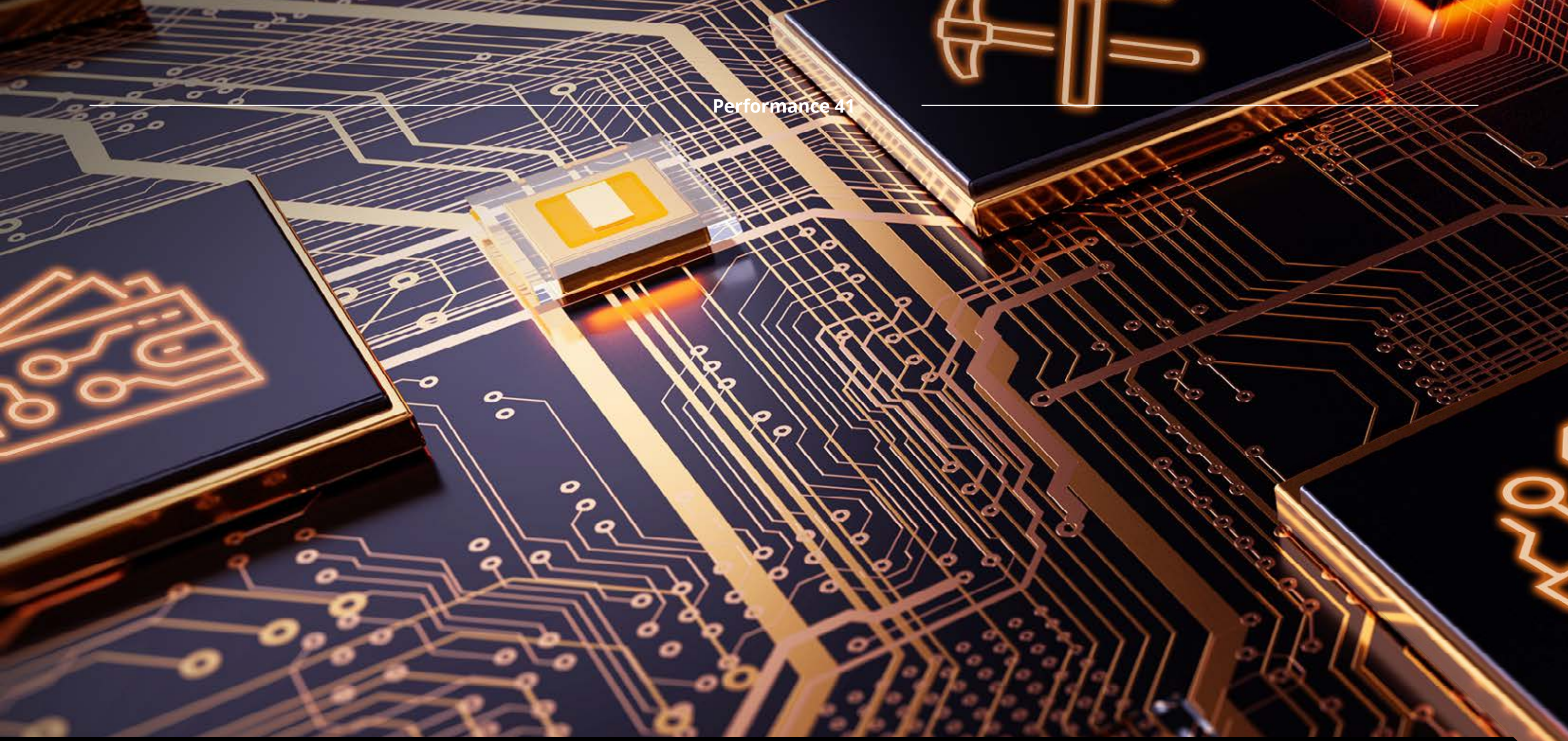
We also share a Luxembourg perspective on the burgeoning global topic of financial crime. Born from a series of financial scandals 10 years ago, the fight against money laundering and terrorist financing has gone from strength to strength. But while Luxembourg battles financial crime by transposing the EU's regulations and imposing robust due diligence measures, the success of these rules relies on other Member States' efforts. We review the principal developments of the past decade and shine a light on what's around the corner.

Rounding out this essential digest are the major topics driving the investment management agenda, including data as an asset, new market opportunities in the East, the opportunities and complexities of cross-border marketing, the bond market's diversification options and, of course, ESG and the race to net-zero. And in our quest to provide you with a broad spectrum of viewpoints, we invited BNY Mellon, Econopolis as well as Mangrove Capital Partners to contribute their valuable insights.

In the whirlwind landscape of investment management, we are delighted to accompany you in this often challenging but always invigorating journey. We hope this 41st edition stands you in good stead for the remainder of 2023.

NICK TABONE
PARTNER
PRIVATE EQUITY LEADER
DELOITTE

XAVIER ZAEGEL
PARTNER, INVESTMENT
MANAGEMENT LEADER
DELOITTE



Data as an investment

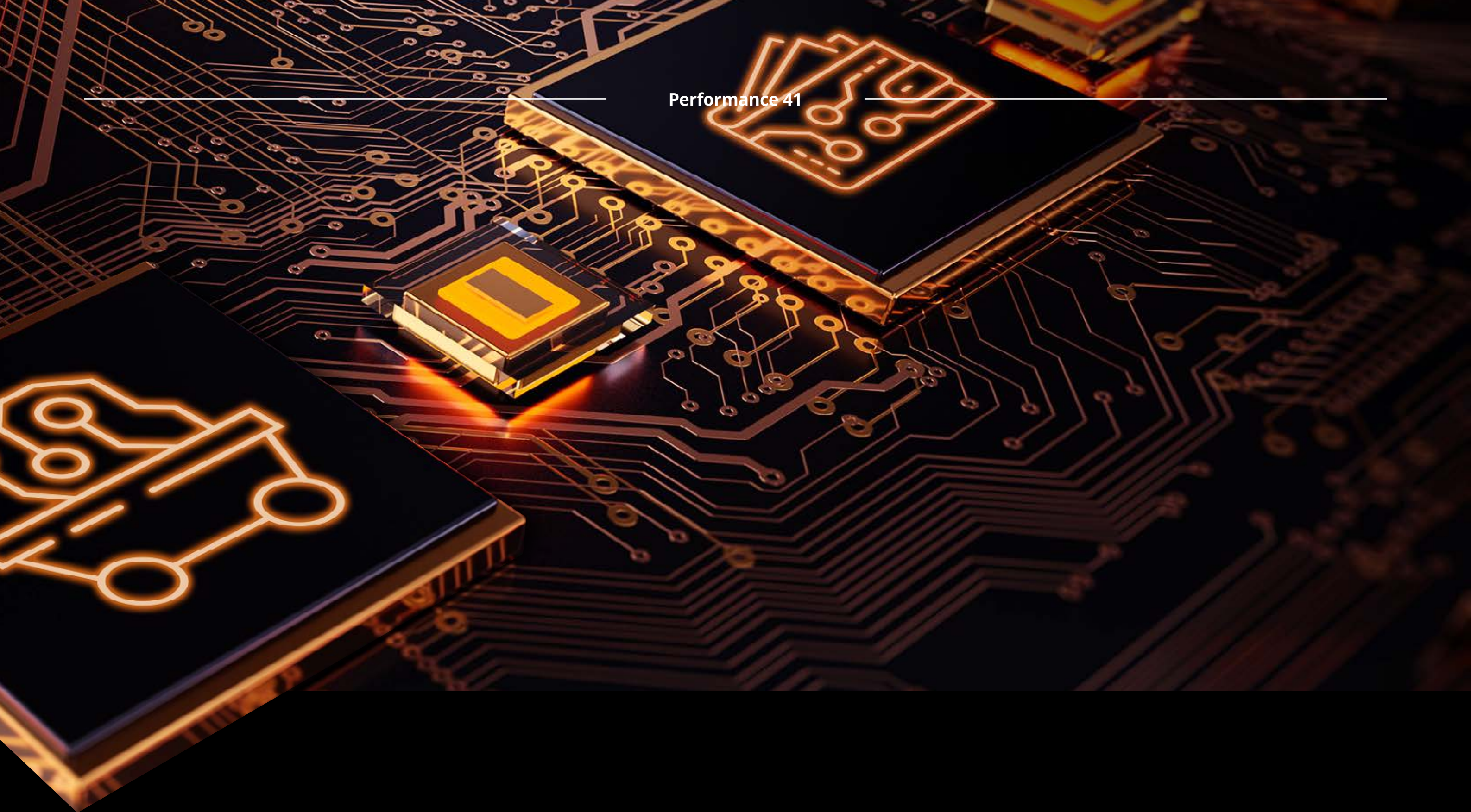
WHY YOU NEED A STRONG STRATEGY AND GOVERNANCE

INTRODUCTION

Assets under management (AuM) are continually growing, reaching a new peak of more than $123 trillion USD by the end of 2021[1]. In parallel, more data is available to investment management (IM) actors than ever. This creates questions around data management at an organizational level, in terms of both technology and governance.

As investment strategies and products expand, regulations are increasingly prevalent, creating a need for strategy; data needs to be secured, managed and structured in a way that provides accurate reporting metrics and information security. A strong data strategy also unlocks real-time self-service analytics, enabling enhanced analytics and AI to predict and simulate previously unconsidered strategies.

Thus, unstructured data is not necessarily the "new gold." But information from cleansed, secured, structured actionable data is. As part of a strong data strategy and governance, IM firms can leverage this meaningful data as an asset for insights that drive sustainability and increase revenue.



SYLVAIN CRÉPIN
PARTNER – ACG IM LEADER
DELOITTE

NICOLAS GRIEDLICH
PARTNER – ARTIFICIAL INTELLIGENCE & DATA
DELOITTE

KUNALSINGH RAMCHURN
SENIOR CONSULTANT – ARTIFICIAL INTELLIGENCE & DATA
DELOITTE

IM firms should reconsider their current data strategy. With digital transformation well underway in an increasing number of firms,[1] now is the perfect time to consider a strong approach, as it also provides a means to generate alpha. To fully reap the benefits, decision makers must shift their mindset and adopt a "data is an asset" mentality. As management buy-in increases, so will the successful implementation of an effective strategy.

Data is an asset: the benefits of structured data

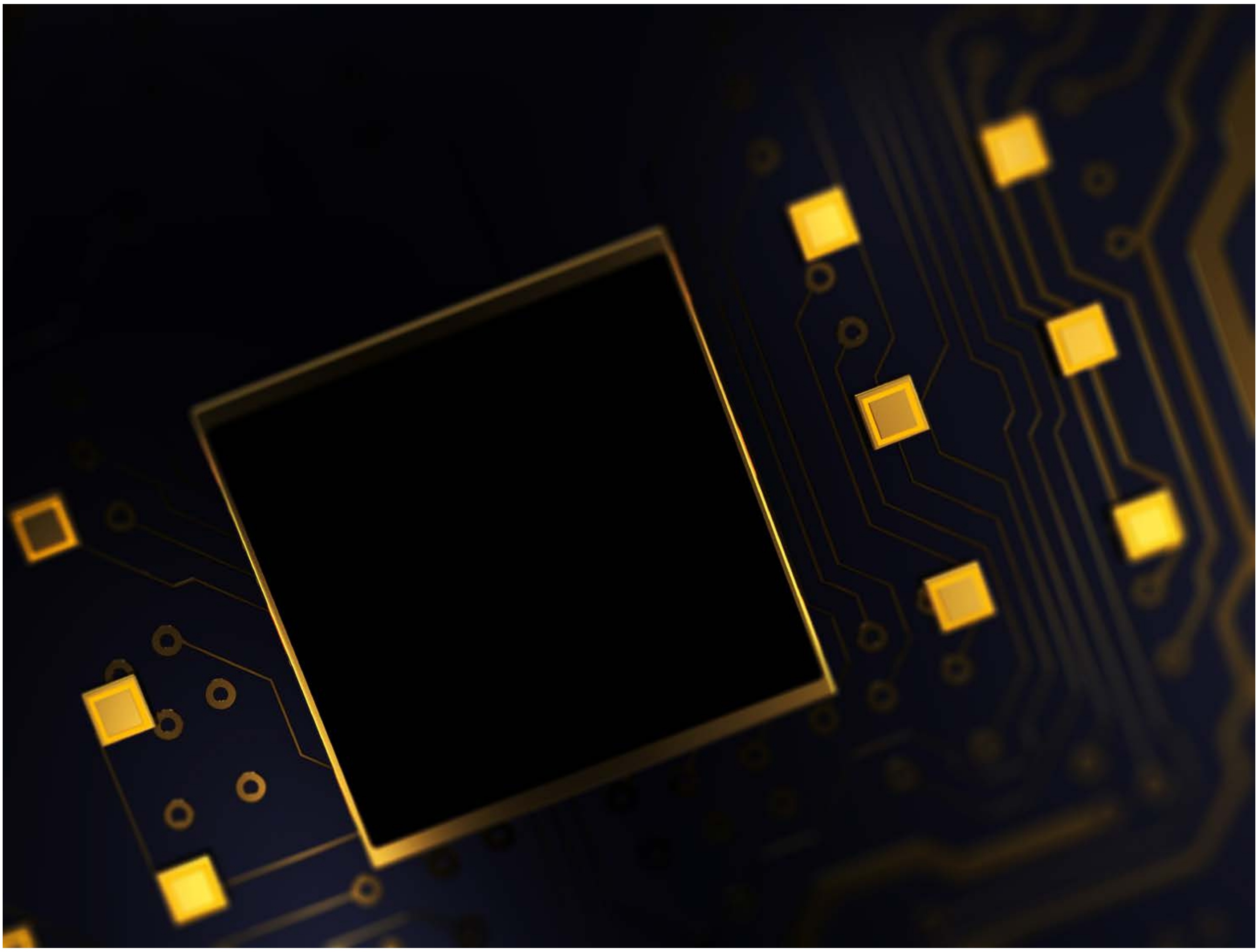
Data is an asset and needs to be managed as such. With this mindset, firms are more likely to embrace a data-driven approach, from which tangible insights can be gained. Incorporating a data strategy requires considering the data's current and target maturity level, and then defining the required steps to transition.

