

# Performance

A triannual topical digest for investment management professionals, issue 17, May 2015



## In focus

Interview—To outsource or not to outsource

Hot topic—Private Equity Investing in Africa

Customer centric journey within Asset Management

Will impact investing save our souls?

DAC vs EUSD—Conceding the battle to win the war (against tax evasion)?

Trust in CRS?—The Common Reporting Standard reporting obligations in the context of trusts

Legislation changes and clarifications impacting investment funds—A French update

Combining active and passive managements in a portfolio

How the CRA Regulation will impact the asset management industry

Hong Kong—Towards a new paradigm?

Fair Value Pricing Survey, Twelfth Edition—Positioning for the future

2015 Alternative Investment Outlook —Complex grounds, new frontiers

Do you really know where your assets are, and if they are safe?

Plans to reform the German Investment Tax Act—Overview and impact

# In this issue

6

14

22

30

36



4 Foreword

5 Editorial

6 In focus

**Interview** — To outsource or not to outsource

14 **Hot topic**  
Private Equity Investing in Africa

22 **Customer centric journey within Asset Management**

30 **Will impact investing save our souls?**

36 **DAC vs EUSD**  
Conceding the battle to win the war (against tax evasion)?

44 **Trust in CRS?**  
The Common Reporting Standard reporting obligations in the context of trusts

48 **Legislation changes and clarifications impacting investment funds**  
A French update

48

54

60

64

72

80

94

98



- 54 **Combining active