Using an effective data management solution with clear governance provides additional support to firms. This is realized through a clearly defined hierarchy of data needs, underpinned by executive oversight. Strong data governance also increases alignment between the IT and business domains; this ensures the requested use of data is prioritized, improving the quality through this increased transparency and understanding. This also makes certain that back and front office staff can trust the data used, helping to drive customer engagement and increase revenue.

Having a single version of truth is also an asset; this can be achieved by creating a "master data system" that transforms unstructured data into one meaningful reference point, reducing reliance on different data sources. This centralization improves controls between systems which guarantees data consistency and reduces risk. A master data source also reduces overall costs as staff spends less time trying to "correct" data. With master data management systems, internal audit compliance is also improved because data can be traced between systems.

As regulatory compliance becomes increasingly critical, the impact of a strong data strategy cannot be overlooked. Appropriate data protection techniques, in compliance with DORA and GDPR, will make data stronger and less vulnerable to cyberattacks within internal systems.[2] This reduces risk and other costs frequently associated with cyberattacks.

1. 2023 investment management outlook | Deloitte Insights
2. Exploring DORA | Deloitte Luxembourg



Data is an asset and needs to be managed as such.

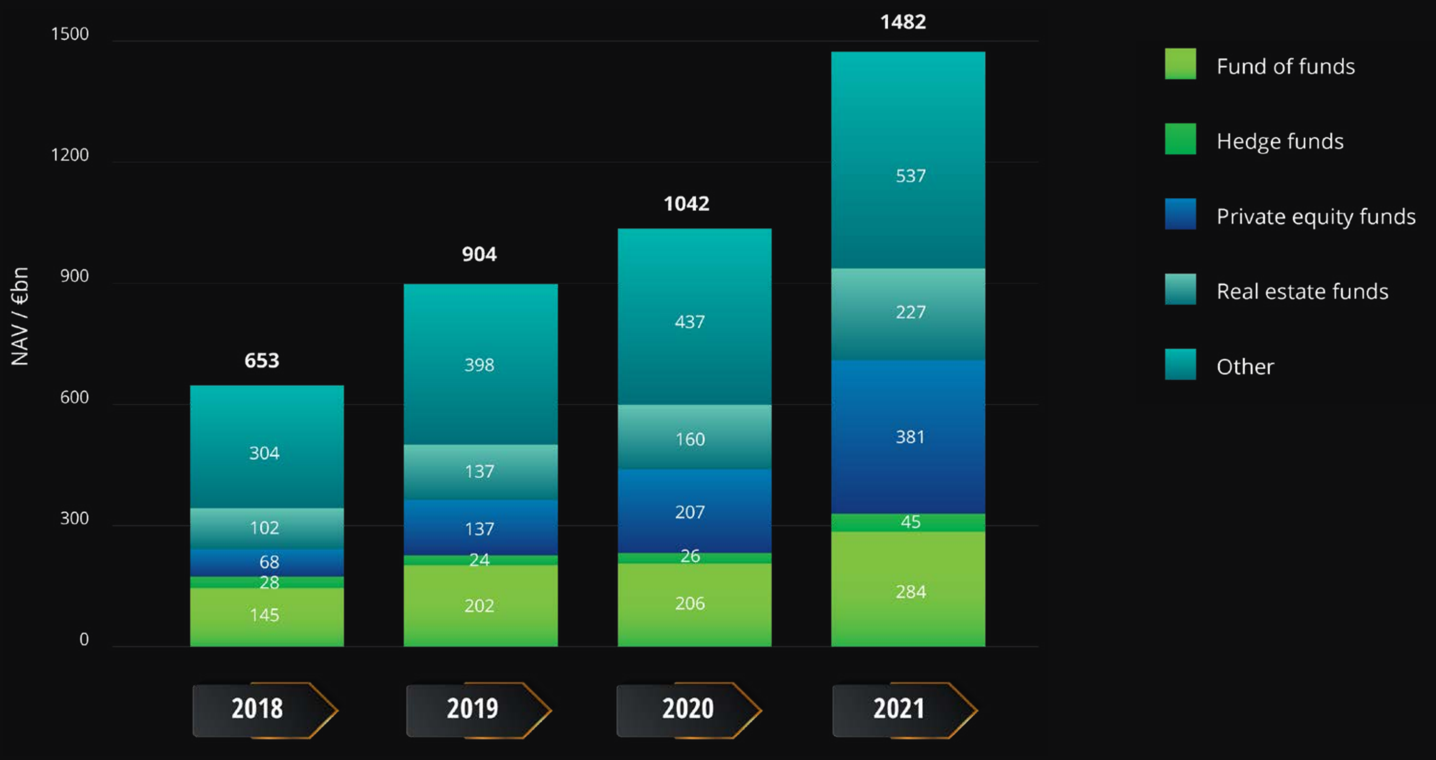
However, to ensure the strategy is followed and completely realized, a well-defined governance structure is required. As data affects everyone, its governance should be organization-wide, regardless of seniority. For robust data governance, roles and responsibilities must be clearly defined, with distribution based on the size of the firm. Strong governance ensures accountability at all levels, and encourages greater alignment between the business and IT domains. This is critical, as both must collaborate to produce trustworthy, secure, actionable data, and it provides a solid foundation from which firms can become insight driven. Building this collaboration and governance also allows organizations to benefit from use cases with traceable oversight, so data that adds value is maintained and is an asset to the firm.

Investing in a more sustainable world

Alternative investment funds (AIFs)— especially within the Luxembourg market—are increasingly attractive, with a net asset value (NAV) of Luxembourg-domiciled AIFs standing at €1.4 trillion at the end of 2021, and with €1.3 trillion AuM.[3] With the AIF market's year-on-year growth (Figure 1), there is a material increase of AIFs that's not expected to slow down anytime soon. For instance, in 2020 private equity and real estate funds accounted for 6% and 13% of the NAV of the AIFs in the European Economic Area's 30 countries (EEA30), respectively.[4] By contrast, in 2021, in the Luxembourgish market, private equity and real estate funds comprised 26% and 15% of the NAV of AIFs, respectively.[5]

3. AIFM Reporting dashboard – December 2021 – CSSF
4: Risk Monitoring (europa.eu)
5: The Corporate Sustainability Reporting Directive (CSRD) (plana.earth)

Figure 1: Year-on-year growth of the Luxembourgish AIF market, split by fund type.



AIFs' illiquidity requires additional ESG considerations. With legislation sparking change in the IM industry, private equity and real estate (PE/RE) fund reporting is especially important. The Corporate Sustainability Reporting Directive (CSRD), for example, strives to improve the quality of sustainable data reported.[6] Given that CSRD is aligned with other legislation, including the Taxonomy Regulations (TR), the quality and storage of data calls for appropriate administration and governance.

With Sustainable Finance Disclosure Regulation (SFDR) Level II in effect, additional disclosures are necessary for article 8 and 9 products; this is related to the introduction of the TR, which has increased the importance of ESG reporting within the PE/RE fund market.[7] TR requires investor alignment with environmental objectives, as well as the appropriate collection of data to prove said alignment. When a robust data strategy is defined, affected systems (operational or technical) will be able to collect data and verify its quality for internal reasons—reporting or otherwise—boosting its accuracy and trustworthiness.

Since the risks of greenwashing are significant, sustainable disclosures have also prompted increased public and regulatory scrutiny of investments. This has made assurances on long-term data critical, and thus, increasingly in demand. And while the CSRD provides means of reinforcing corporations, a robust data strategy should be the primary foundation from which to increase trust in the data collected, released, and—eventually—audited.

With a continued push towards more sustainable investment practices, more regulations will emerge and evolve over time; this includes sustainable finance related data. And as part of the European Data Strategy, changes can be expected in terms of ESG product offerings for investors. Thus, defining a strong data strategy and governance will help IM firms be prepared for when these changes come into effect.[8]

6. Global Distribution Conference | Alfi Events
7. Sustainable Finance Roadmap 2022-2024 (europa.eu)
8. Demystifying Data | Deloitte Australia | Deloitte Access Economics

Data strategies return more than just the initial investment

Strong data strategies integrate all sources of data and ensure they are traced from creation to consumption, simplifying the integration of additional data sources. A robust data strategy also applies the principle of least privilege, which ensures data is accessible only to those who need it; this further reduces risk and operational failures.

And to turn insights into opportunity, data from vendors and data provided to partners and clients, can be merged and reconciled across reporting domains for a more accurate and detailed perspective that spans functional domains and share classes. Providing self-service analytics is critical to determining such insights, and it's the consolidated data that helps create a trusted single version of the truth. As a result, end users are more likely to experiment with data, testing and simulating the ideas it provides.

Investing in a strong data strategy doesn't solely promote trust in the quality of data used; it can also improve reporting. Often disparate, data can have varying levels of quality assurance and poorly defined ownership. This creates issues with data veracity, and—as mentioned before— determining a single source of truth becomes nearly impossible. But as data storage becomes leaner, a single source of truth becomes defined and less dependence is placed on external systems, improving the quality and time spent on internal reporting. This also creates a maintainable audit trail, reducing external reporting time.

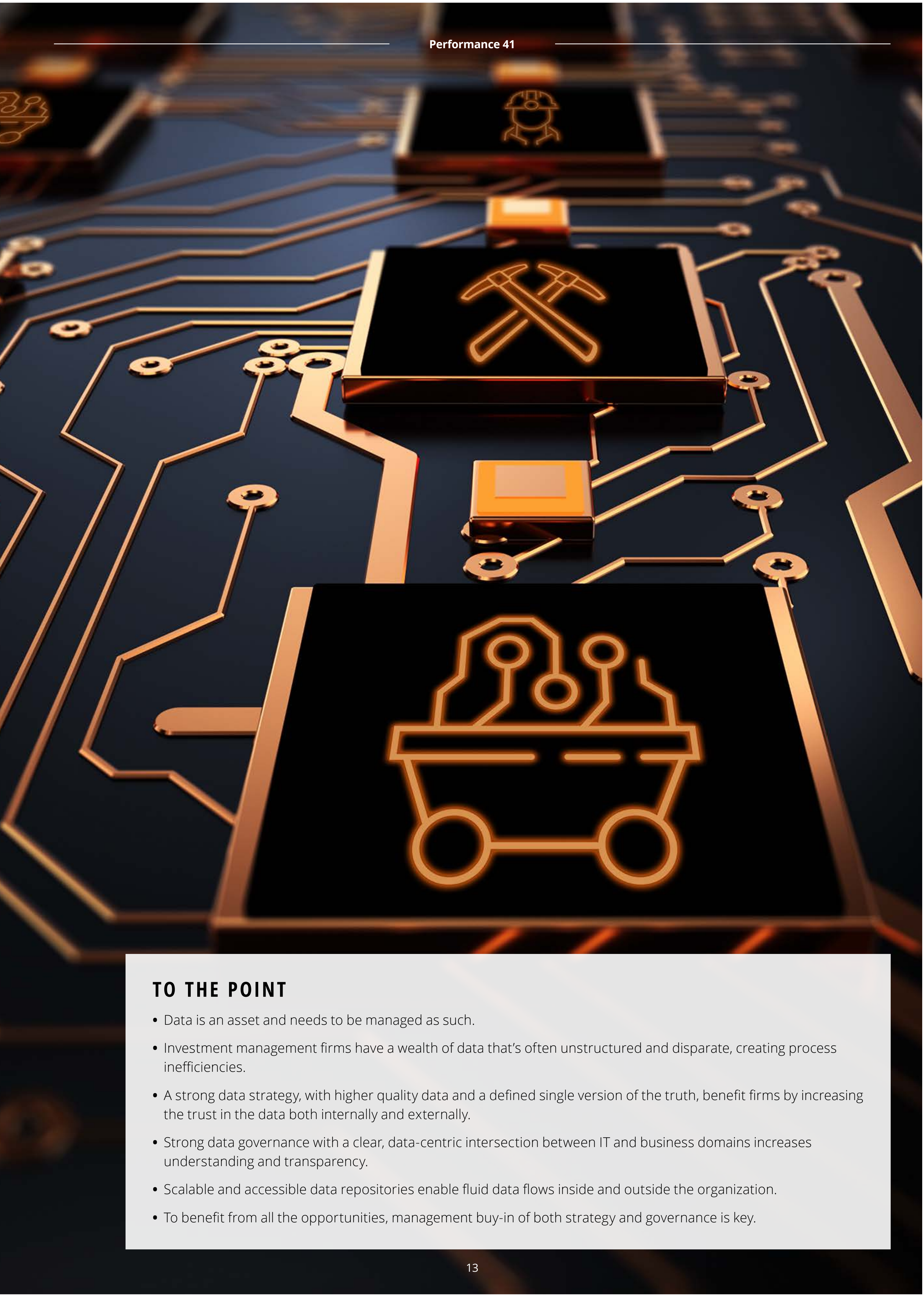
A well-known example of a single, consolidated data source in investment management is the Investment Book of Records, or IBOR. Full of positions and exposures for traders and portfolio managers, it supports more informed investment decisions and reporting, and removes lengthy reconciliation procedures between multiple middle and back-office systems.

While high-quality, centralized data can be used for analytics, as a firm's data maturity increases, the complexity of analytics to be exploited does as well. A strong data strategy leverages the tools needed to effectively manage data, unlocking artificial intelligence and machine learning use cases, which in turn, generate business value (Figure 2).

CONCLUSION

A strong data strategy and governance ensures that firms treat data as the asset it can be. In assuming a focused strategy, data becomes more structured and better managed, both operationally and technically speaking. This helps to unlock existing silos, reduce operational risks and costs, and enable more accurate reporting and customer engagement. With increasing ESG legislation, a strong data strategy also increases the trust in the data reported and provides additional futureproofing for providing and storing data. A robust data strategy and governance also creates a single version of the truth, which users can exploit for more advanced analytics that can generate additional value.

Figure 2: Levels of analytical complexity for improved business value.



TO THE POINT

- Data is an asset and needs to be managed as such.
- Investment management firms have a wealth of data that’s often unstructured and disparate, creating process inefficiencies.
- A strong data strategy, with higher quality data and a defined single version of the truth, benefit firms by increasing the trust in the data both internally and externally.
- Strong data governance with a clear, data-centric intersection between IT and business domains increases understanding and transparency.
- Scalable and accessible data repositories enable fluid data flows inside and outside the organization.
- To benefit from all the opportunities, management buy-in of both strategy and governance is key.

SAM XU
CHINA COUNTRY EXECUTIVE
BNY MELLON

MAGDALENE TAY
HEAD OF GLOBAL MARKETS MANAGEMENT, APAC,
ASSET SERVICING AND DIGITAL
BNY MELLON

The next mile:

SMOOTHING THE PATH FOR FOREIGN INVESTORS ACCESSING CHINA

INTRODUCTION

While China has enjoyed a meteoric rise to become the world's second-largest economy, foreign participation in its capital markets has not kept pace.

However, rapidly changing conditions are prompting foreign investors to look again. The government's efforts to open up market access, the inclusion of Chinese bonds and equities in major global indices, and economic growth that still outstrips those of developed markets[1] have seen Chinese assets' proportions growing on many investors' portfolios. With many barriers removed, foreign investors' access to China's capital markets is easier than a decade ago.

Nevertheless, market friction persists due to a lack of harmonization across access schemes, complex local infrastructure, limitations on sophisticated investment instruments, and post-trade processes falling short of international best practices. Regulatory reforms and market-led solutions comprise the "next mile" of steps to boost the expansion of investors' China portfolios—although external factors like potential shifts in US-China relations may influence how quickly foreign investors grow their allocations.

BNY Mellon's latest survey finds that 80% of global asset managers and owners intend to increase their China equity and bond allocations over the next 2 years. However, as they scale up their portfolios and explore a broader range of investments, they must overcome these market access and operational challenges.

1. International Monetary Fund real GDP growth forecasts for 2022.

Which industry sectors are of greatest interest for foreign investors' private equity investments in China over the next two years?

Figure 1: Foreign investors will be discerning about their private equity allocations

Investors are wading in but picking their sectors

Most survey respondents intend to grow their China allocations, albeit cautiously. For example, 74% will increase their China equity holdings at the same pace or slower than the rate at which global equity indices increase their China weightings, and 63% say the same for China bonds. Only 6% will increase equity allocations faster than the rate of increase in mainstream index weightings to China, and 18% for bond allocations.

Foreign investors seeking private equity opportunities appear discerning in their investment sector selection. More than half the survey respondents will focus on consumer and retail (56%), while technology, media and telecommunications (49%) and healthcare (48%) will also gain traction.

Progress on three key issues will influence future allocation decisions

Foreign investors identified three main factors that will most impact their China investments over the next 2 years: (i) whether capital market rules further align with international norms, (ii) regulatory risk, and (iii) ESG disclosures and standards progress.

Market access agility

As asset owners diversify their China portfolios and asset managers increase their fund offerings, flexibility is critical to their access scheme selection. Access to a broader range of Chinese equities and bonds

is the top criterion of survey respondents (46%) when selecting access schemes.

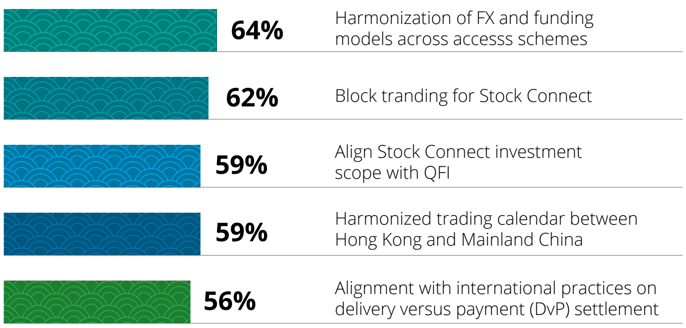
Interestingly, institutions investing directly in China for the longest period (4 years or more) are most likely to increase their use of both offshore (65%) and onshore access schemes (62%) over the next 2 years. This reflects the need for institutions with more sophisticated China strategies to use multiple schemes to build their exposures.

Harmonization must be the goal

When asked which measures they want Chinese regulators to prioritize over the next 2 years, harmonization of FX and funding models across access schemes came top, followed by reforms enabling block trading for Stock Connect and aligning investment scope across different schemes.

What measures would you like to see China's regulators prioritize over the next two years? (Percentage ranking measures among their top three priorities)

Figure 2: Foreign investors want China's regulators to prioritize greater harmonization of market access schemes



Foreign investors want a standard FX model for all access schemes across onshore and offshore markets, but onshore CNY FX dealings are restricted. For example, investors can only appoint one FX bank for the QFI scheme, and switching between CNY and CNH for the China Interbank Bond Market (CIBM Direct) scheme is also restricted. Such constraints mean that onshore and offshore accounts must be segregated.

Only 6% will increase equity allocations faster than the rate of increase in mainstream index weightings to China, and 18% for bond allocations.

Removing friction as sophistication grows

As foreign investors' China allocations grow, so does their interest in more sophisticated approaches to managing liquidity and maximizing returns. However, some barriers remain.

A way forward for SBL

Our survey shows strong interest in participating in SBL in China, particularly among North American asset owners.

While asset owners see opportunities to add value to their China portfolios through securities lending, the current market infrastructure is not ideal. There are concerns about the China Securities Finance Corporation's (CSFC) status as the central counterparty, and the lack of a sophisticated agent lender infrastructure and providers offering indemnification to reduce counterparty risk.

Positive change may be forthcoming. Industry trade associations like ASIFMA and PASLA are working closely with Chinese regulators and exchanges to increase the use of the QFI stock-borrowing facility.

In addition, last year, the People's Bank of China announced new measures to regulate bond borrowing and lending in the CIBM to increase market liquidity and protect market participants' rights and interests.

There is also a gradual uptake of mechanisms enabling Stock Connect and Bond Connect listed securities to be used as collateral under a pledge structure, as CSFC rules dictate. This paves the way for greater use of these assets in securities finance transactions.

Time to unlock the benefits of collateral management

To keep growing their China exposures, foreign investors need to maximize these securities' utility. The ability to use Chinese stocks and bonds as collateral to finance trading activity will be increasingly important; however, participation remains limited. One reason is the operational complexity involved.

From an onshore perspective, there are limited options for the use of collateral, and only available through the Shanghai Clearing House (SCH) and China Central Depository & Clearing (CCDC). This creates inefficiencies when investors seek to post collateral and manage their positions. Another challenge is the ambiguity in the legal rules governing defaults. Moreover, processes deviate from international best practices, producing concerns about how a default scenario would be managed.

Investors using offshore access schemes have some alternatives. Some global triparty agents offer Stock Connect and Bond Connect solutions, allowing clients to use these assets for certain collateral purposes.

The advantages of operational efficiency and liquidity and in reducing credit, market and settlement risks make collateral management attractive. If regulations ease the use of collateral per international best practices, greater participation is likely.

To keep growing their China exposures, foreign investors need to maximize these securities' utility.

Fast-tracking ESG integration

The inability to obtain ESG data for compliance and reporting in their home countries was investors' top concern about integrating ESG criteria into their China portfolios. Foreign investors from Europe and North America face mounting demands from their home regulators and clients to invest responsibly.

Other concerns are that limited ESG disclosures from Chinese equity and bond issuers may expose investors to hidden investment risk, and the number of issuers meeting their ESG criteria may limit the investable universe.

Asset managers forge a path

Well-resourced foreign investors are not allowing current disclosure limitations to hold back their ESG ambitions. They are undertaking a significant amount of proprietary analysis to supplement available data and ratings from ESG data vendors.

CONCLUSION

If China continues to open up its market to foreign investments, there is room to increase investors' China allocations.

But for foreign investors to accelerate the scaling of their portfolios, Chinese regulators must further harmonize access schemes, enable access to a wider Chinese investment universe, embrace more complex instruments, and fully integrate ESG considerations.

The industry should also explore approaches and adopt global best practices and standards to overcome these challenges, such as:

- Working with service providers and the industry to accelerate market entry and employ digital tools and international standards to improve market efficiency and the settlement ecosystem;
- Embracing securities financing and triparty solutions in collateral management to optimize returns and enhance liquidity; and
- Adopting ESG data analytics platforms to overcome disclosure gaps by aggregating many data sources and optimizing investment and reporting processes.

Our survey shows foreign investors are ready to expand their portfolios if the remaining friction points are addressed. Continued efforts will support the scalability of services, drive efficiency and optimize investment decisions, while investors must stay agile to navigate today's uncertain geopolitical and macroeconomic landscape.

TO THE POINT

While many barriers to foreign investment have been removed in China, market friction persists. The BNY Mellon report, surveying 300 global asset owners and managers, finds that:

- Most foreign investors plan to increase China equity (80%) and bond (81%) allocations over the next 2 years, with 63% likely to invest in private equity over the same period.
- Long-term foreign investors embrace a mix of onshore and offshore access schemes to flexibly pursue their investment goals.
- Collateral management and trade settlement mechanisms still create operational challenges for foreign investors. While regulatory changes cannot immediately eliminate friction, service providers offer investors greater flexibility.
- Foreign investors look to regulators to harmonize foreign exchange (FX) and funding models across China's access schemes.
- Forty-nine percent of asset managers say a lack of data makes it challenging to define the China securities to include in sustainable funds. Nevertheless, asset managers embrace new ESG products by conducting proprietary analysis to supplement information from data vendors.

Continued tailwind for climate solutions

INVESTMENTS OF €2 TO €3 TRILLION PER YEAR NEEDED TO REACH NET-ZERO

INTRODUCTION

The effects of global warming have never been so visible. Today, we have reached a tipping point. Actions taken in the next few months and years will decide whether we will reach net-zero by 2050.

This goal requires an investment of €2 to €3 trillion per year into clean energy and infrastructure, giving rise to many challenges but also numerous investment opportunities. Companies offering climate solutions are set to benefit from one of our generation's most significant investment trends.

PHILIPPE VAN LOOCK
DIRECTOR
SENIOR PORTFOLIO MANAGER
ECONOPOLIS

PIETER SLEGERS
PORTFOLIO ANALYST
ECONOPOLIS

Wide range of investment themes

There's much more to climate solutions than pure electric vehicle manufacturers or renewable energy firms.

In his book Drawdown: The Most Comprehensive Plan Ever Proposed to Reverse Global Warming, Paul Hawken summarizes the 100 most impactful climate solutions to reach net-zero.[i] Generally, every solution can be categorized into six different climate clusters:

01. Renewable energy
02. Sustainable food and agriculture
03. Sustainable transport
04. Circular economy
05. Energy-efficient infrastructure
06. Carbon capture

Each cluster gives rise to several subthemes. For example, the sustainable transport cluster offers a myriad of investment opportunities beyond BYD or Tesla, such as mass transit (electric and hydrogen trains), charging infrastructure, lithium suppliers, semiconductors, testing equipment, battery producers, and recyclers of lithium batteries.

Climate challenge generates investment opportunities

Despite its many challenges, the energy transition fosters diverse opportunities that governments are bolstering with policies. For example, Europe's solar and wind-energy capacity is set to quadruple in the coming years, thanks to a multitude of government initiatives such as the European Green Deal, REPowerEU, the European Inflation Reduction Act, the Net Zero Industry Act and the Critical Raw Materials Act.

No other trend offers such a robust flow of investments as climate solutions, with climate stocks set to enjoy a continued tailwind.

Companies offering green solutions will benefit from structurally increasing demand in the coming years and even decades, leading to higher sales as well as profits. As stock prices follow companies' underlying performance in the long term, this segment offers many alluring opportunities.

Clear outperformance

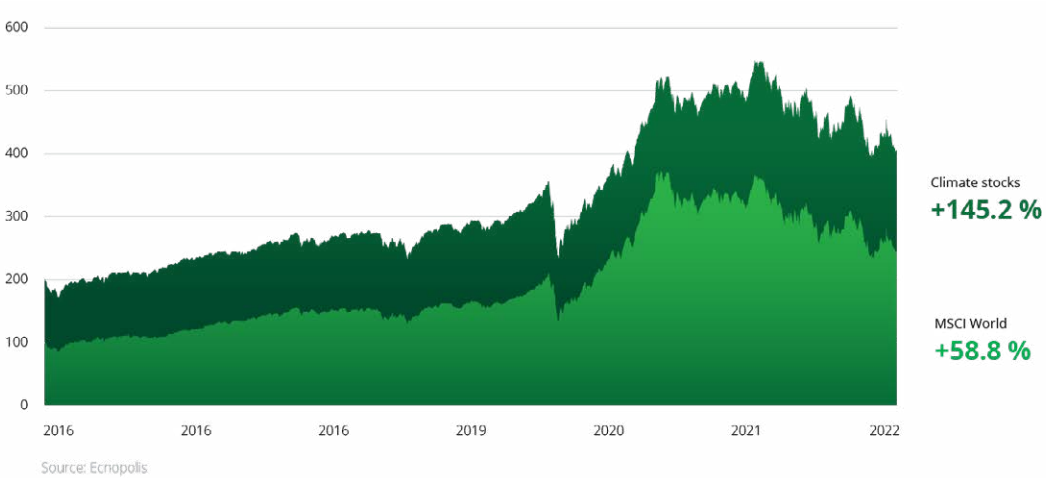
In recent years, climate stocks have already proven to be good investments. Since 2016, the MSCI Global Environment Select Index has returned 148.8% to shareholders (13.9% per year), compared to 58.8% (6.8% per year) for the MSCI World Index.[ii]

Due to its complexity and importance, the energy transition will continue to receive huge investments and support for years, even decades. Therefore, we are convinced that climate stocks will keep outperforming going forward.

i. Paul Hawken, Drawdown: The Most Comprehensive Plan Ever Proposed to Reverse Global Warming (New York: Penguin Books, 2017).
ii. The MSCI Global Environment Select Index comprises securities of companies that derive at least 75% of their revenues from environmentally beneficial products and services.

Climate stocks perform well

Evolution since first January 2016 (performance in EUR)



The MSCI Global Environment Select Index was used as a proxy for climate stocks. The MSCI Global Environment Select Index is comprised of securities of companies that derive at least 75% of their revenues from environmentally beneficial products and services

CONCLUSION

- With the accelerating effects of climate change, there is a push to achieve net-zero by 2050 through huge investment in and support for the green transition.
- Climate solutions are enjoying a strong tailwind, bolstered by government policies and growing investor demand.
- Climate stocks have outperformed in recent years, a trend likely to persist in the future.

TO THE POINT

- With the effects of global warming more visible than ever, there is a growing demand for climate solutions to reach net-zero by 2050.
- Companies offering climate solutions will benefit from plentiful investment flows supported by government initiatives and investor demand.
- The recent outperformance of climate stocks is set to continue for years, even decades.

Opportunities and paradoxes of marketing investment funds across borders

REGULATORY STANDARDIZATION BRINGS MORE COMPLEXITY

GUILLAUME SCAFFE
PARTNER
CONSULTING IM & PERE
DELOITTE

CHLOÉ PIQUET
SENIOR MANAGER
CONSULTING IM & PERE
DELOITTE

INTRODUCTION

The Capital Markets Union (CMU) is an initiative launched by the European Union (EU) to create a single market for capital across the Member States (MS). Their objective is to increase capital in the EU, improve investments and support economic growth by harmonizing the regulatory framework. So far, the CMU has achieved significant progress in implementing legislative initiatives. However, the current regulatory framework to which investment funds must comply is a paradox of standardization that creates complexity. In fact, it increases cost, compliance requirements, reporting, and disclosures obligations for IFM. We will tackle the following topics in this article:

01. The opportunities brought by the standardization of the regulatory framework
02. The current trends in the investment funds industry help
03. The challenges and difficulties investment fund managers are encountering

Luxembourg is known as one of the main hubs for investment funds to domicile (9% of the worldwide net assets). Over the years Undertakings for the Collective Investment in Transferable Securities (UCITS) have become an extremely popular product. What are the trends for the future?

Since 2014, the biggest growth of the net assets of investment funds domiciled in Europe has been among AIFs (+95,10%). This can be explained by two factors.

First, certain regulations (Alternative Investment Fund Managers Directive (AIFMD), European Long-Term Investment Fund (ELTIF), Cross-Border Distribution of Funds (CBDF)) were created to ease the marketing of EU AIFs. Indeed, raising money became much simpler and quicker thanks to the introduction of (i) the marketing passport, (ii) the simplification of eligible investments requirements and (iii) the harmonization for the provisions of facilities to investors.

Second, the recent economic situation also boosted the interest in the alternative assets. At the end of 2021, we emerged from a period of low interest rates and high stock share values, and investors started looking for more attractive investment opportunities. This trend materialized in a massive increase of AIF net assets from 2020 to 2021 (+12,5%).

The 2022 economic crisis strengthened this trend. Declines across stock market indices from January to October 2022, geopolitical uncertainty and inflation had a limited impact on these asset classes. In November 2022, AIF net assets represented 18.7% of the total net assets of Luxembourg investment funds (versus 16% in November 2021).

Do we believe that current trends are indicative of the future or just a temporary fad?
We anticipate strong growth over the next years from existing solid regulatory foundations and current economic context. IFMs known to offer UCITS are developing more strategies in alternative funds. Also, the target audience is no longer limited to professional investors. Well-informed or High-Net-Worth Individuals, namely retail investors with a financial qualification or high savings, are more and more interested in real assets. To ease accessibility, IFMs adapt their products by designing open-ended AIFs to meet real investors' liquidity needs.

While the aim of the European legislative framework is to standardize marketing rules across the EU, the provision of AIFMDs give each MS the discretion to market to retail investors. As of today, only a few jurisdictions offer this possibility (like Ireland, Portugal, Netherlands). This dichotomy is ambiguous, but it seems to evolve. In response to the growing number of requests, certain NCAs (such as in the Nordics) have become more flexible and authorized marketing by foreign AIFs to local retail investors.

Going forward, we can expect an increased regulator tolerance and thus a wider offer of alternative asset classes.

The regulatory framework creates both standardization and intricacy, which inconsistently coexist. In practice, what is the reality for the alternative universe?
We observe two important regulatory trends.

On the one hand, we see a clear, steadily progressing harmonization in the AIFM passport. The regulatory harmonization took a big step forward in 2021 with the abolishment of the requirement for local agents in favor of remote facilities to investors. This change simplifies the marketing of AIFs to retail investors, much like the recent implementation of PRIIPs Regulation that eliminated some need for country-specific disclosure requirements.

On the other hand, there is an ever-increasing level of investor protection combined with more and more detailed transparency requirements. Recent examples include (i) the Sustainable Finance Disclosure Regulation (SFDR) which introduced new disclosure requirements and reporting, (ii) the European Securities and Markets Authority (ESMA) Guidelines on Marketing Communications and, (iii) Luxembourgish regulator's Commission de Surveillance du Secteur Financier (CSSF) guidance on marketing communication, for instance.

These new obligations are becoming more cumbersome, leading to complicated processes and increased costs for the IFM to comply with all ongoing obligations toward investors regarding fund distribution.

In light of the rise of AIFs, what are new challenges for industry players and impacts on internal organization and governance?
The regulation for distributing investment funds across borders mandates that the IFM is responsible for ensuring that any marketing communication for their managed funds aligns with the legal documentation of the fund.

In its recent guidance on marketing communication, the CSSF clarified that this responsibility lies with IFMs, whether there is a contractual relationship in place with the marketing intermediary or not. Market players are critical of this clarification, as it adds complexity for IFMs.

For any marketing intermediaries that are part of a contractual agreement, the responsibilities and limitations applicable to each party for the creation and dissemination of the marketing communications should be defined in the contract. When such contracts do not exist, the CSSF may expect the IFM to implement random screenings to catch potential communications issued on behalf of their funds. The CSSF will certainly clarify its expectations during the inspection on marketing communications that will be conducted.

Would you consider that this position is aligned with the European trend on marketing communications?
Yes, the CSSF's guidance clarifies some practical aspects of the ESMA guidelines on Marketing communication.

However, many MS, including Luxembourg, have developed some local specificities creating a European cacophony around marketing communications.

An example of this regulatory frenzy is the Dutch Authority for the Financial Market (AFM), which requests the integration of a specific logo on communication designed for retail investors.

The French Autorité des Marchés Financier (AMF) defined another approach, dictating that any sustainable fund marketed to French retail investors that doesn't comply with French requirements must include a specific disclaimer in its marketing communications.

On top of the requirements linked to marketing communication, the IFM must track all additional pieces of regulation and ensure that each local regulator does not add a layer of specific requirements that will need to be applied when distributing in this country. This necessitates a regulatory watch in all the countries where funds are distributed and can be very onerous for the IFM, especially for small structures.

How do you correlate such regulatory frenzy with the standardization of the distribution?

We are facing an interesting contradiction. Over the years, the European standardization has increased the possibilities offered to IFM to distribute their funds to a wider target market.

However, we can see residual concerns from NCAs that the marketing of alternative assets to retail investors might expose them to risks they do not understand. The European regulator took these concerns into consideration over the past months and tried to get a better grasp of the latest marketing trends and the risks they entail.

It is interesting to note that ESMA recently scheduled a Common Supervisory Action (CSA) with NCA on the application of MiFID II disclosure rules about marketing communications across the European Union for 2023.

CONCLUSION

What do you see as the trend in the future?

We foresee a promising future for the alternative assets. Despite being known as riskier, these asset classes are less impacted by the evolving economics factors and are, therefore, less volatile.

Amid current economic turmoil, investors eagerly diversify their portfolios and favor real assets over more traditional strategy.

Meanwhile, we expect more flexibility from the NCAs in authorizing the marketing of alternative assets to retail investors. We also foresee an increased regulatory focus complicating investor communications and marketing materials. ESMA's CSA will further exemplify the paradox described in this article, wherein the quest for harmonization leads to additional guidance that mandates new reporting or increased transparency.

TO THE POINT

- Investment Funds Managers (IFM) are developing new strategies in alternative products to reply to the market's growing demand, that comes from both well-informed investors and High-Net-Worth Individuals.
- Despite the harmonization of marketing rules for professional investors in the EU, significant obstacles remain for the distribution of Alternative Investment Funds (AIF) to retail investors. To protect their local markets, most EU National Competent Authorities (NCA) are reluctant to open their local market to foreign alternative assets, creating inconsistencies within the EU.
- A legislative framework aimed at harmonizing marketing communications at a European level entered into force. However, this territory remains highly protected by the NCAs creating a European cacophony that can be hard to follow.
  We anticipate a high regulatory focus on the marketing materials that will be made available to retail and professional investors, which will create further complexity for IFM.

Devastating times for bond investors

MICHAËL DE MAN
CEO
ECONOPOLIS WEALTH MANAGEMENT

INTRODUCTION

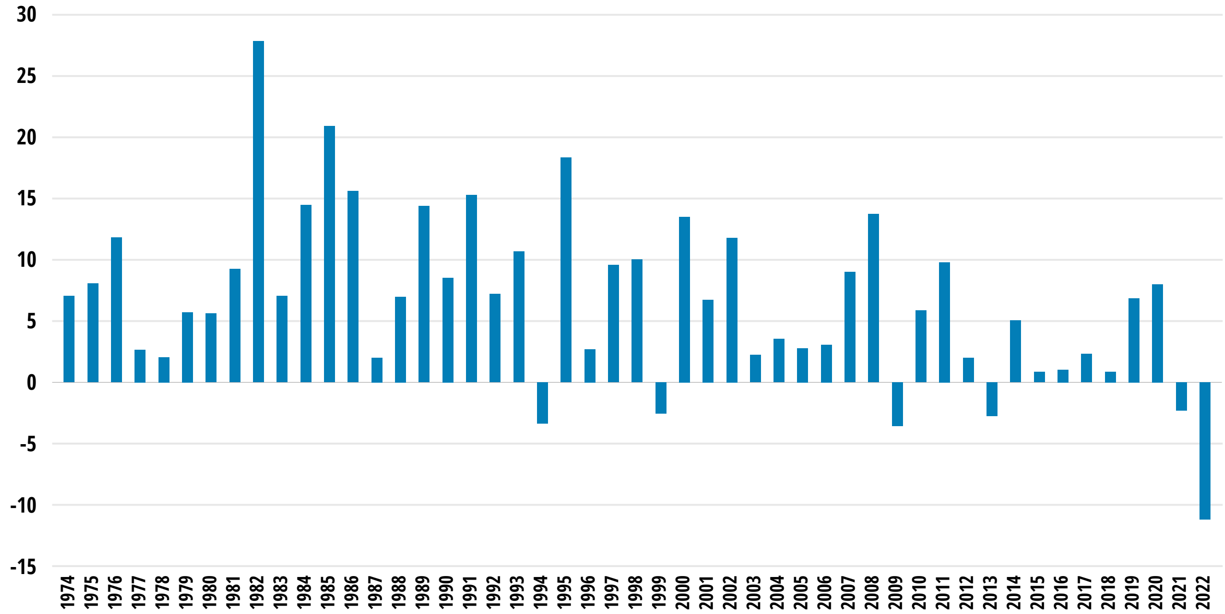
Skyrocketing inflation and central banks' interest rate reversals are ravaging bond markets, resulting in unprecedented losses.

Historic crash in bond markets

Investors often regard high-quality government bonds as safe havens, and they were right —at least until last year. For over 50 years, US government bonds (on average in dollar terms) had never fallen more than 5% in one calendar year.

However, in 2022, US government bonds plummeted by more than 10%, the largest decline since the 19th century. Peak to trough, the loss amounted to almost 20%, representing unprecedented losses for a safe haven.

Figure 1: Dramatic year for US government bonds



Source: Bloomberg, Econopolis

The year 2022 not only disproved these types of bonds as guaranteed safe bets, but also smashed the stock market wisdom of them providing a counterweight during falling stock markets. It is well on its way to entering the history books as the black year for bond investors.

Two years ago, negative interest rates were the norm on euro government bonds, especially all short-term ones (even Italy and Portugal), with positive yields for quality bonds only found for long maturities. This phenomenon has completely disappeared today.

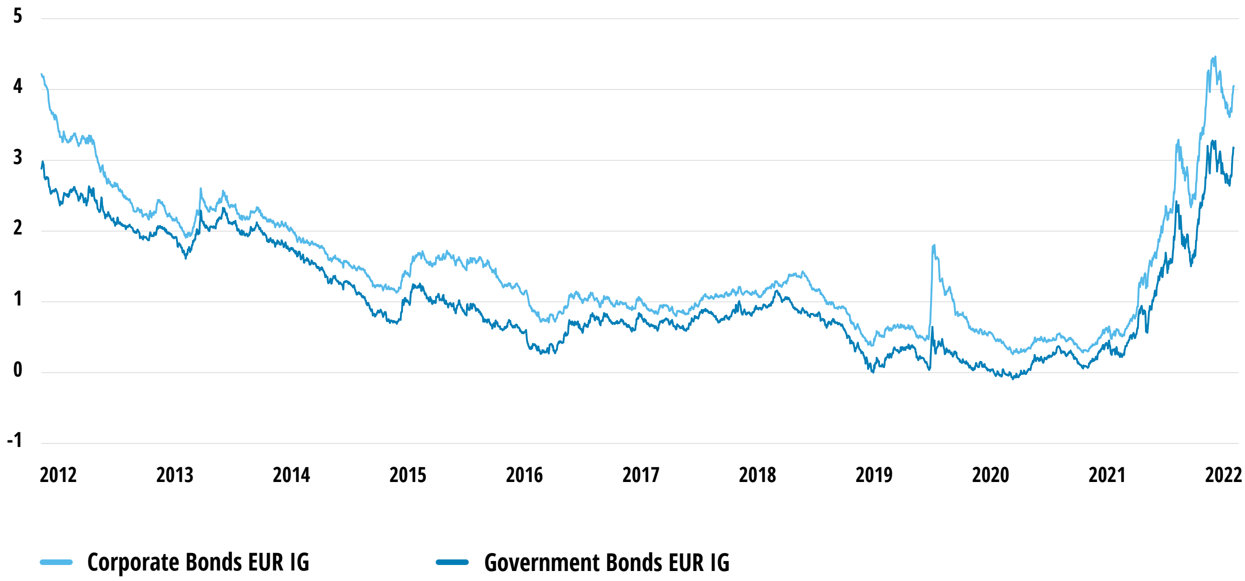
Euro bonds also experienced a historic crash since records began in 1999, tumbling by 15% on average.

Bond yields are back

Meanwhile, steep interest rate hikes are making bonds increasingly attractive. While the outlook is difficult to assess in the short term, the bond markets offer plenty of opportunities for buy-and-hold investors.

Interest rates on quality euro-denominated corporate bonds jumped above 4% in 2022, the highest rate in a decade, with high-yield bonds approaching the 9% mark.

Figure 2: Evolution of interest rates on euro government and corporate bonds



Source: Bloomberg, Econopolis

Emerging markets shine

Perhaps the biggest surprise has come from emerging markets, which continued to perform well despite falling stock markets and rising interest rates.

This is due to many commodity-exporting countries benefiting from high commodity prices. In addition, several emerging-market central banks were quicker to raise interest rates last year to fight inflation than the Federal Reserve, European Central Bank and Bank of England. Finally, inflation increased less in important emerging markets like China, Brazil, India, Mexico, South Africa and Indonesia, compared to more established ones.

Short maturities outperform

Emerging market bonds were not the only winners. In general, the lower the bond's maturity, the better the return, with inflation-linked bonds with short maturities proving the best performers.

CONCLUSION

Bond investments were known as safe havens until last year. While not all bonds were hit equally hard and some saw positive returns, overall, the bond markets witnessed a historic crash, especially for quality bonds.

On the positive side, interest rates on quality euro bonds are now at levels not seen for the last 10 years, and bonds are once again a sound option to diversify an investment portfolio.

TO THE POINT

- Until recently, investors saw bonds as safe havens due to their solid performance for over 50 years.
- However, 2022 witnessed a historic crash in the bond markets as most bonds plummeted to record lows.
- Emerging-market and short-maturity (inflation-linked) bonds were some of the few pockets with positive returns.
- Higher interest rates have increased opportunities for bond investors and diversification options for portfolios.

New vistas for Alternative Investments and Venture Capital in Luxembourg

NICK TABONE
PARTNER
PRIVATE EQUITY LEADER
DELOITTE

HANS-JÜRGEN SCHMITZ
MANAGING PARTNER
MANGROVE CAPITAL PARTNERS

INTRODUCTION

Luxembourg has established itself as a leading player in the financial world, particularly in the realm of alternative asset management and venture capital. In this exclusive interview, Nick Tabone interviews Managing Partner of Mangrove Capital Partners, Hans-Jürgen Schmitz to talk about Luxembourg's venture capital industry. The regulatory framework of the country, which includes influential entities like SICAR and RAIF, has played a crucial role in nurturing the growth of venture capital, attracting numerous firms eager to leverage the region's advantageous financial climate. Hans-Jürgen Schmitz has a unique perspective on the world of venture capitals and uncovers which hurdles asset managers have to go through. Dig into our conversation, as we uncover the evolution and hurdles in Luxembourg's venture capital world.

Mangrove Capital Partners was born in Luxembourg and is a success story. While you have a presence all over the world, Israel, Berlin, London, Barcelona, you have chosen to remain headquartered in Luxembourg. What is it about Luxembourg that makes you want to stay?

Hans-Jürgen Schmitz: When we started off in Luxembourg, VC in Europe was basically nowhere apart from a few players. Back then, we were in a market environment where we had maybe 20-30, maximum 50, venture capital managers. Today, there are over 500, so a tenfold increase in the last 20 years. Adding to this, the average fund volume has increased, which means that the amount of capital that can be deployed in European companies through venture capital has increased about 50 times. Today versus 20 years ago. So, we had a relatively open field at the time. To define who we wanted to be and what we wanted to do was relatively straightforward, there weren't many benchmarks.

Why did we choose Luxembourg at the time? It was a combination of obvious personal reasons. My family and job was here. The founders left their jobs as partners at Arthur Andersen, and it was not an easy decision, so we did not want to change too many parameters.

The other reasons were more practical. We needed to know how to set up a fund, and what it meant for investors, depending on the way the funds were set up? While Luxembourg did not have the toolbox that we have today, the basic instruments that we could use were there, particularly the framework for Part II funds, which is what we used in the beginning. What was also given was the framework, the competency, and the fundamentals of investment management with tax, legal or any other services for that, so that was a relatively easy decision.

And fast forward to today, we never regretted that decision. In hindsight, that choice was probably the best we could have made. Given how Luxembourg has evolved as a financial center and the toolbox it has developed, such as the SICAR or the RAIF, these are all results of the recognition of the market opportunity in alternative asset management. In addition, we never had to second-guess if our fund or our fund structure is compatible with a European, U.S., or Asian investors, whether it's a family office or institutional. It's almost a one-size-fits-all, at least for venture capital.

From an investor perspective, you don't have to explain to them why Luxembourg. And that again takes a lot of friction out of the fundraising process.

What are the biggest challenges facing the VC industry today and how is Mangrove Capital Partners adapting to them?

HJS: Small asset managers, including venture capital firms, have to face a significantly higher regulatory burden compared to larger entities, such as private equity houses. Today, this is a barrier to entrance for a VC especially if you want to market inside of Europe. It may also force VCs to grow disproportionately, which can be problematic, particularly for early-stage investments, where the need to produce for investors may conflict with certain investment strategies.

As we look at the VC landscape today, many are still micro or small funds, 30 - 50 million Euro — the size that we at Mangrove Capital Partners started with. Unless they find some creative way of maneuvering AIFMD, at least in Europe, compliance with regulation may prove to become a knock-out criterion. They do not usually have the resources that we have for example, with dedicated legal and compliance people. This was again a choice we made many years ago.
Outsourcing can be an option of course but you must monitor the performance and costs closely.

I see technology emerging as another solution here in the form of software for investor management, KYC/AML checks, portfolio reporting etc., but it is and remains a major challenge that burdens the VC industry in Europe (vs. the U.S. for example).

The other factor is that in Europe we have an abundance of funding capability for seed and early investments.

On the flipside, money for the growth and scale up phase is at deficit now and, therefore, around 70% of that money comes from outside of Europe, mainly from the U.S. and increasingly from Asia.

Another challenging phenomenon are valuations. Not surprisingly, in the current market the late(r) stages valuations have dropped massively, at least 50% in tech. They track the value trends in the public markets. But the more you look to early stage, the less that drop became visible to the point where I saw some statistics showing that 2022 valuations were at least at the same level, if not higher than in 2021 in early stage, which is completely counterintuitive. As a result, entry valuations remain high, while the short to mid-term perspectives for funding and value creation are gloomy at this stage.

How is this going to play out? I'm not limiting myself to venture capital, but more broadly to the industry. When are we going to see a rebound in sentiment, in valuations, or in market values? To some extent we were all hoping that 2023 would mark a turnaround, but it's likely that it won't happen until 2024.

And then again, I predict this rebound will be slower than post the financial crisis. A few fundamentals are different. We have overriding political uncertainties and crises that we didn't have at that time. Next, the interest rate level (if it lasts) will lead to asset reallocation. Investors have the choice of balancing high(er) risk tech stocks with high alpha and more conservative investments including fixed-income options, which will likely redirect money away from alternative assets, and less money supply will affect asset prices.

Finally, higher interest rates will also weigh on valuations because it means higher discounts on future cash flows, thus lower valuations. To illustrate, one of the key valuation measurements in high-growth private companies is sales or revenue multiples. They used to be as high as 15 of 16 on average on listed stocks in 2021. Now we are at 5 to 7. We may not see these come back anytime soon.

The first signals of recovery are usually expected from the public markets, at least in the tech industry.

With 2022 being one of the worst years in recent history the earnings announcements in the next quarters will set the sentiment here. Before it trickles down to growth and early-stage tech in terms of market sentiment, valuations, multiples, etc., 2024 could be the year of rebound. Provided interest rates ease, as some experts believe, assuming that on the political front, we start to see ways out of some of the current crisis.

Generative AI is the new hype – as avid investors into the tech sphere, what are your thoughts on this trend and the impact, not only from an investment perspective but even in your business as a venture capitalist?

HJS: AI is obviously the talk of the town. And used (sometimes abused) in every second pitch deck we see. Truth is, it's being developed by experts for at least ten years. Without being noticed by the general public. Until last November, when ChatGPT3 hit the main stage and gave the public a tangible glimpse of what it could do and mean for everyday tasks.

From an industry point of view, we are likely at a seminal moment in (tech) history, comparable to the introduction of the internet. As this technology continues to develop, it is likely that we will see many new and innovative uses for it in the future. And investment opportunities abound. Examples span from content creation, product design, gaming, all the way to specialty application in robotics, healthcare, finance, mobility, legal profession, just to name a few. From an investment perspective, one of the key attributes we will look for are applications that develop and train models on proprietary training data sets (as opposed to those using publicly accessible data sets). K Health, again, is an excellent example as it develops its algorithms exclusively on proprietary medical data. As is edgify.ai, which develops visual recognition-based applications for the retail sector.

In the context of our own business, I think AI enabled applications could become very relevant in deal sourcing, due diligence, and portfolio tracking. There are already quite a few initiatives in this regard, certainly in private equity. AI can be used to identify and evaluate potential investment opportunities with higher accuracy and in less time. Once invested, AI based applications can be used for performance monitoring. On the investor side, identification of new capital sources and more broadly investor relations management could be an area of use. Not to forget, of course, compliance monitoring across the organization in alternative asset management.

Not many venture capital firms get to have unicorns in their portfolios and Mangrove Capital Partners have been involved as early investors in five unicorns, such as Skype, Wix, Walkme, K Health, and TBOL. What is the secret ingredient? (In the business industry, a unicorn is a privately held startup company valued at over US$1 billion)

HJS: The term unicorn is being used, abused and overly emphasized. Statistically out of 1.000 investments over a lifetime not even two would reach unicorn status. By just being long enough in the business or by deploying enough money into the ecosystem alone will not guarantee you will ever encounter one in your portfolio. The profile you create for your firm (VC) and how you position yourself is important in attracting the founders of these startups to take your money.

Firstly, our business is a people's business.

From the founders' perspective, our experience shows that experienced entrepreneurs are more likely to succeed in reaching these levels. Examples for this in our portfolio are The Bank of London and K Health.

Second, it is our observation that many very successful products and companies were built by people with no prior experience in the industry they target. Oftentimes it is about challenging the status quo — free of legacy — to develop groundbreaking solutions. As an example, K Health was not built by doctors, Skype not by telco experts. And while not a rule per se, it has been a key ingredient in our history and success.

Third, it is about a relentless focus on execution and speed. Pursuing an ambitious goal goes hand in hand with building a team and organization that is fast and agile to master growth. A lot of trials, errors, and pivots to keep the focus and adjust your organization along the way, is a rare combination and oftentimes the point of failure. Our job as investors in the early days is to help foster that sense of urgency, the need for speed, the belief in the opportunity. Then help find the right people, help build the foundation of the organization. You will be able to see in a couple of years whether the leadership team is able to perpetuate that recipe and produce outsized business growth as a result.

TO THE POINT

- Luxembourg has emerged as a leading financial center for alternative asset management, including venture capital.
- Luxembourg's regulatory framework, such as the SICAR and RAIF, has been instrumental in facilitating the growth of the venture capital industry in the country.
- The high regulatory burden for small asset managers, including venture capital firms, is a significant challenge, particularly for those seeking to market their services within Europe.
- The growth of the venture capital industry in Europe has increased significantly over the last 20 years, with the number of venture capital managers increasing tenfold.
- Early-stage investments require substantial returns, and growth pressure can be problematic for venture capital firms.

A decade in the fight against money laundering and terrorist financing

ACHIEVEMENTS, CHALLENGES, AND PERSPECTIVES

INTRODUCTION

In the past decade, governments, businesses, and organizations worldwide have increasingly fought against money laundering and terrorist financing. Despite progress, these threats persist and evolve.

The article provides an overview of some of the most drastic events of the past ten years and regulatory developments in the EU, particularly in Luxembourg, and an outlook on future regulatory developments and perspectives regarding the fight against financial crime.

ALICE LEHNERT
DIRECTOR, FINANCIAL ADVISORY
DELOITTE

ANDREAS SCHMITT
MANAGER, FINANCIAL ADVISORY
DELOITTE

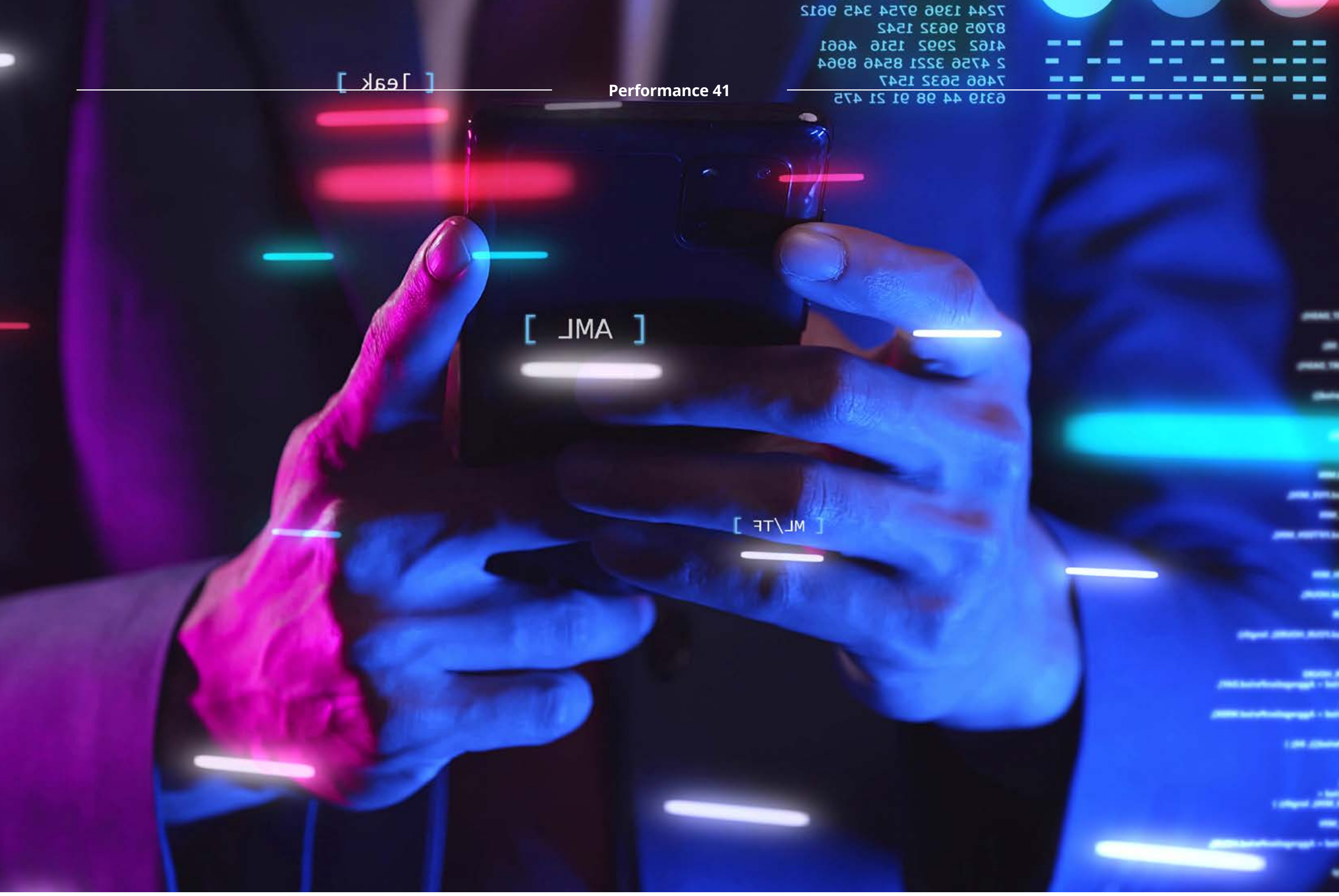
Revelations of the last ten years

Multiple revelations (so-called leaks), scandals, and other incidents related to financial crime have had significant economic, legal, and social repercussions, demonstrating a lack of transparency and ethical behavior.
Despite some of these events being relegated to the background due to numerous developments, it is crucial to revisit the events, to better understand the regulatory changes in the past decade.

February 2014
Crimea annexation

In February and March 2014, Russia annexed the Crimean Peninsula. This event was globally recognized as a violation of Ukraine’s sovereignty and territorial integrity.

In response, the EU and other jurisdictions implemented sanctions and restrictive measures aimed at economically and politically pressuring Russia.



Highly analytical restrictions fell on financial stakeholders with very limited guidance at the time.

November 2014
Luxembourg Leaks

Luxembourg Leaks exposed the tax arrangements made between global companies and the Luxembourg government to optimize tax liability for these companies.

The whistleblower of the relevant tax documents was charged and found guilty. In February 2023, the European Court of Human Rights ruled in favor of whistleblowers' protection.

This is considered by many as "year zero" of whistleblowing definition and protection framework. The EU Directive 2019/1937 and the Luxembourg bill 7945 are rooted there.

April 2016
Panama Papers

The disclosure of approximately 11.5 million confidential documents by the Panamanian law firm Mossack Fonseca, which specialized in the set-up of offshore companies, revealed various financial dealings of politicians, businessmen and celebrities. It also disclosed extensive use of offshore companies to conceal ownership and control structures.

November 2017
Paradise Papers

This leak comprised approximately 13.4 million documents originating from various offshore service providers, attributed to 19 tax havens, and exposed the extensive and complex nature offshore structures used to hide assets, minimize tax burden and conceal the true beneficial owner.

October 2021
Pandora Papers

The Pandora Papers leaked approximately 11.9 million documents from 14 different offshore service providers, exposing the use of offshore structures to evade taxes and conceal ownership.
The publication of the Panama, Paradise and Pandora Papers led to investigations, inquiries, resignations and dismissals. Regarding Pandora Papers, which is considered one of the largest revelations to date, the Financial Action Task Force (FATF) highlights the relevance of transparency about actual beneficial owners' identities.

February 2022
Russian invasion

In February 2022, the President of the Russian Federation ordered a "special operation" to invade four main Ukrainian regions (Kherson, Zaporizhzhia, Luhansk and Donetsk), which escalated the ongoing conflict.

The EU and other jurisdictions implemented and reinforced further sanctions to stop Russia's actions and safeguard Ukraine's sovereignty.
Over the past year, the consequences of sanctions have manifested in various forms.

December 2022
Qatargate

Even before the 2022 World Cup was held in Qatar, it was considered controversial within the EU for various corruption allegations. It is claimed that a Qatari company paid bribes to European politicians to support Qatar's bid to host the tournament.

This has raised ongoing concerns about the integrity and oversight of the EU's decision-making processes and controls within such supranational bodies.

During the last ten years, many other events, such as the Danske Bank scandal, the Russian Laundromat, the CumEx/CumCum files, the Wirecard scandal, or the Berlin clan real estate scandal, occurred in the area of financial crime, triggering regulatory attention and activity. The mentioned events are (in) directly related to the following topics:

- Tax offenses and combating tax crime
- Transparency requirements of beneficial owners
- Restrictive measures (sanctions)
- Whistleblowing

Review of regulatory developments

In the EU, a stable system, created by five successive EU AML/CTF Directives for combating ML/TF, has emerged over the last few decades.

The first AML/CTF Directive was adopted in 1991 to address ML/TF threats to single markets and has since been revised several times to align with FATF standards. Each new EU AML/CTF Directive aims to close gaps — either by expanding scope and/or by introducing targeted measures to detect and prevent new ML/TF practices.

The latest and 5th EU AML/CTF Directive extends its scope beyond the financial sector to include parties, like lawyers, notaries, auditors, real estate agents, luxury goods dealers and all gambling services. The tightened measures concern among others:

- Requirements for identification, tracing, seizure, and forfeiture of criminal assets and proceeds;
- Transparency in money transfers with enriched data and enhanced monitoring;
- Requirements for exchange of information between EU Member States (and the interconnection of beneficial ownership registers within the EU, as well as the improvement of cooperation between FIUs and supervisory authorities);
- Increasing transparency and guidance on ultimate beneficial ownership of legal entities and trusts;
- Expanding scope to include digital assets and new regulations for cryptocurrencies and related financial intermediaries.

However, an EU Directive can only be effective if it is properly and fully implemented by EU Member States at their national level.

How has Luxembourg enforced AML/CTF regulations over the past decade? In Luxembourg, the basis for combating ML/TF was created by the law of 12 November 2004 (the Luxembourg AML/CTF Law), which aimed to implement the 2nd EU AML/CTF Directive.

To comply with international standards and recommendations, both the legislation around ML/TF and the Luxembourg AML/CTF Law have been continuously amended; most recently in 2022. This continuous improvement reflects efforts to adapt to changing circumstances and address the following topics:

- The **scope of professionals** subject to the legislation has expanded to include real estate developers operating in Luxembourg, notaries, virtual asset providers, custodial or administrative service providers, and brokers of art work, including art galleries and auction houses, where the value of a or related transaction(s) amounts to €10.000;
- The requirement for an annual **corporate ML/TF risk assessment** that was introduced, enabling professionals to identify and assess ML/TF risk, as well as establish and adapt internal processes and systems using a risk-based approach;
- The **expansion of enhanced due diligence** measures to include counterparties with politically exposed persons (PEPs) connections and counterparties with relation to high-risk countries;
- The expanded definition of **PEPs** and family members. Directors, deputy directors and board members of international organizations are considered PEPs, and siblings as PEPs family members. This expansion brings board members of an organization, such as the FIFA, under increased scrutiny and due diligence obligations;
- The introduction of a **register of beneficial owners** and the associated information sharing requirements;
- The **Financial Intelligence Unit (FIU)** is vital in

combatting ML and TF, a fact repeatedly highlighted by the FATF. The analysis of collected Suspicious Activity and Transaction Reports (SARs and STRs) and the cooperation with FIUs of other jurisdictions, as well as the relevant law enforcement authorities, contributes to the detection of cross-border ML/TF cases.

Other laws, as well as Grand-Ducal or CSSF ordinances and circulars, supplement the Luxembourg AML/CTF Law. The ordinances and the CSSF circulars provide detailed guidance for individual sectors of Luxembourg's financial industry.

Another cornerstone of the ML/TF fight in Luxembourg is CSSF Regulation 12-02, updated in August 2020, which addresses (among others) investment fund managers and their business activities. Investment fund managers must apply risk-based **due diligence to the assets** in which an investment fund invests and which are tangentially held by various counterparties. The EU is unique in not focusing exclusively on the client/investor side and addressing the associated ML/TF risks, but other countries are expected to follow suit and adopt similar legislation.

The law of 13 January 2019, which regulates the establishment of a **central registry of beneficial owners** of legal entities domiciled in Luxembourg, implemented its 4th EU AML/CTF Directive to improve transparency and traceability of beneficial owners. This measure is indirectly related to some of the events listed above (like Panama Papers), which revealed the need for greater transparency regarding ownership and control structures.

The register was publicly accessible until the European Court of Justice (ECJ) ruled on 22 November 2022 that the fifth EU AML/CTF Directive was invalid for its provision to publicize the information on beneficial owners.

This has temporarily blocked public access to the register in Luxembourg (and other EU countries) until December

2022, and it is now only accessible to professionals with an appropriate authorization to retrieve the data. The EU must revise its EU AML/CTF Directive to ensure the protection of the privacy of beneficial owners. These developments complicate the fight against corruption, money laundering, terrorist financing and the enforcement of sanctions in the EU.

According to statistics, employees are the most frequent whistleblowers of professional fraud incidents, highlighting the need to establish a framework to protect them, as demonstrated by the Luxembourg Leaks. The EU Whistleblower Directive, published on 23 October 2019, aimed to address this issue. However, Luxembourg, among other EU countries failed to meet the deadline for national transposition, which was set for 17 December 2021, due to concerns about the draft's superfluous content like insufficient protection of civil servants, ambiguity regarding imposition of sanctions and data privacy. After the revised draft was resubmitted to the State Council on 23 March 2023, the respective Law was finally published in the Official Memorial on 17 May 2023.

In Luxembourg, the law of 19 December 2020 establishes the framework for **implementing restrictive measures in financial matters**, including those imposed by the UN and EU, such as those regarding Russia. The CSSF prioritizes timely elaboration of relevant processes and screening tools, as assessed during on-site inspections. However, the recent tightening of Russia's sanctions has emphasized the need for financial institutions to adapt further to changing legal and geopolitical conditions.

The law of 23 December 2016 was enacted to prevent tax crime. This led, among others, to the expansion of the list of predicate offenses for money laundering, which includes aggravated tax evasion ("fraude fiscale aggravée") and tax evasion ("escroquerie fiscale"). Simple tax fraud, on the other hand, is subject only to administrative sanctions. All three concepts are clearly defined and distinguished from each other in the law.

In addition, the CSSF published Circular 17/650, supplemented by Circular 20/744, listing the indicators of possible tax crime for the banking and investment fund industry. Both the consideration of tax crime as a money laundering offense in accordance with the requirements of the 4th EU AML/CTF Directive and especially the integration of this issue in terms of combating ML/TF by means of detailed regulatory provisions for the financial industry, highlight Luxembourg's far-sighted position.

The **mutual evaluation of Luxembourg by the FATF** in November 2022, as part of the 4th evaluation round, is another key event to mention, alongside the increasing regulatory requirements compared to the 2010 evaluation report. The plenary discussion related to the visit is scheduled for June 2023. Until then, the outcome of the FATF evaluation and related measures for Luxembourg remain to be seen.

Outlook for regulatory developments

In July 2021, the European Commission presented a package of four legislative proposals to strengthen the EU AML/CTF framework.

In March 2023, the EU adopted three pieces of draft legislation on provisions of the EU AML/CTF package that consists of:

1. the EU "single rulebook" regulation with provisions on:

- conducting due diligence on customers by different entities, such as banks, assets and crypto assets managers, real and virtual estate agents and high-level professional football clubs;
- exchanging information on beneficial ownership, bank accounts, land or real estate registers whereby beneficial ownership means having 15% plus one share, or voting rights and other direct/indirect ownership interest, or 5% plus one share in a high-risk situation;
- lowering the cash payment limit to €10,000;
- using anonymous instruments, such as crypto-assets, and new entities, like crowdfunding platforms and;
- banning citizenship by investment schemes (golden passports) and imposing strong AML controls on residence by investment schemes (golden visas).

2. The 6th EU AML/CTF Directive with provisions on:

- Financial Intelligence Units and their cooperation with Europol, the European Anti-Money Laundering Authority (AMLA), Eurojust and the European Public Prosecutor's office;
- granting access (for at least 2.5 years) to beneficial owner registries including the interconnected central registries for persons with legitimate interest like journalists, reporters, civil society organizations, higher education institutions;
- aggregating information on ownership of goods like yachts, planes, and cars worth more than €200,000 or goods stored in free zones.

3. The regulation establishing the AMLA, a supervisory authority responsible for monitoring risks and threats within and outside the EU and directly supervising specific credit and financial institutions based on their risk level. AMLA can require companies and individuals to provide information, conduct on-site visits with judicial authorization, and impose sanctions.

The EU aims to extend the agency's competence, allowing it to create lists of high-risk non-EU countries and granting AMLA the authority to mediate between national financial supervisors. It also wants AMLA to settle disputes, supervise and investigate the national implementation of the single AML rulebook, monitor the supervisors in the non-financial sector and receive whistleblower complaints. The EU plans to implement AMLA in 2024.

The three draft legislations mentioned are ready for negotiation with the European Parliament after being confirmed during April's plenary session.

The 4th legislative proposals, endorsed by the Council in October 2022, is to revise 2015's Regulation on Transfers of Funds to include transfers of crypto-assets. The proposal was debated in European Parliament on 19 April 2023 and approved on 20 April 2023, in conjunction with the Markets in Crypto-assets regulation (MiCA).

CONCLUSION

Money laundering and terrorist financing are fundamental cross-border problems, particularly for Luxembourg. To combating them effectively, Luxembourg aims to be a leading example in the fight against organized crime.

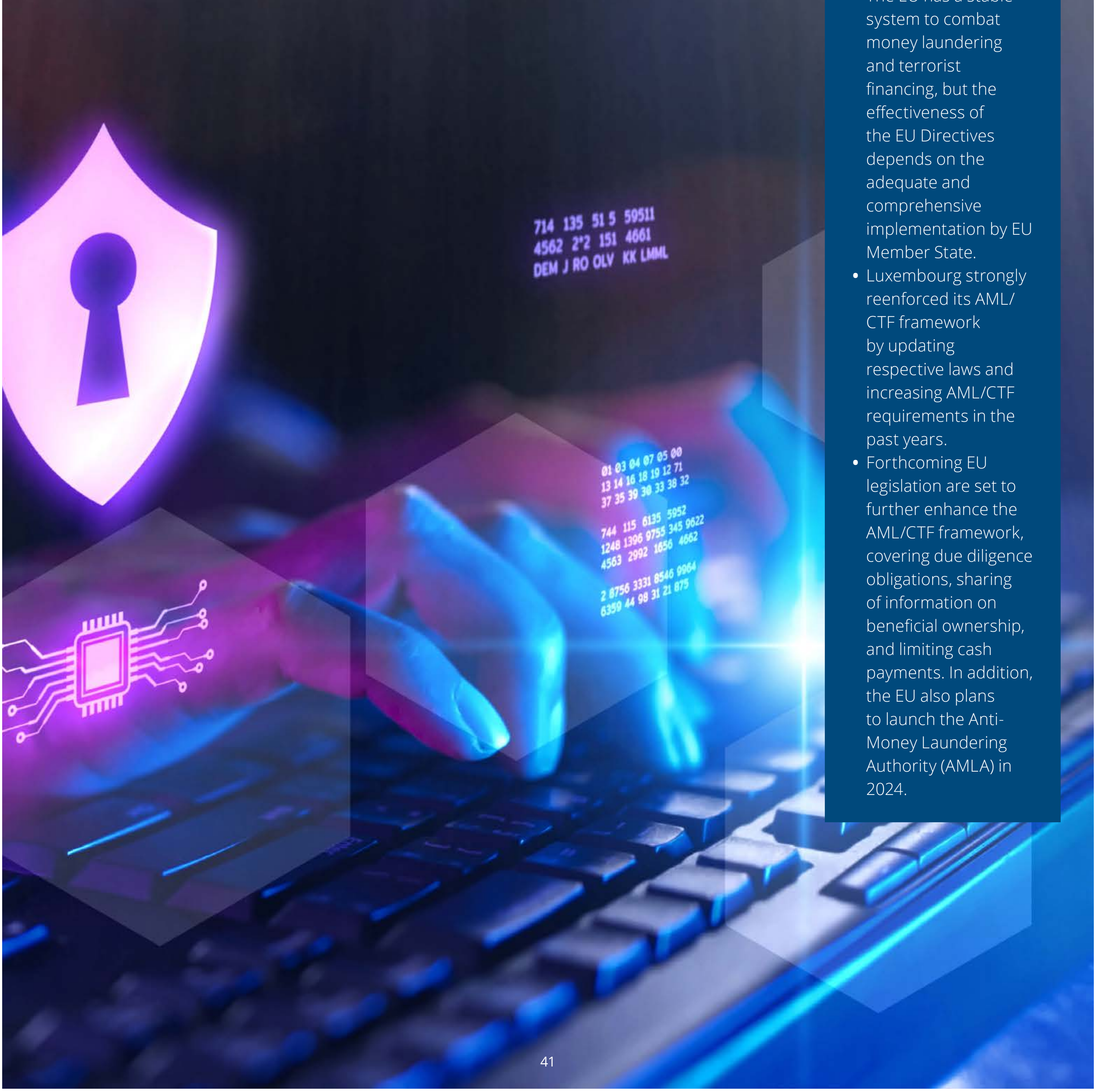
As this article highlights, financial crime intentions and practices and regulatory requirements are both constantly evolving. However, the velocity at which these developments proceed is different. Regulatory developments are often corrective actions that try to cure existing criminal practices.

In addition, EU Directives might be transposed into national legislation with interpretation and local markets specificities, creating potential gaps, inconsistencies, and loopholes for criminals to exploit. Therefore, instead of EU Directives and as already foreseen in the upcoming EU legislative AML/CTF package, EU regulations for combating ML and TF should be issued to have an immediate binding character for all EU member states.

It remains exciting to see how the EU's fight against financial crime will develop and whether current plans can be implemented smoothly and promptly to promote sustainable economic growth.

TO THE POINT

- The last ten years have seen a series of financial scandals, which have led to increased regulatory attention and activity in areas such as tax offenses, beneficial ownership transparency, restrictive measures, and whistleblowing.
- The EU has a stable system to combat money laundering and terrorist financing, but the effectiveness of the EU Directives depends on the adequate and comprehensive implementation by EU Member State.
- Luxembourg strongly reenforced its AML/CTF framework by updating respective laws and increasing AML/CTF requirements in the past years.
- Forthcoming EU legislation are set to further enhance the AML/CTF framework, covering due diligence obligations, sharing of information on beneficial ownership, and limiting cash payments. In addition, the EU also plans to launch the Anti-Money Laundering Authority (AMLA) in 2024.



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Contacts

Africa - East, West, Central and South


Dinesh Munu
Partner - Audit
+27 011 806 5767
dmunu@deloitte.co.za


David Nchimbi
Partner - Audit
+255 222 169 000
dnchimbi@deloitte.co.tz


Joshua Ojo
Partner - Audit
+234 190 421 30
jojo@deloitte.com.ng

Australia


Neal Brown
Partner - Assurance & Advisory Wealth Management
+61 3 967 171 54
nbrown@deloitte.com.au


Siew-Kee Chen
Partner - Tax
+61 2 9322 3823
skchen@deloitte.com.au


Declan O'Callaghan
Partner - Assurance & Advisory
+61 2 932 273 66
deocallaghan@deloitte.com.au


James Oliver
Partner - Assurance & Advisory
+61 3 9671 7969
joliver@deloitte.com.au

Austria


Dominik Damm
Partner - Financial Services Industry Leader
+431 537 005 400
dodamm@deloitte.at


Nora Engel-Kazemi
Partner – Tax
+431537005420
nengel@deloitte.at


Robert Pejhovsky
Partner - Tax & Audit
+431 537 004 700
rpejhovsky@deloitte.at

Bahamas


Lawrence Lewis
Partner - ERS
+1 242 302 4898
llewis@deloitte.com

Belgium


Wim Eynatten
Partner, Tax & Legal
+ 32 478 78 26 27
weynatten@deloitte.com


Tom Renders
Partner, Audit & Assurance
+ 32 474 62 43 78
trenders@deloitte.com


Caroline Veris
Partner - Risk Advisory
+32 477 37 36 58
cveris@deloitte.com

Bermuda


Mark Baumgartner
Partner - Audit
+1 441 299 1322
mark.baumgartner@deloitte.com


Muhammad Khan
Partner - Audit
+1 441 299 1357
muhammad.khan@deloitte.com

Brazil


Cristina Yong Hae Soh
Partner - Consulting
+55 11 5186 1305
csoh@deloitte.com

British Virgin Islands


Carlene A. Romney
Partner - Audit
+1 284 494 2868
cromney@deloitte.com

Canada


Natan Aronshtam
Partner – Tax & Legal
+14 166 438 701
naronshtam@deloitte.ca


Rob Galaski
Partner - Consulting
+14 166 014 594
rgalaski@deloitte.ca


George Kosmas
Partner – Audit & Assurance
+14 166 016 084
gkosmas@deloitte.ca


Mervyn Ramos
Partner – Audit & Assurance
+14 166 016 621
merramos@deloitte.ca


Lilly Zhou
Partner - Tax & Legal
+14 165 214 549
lilzhou@deloitte.ca

Cayman Islands


Dale Babiuk
Partner - Audit & Assurance
+13 457 436 225
dbabiuk@deloitte.com


Anthony Fantasia
Partner - Tax
+13 457 436 244
anfantasia@deloitte.com


Norm McGregor
Partner - Audit & Assurance
+13 458 142 246
nmcgregor@deloitte.com


Stuart Sybersma
Partner – Financial Advisory
+13 458 143 337
ssybersma@deloitte.com

Chile


Ricardo Briggs
Partner - Consulting
+56 2 2729 7152
rbriggs@deloitte.com


Pablo Herrera
Partner - Financial Advisory
+56 2 2729 8150
paherrera@deloitte.com


Alberto Kulenkampff
Partner - Audit
+ 56 22729 7368
akulenkampff@deloitte.com

China (Southern)


Sharon Lam
Partner - International Tax Services
+852 28 52 65 36
shalam@deloitte.com.hk


Anthony Lau
Partner - International Tax Services
+852 2852 1082
antlau@deloitte.com.hk

China (Easter and Northern)


Natalie Na Yu
Partner - Tax Services
+86 10 85207567
natyu@deloitte.com.cn


Lily Fang Wang
Partner - Audit
+86 2161412431
lilyfwang@deloitte.com.cn


Jason Guo
Partner - Investment Management
+86 1085207289
jasonguo@deloitte.com.cn

Colombia


Ricardo Rubio
Partner - Financial Advisory Services
+57 1 546 1818
rrubio@deloitte.com

Denmark


Anders Oldau Gjelstrup
Partner - Audit
+45 20 41 68 02
agjelstrup@deloitte.dk

Finland


Ilkka Huikko
Partner - Consulting
+358 40 740 3529
ilkka.huikko@deloitte.fi


Sami Toivoniemi
Director - Regulatory Risk
+358 207 555 808
sami.toivoniemi@deloitte.fi


Juha Hyttinen
Senior Manager - Strategy and Operations
+358 207 555 653
juha.hyttinen@deloitte.fi

France

Hélène Alston
Partner - Tax
+33 1 55 61 60 32
healston@taj.fr

Yoan Chazal
Partner - Risk Advisory
+33 1 40 88 72 19
ychazal@deloitte.fr

Stéphane Collas
Partner - Audit
+33 1 55 61 61 36
scollas@deloitte.fr

Bruno de Saint Florent
Partner - Consulting
+33 1 58 37 04 46
bdesaintflorent@deloitte.fr

Jean-Marc Lecat
Partner - Audit
+33 1 55 61 66 68
jlecat@deloitte.fr

Sebastien Manelfe
Partner - Financial Advisory
smanelfe@deloitte.fr
+33 1 40 88 85 54

Germany

Andreas Koch
Partner - Audit
+49 892 903 687 39
akoch@deloitte.de

Dorothea Schmidt
Partner - Consulting
+49 699 713 734 6
dschmidt@deloitte.de

Nina Schrader
Director - Consulting
+49 173 258 5554
nschrader@deloitte.de

Christof Stadter
Partner - Audit
+49 89 29036 8269
cstadter@deloitte.de

Alexander Wenzel
Partner - Tax & Legal
+49 69 75695 6111
alwenzel@deloitte.de

Greece

Alexandra Kostara
Partner - Audit
+30 210 67 81 152
akostara@deloitte.gr

Despina Xenaki
Partner - Audit
+30 210 67 81 100
dxenaki@deloitte.gr

Guernsey

John Clacy
Partner - Audit
+44 1 481 703 210
jclacy@deloitte.co.uk

Hong Kong

Anthony Lau
Partner - International Tax Services
+852 285 210 82
antlau@deloitte.com.hk

Iceland

Gunnar Thorvardarson
Partner - Audit
+354 580 3031
gthorvardarson@deloitte.is

India

Rajesh Gandhi
Partner - Tax Leader
+91 22 6185 4380
rajegandhi@deloitte.com

Bimal Modi
Partner - IM Leader
+91 22 6185 5080
bimalmodi@deloitte.com

Indonesia

Rosita Sinaga
Partner - Audit
+62 21 2992 3100
rsinaga@deloitte.com

Ireland

David Dalton
Partner - Consulting
+353 140 748 01
ddalton@deloitte.ie

Brian Forrester
Partner - Audit
+353 141 726 14
bforrester@deloitte.ie

Mike Hartwell
Partner - Audit
+353 141 723 03
mhartwell@deloitte.ie

Brian Jackson
Partner - Audit
+ 353 141 729 75
brijackson@deloitte.ie

Christian MacManus
Partner - Audit
+353 141 785 67
chmacmanus@deloitte.ie

Deirdre Power
Partner - Tax
+353 141 724 48
depower@deloitte.ie

Israel

Ran Feldboy
Partner - Audit
+972 3 6085478
rfeldboy@deloitte.co.il

Italy

Diego Messina
Risk Advisory – IM Leader
+390 283 322 621
dmessina@deloitte.it

Savino Capurso
Audit & Assurance – A&A IM Leader
+390 283 322 531
scapurso@deloitte.it

Paolo Vendramin
Consulting – Consulting IM Leader
+390 283 323 240
pvendramin@deloitte.it

Mauro Lagnese
Tax & Legal – Tax IM Leader
+390 283 324 097
mlagnese@sts.deloitte.it

Japan

Yang Ho Kim
Partner - Tax
+81 3 621 338 41
yangho.kim@tohmatsu.co.jp

Nobuyuki Yamada
Partner - Audit
+81 90 650 345 34
nobuyuki.yamada@tohmatsu.co.jp

Ken Atobe
Director - Risk Advisory
+81 80 405 691 77
ken.atobe@tohmatsu.co.jp

Kazakhstan

Roman Sattarov
Partner - Audit
+7 7272 581340
rsattarov@Deloitte.kz

Luxembourg

Eric Centi
Partner - Cross-Border Tax
+352 451 452 162
ecenti@deloitte.lu

Pascal Denis
Partner - Advisory & Consulting
+352 451 452 970
padenis@deloitte.lu

Laurent Fedrigo
Partner - Audit
+352 451 452 023
lafedrigo@deloitte.lu

Lize Griffiths
Partner - Audit
+352 451 452 693
lizgriffiths@deloitte.lu

Nicolas Hennebert
Partner - Audit
+352 451 454 911
nhennebert@deloitte.lu

Simon Ramos
Partner - IM Advisory & Consulting
+352 451 452 702
siramos@deloitte.lu

Nick Tabone
Partner - Private Equity Leader
+352 451 452 264
ntabone@deloitte.lu

Xavier Zaegel
Partner - Financial Services
+352 451 452 748
xzaegel@deloitte.lu

Malta

Michael Bianchi
Partner - Audit
+356 2343 2879
mibianchi@deloitte.com.mt

Mexico

Ernesto Pineda
Partner - Financial Services
+52 55 5080 6098
epineda@deloittemx.com

Monaco

Julien Le Marrec
Director – Risk Advisory
+377 97 77 27 41
jlemarrec@deloitte.mc

Pascal Noël
Director – Risk Advisory
+377 97 77 47 37
pasnoel@deloitte.mc

Netherlands

Jan-Wouter Bloos
Partner - Consulting
+31 88 288 2768
JBloos@deloitte.nl

Bas Castelijn
Partner - Tax
+38 288 6770
BCastelijn@deloitte.nl

Marieke van Eenennaam
Partner - Risk Advisory
mvaneenennaam@deloitte.nl
+31 88 288 2500

Remy Maarschalk
Partner - Audit
+31 88 288 1962
RMaarschalk@deloitte.nl

Evert van der Steen
Partner - Enterprise Risk Services
+31 62 078 9545
evandersteen@deloitte.nl

Norway

Sverre Danielsen
Partner - Enterprise Risk Services
+47 99 517 686
sdanielsen@deloitte.no

Henrik Woxholt
Partner - Audit & Advisory
+47 23 27 90 00
hwoxholt@deloitte.no

Philippines

Bonifacio Lumacang
Partner - Audit
+63 2 581 9000
blumacang@deloitte.com

Portugal

Maria Augusta Francisco
Partner - Audit
+351 21 042 7508
mafrancisco@deloitte.pt

Singapore

Ei Leen Giam
Partner - Global Financial
Services Industry
+ 65 62 163 296
eilgiam@deloitte.com

Ho Kok Yong
Partner - Global Financial
Services Industry
+65 621 632 60
kho@deloitte.com

Michael Velten
Partner – Tax
+65 6531 5039
mvelten@deloitte.com

Slovakia

Peter Longauer
Partner - Audit
+421 2 582 49 411
plongauer@deloitte.com

Spain

Rodrigo Diaz
Partner - Audit
+349 144 320 21
rodiaz@deloitte.es

Francisco Rámirez Arbues
Partner - Tax
+34 606289571
framirezarbues@deloitte.es

Antonio Rios Cid
Partner - Audit
+349 915 141 492
arioscid@deloitte.es

Alberto Torija
Partner - Audit
+349 143 814 91
atorija@deloitte.es

José María Grande Esturo
Partner - M&A Consulting
+34 944 447 000
jgrande@deloitte.es

Ignacio García Alonso
Partner - Tax
+34 67 952 180
igarciaalonso@deloitte.es

Switzerland

Marcel Meyer
Partner - Audit
+41 58 279 7356
marcelmeyer@deloitte.ch

Simona Terranova
Partner - Audit
+41 58 279 8454
sterranova@deloitte.ch

André Kuhn
Director - Tax
+41 58 279 6328
akuhn@deloitte.ch

Markus Weber
Partner - Tax
+41 58 279 7527
markweber@deloitte.ch

Taiwan

Vincent Hsu
Partner - Audit
+886 2 545 9988 1436
vhsu@deloitte.com.tw

Olivia Kuo
Partner - Audit
+886 2 25459988
oliviakuo@deloitte.com.tw

Jimmy S. Wu
Partner - Audit
+886 2 2545 9988 7198
jimmyswu@deloitte.com.tw

Thailand

Somkrit Krishnamra
Partner - Risk Advisory
+66 2 676 5700
somkrishnamra@deloitte.com

United Kingdom

Allee Bonnard
Partner - Audit
+44 20 7303 0472
abonnard@deloitte.co.uk

Gavin J Bullock
Partner - Tax
+44 20 7007 0663
gbullock@deloitte.co.uk

Jonathan Burdett
Partner - Risk Advisory
+44 20 7303 2580
jburdett@deloitte.co.uk

Baber Din
Partner - Financial Services
+44 20 7303 2878
bdin@deloitte.co.uk

Sheelan Shah
Partner - Tax
+44 20 7007 2779
sheelanshah@deloitte.co.uk

Andrew McNeill
Partner - Consulting
+44 20 7007 6151
amcneill@deloitte.co.uk

United States

Patrick Henry
Vice Chairman
National Sector Leader
+1 212 436 4853
phenry@deloitte.com

Kristina Davis
Investment Management Leader
Risk & Financial Advisory
+1 617 437 2648
kbdavis@deloitte.com

Dave Earley
Partner - Tax
Investment Management Leader
+1 617 319 2048
dearley@deloitte.com

Paul Kraft
Partner - Audit
US Mutual Fund and Investment
Adviser Practice Leader
+1 617 437 2175
pkraft@deloitte.com

Jagat Patel
Partner - Consulting
Investment Management Leader
+1 203 708 4028
jagpatel@deloitte.com

Tania Taylor
Partner - Audit
Investment Management Leader
+1 212 436 2910
tlynn@deloitte.com

Vietnam

Thinh Pham
Managing Partner
+84 839100751
thpham@deloitte.com

Contacts

Julia Cloud
Partner - Global Investment Management Leader
+1 312 486 9815
jucloud@deloitte.com

Vincent Gouverneur
Partner - EMEA Investment Management Co-Leader
+352 451 452 451
vgouverneur@deloitte.lu

Tony Gaughan
Partner - EMEA Investment Management Co-Leader
+44 20 7303 2790
tgaughan@deloitte.co.uk

Ryota Fukui
Partner - Asia Pacific Financial Services Leader
+81 50 303 361 18
ryota.fukui@tohmatsu.co.jp

Please do not hesitate to contact your relevant country experts listed in the magazine.

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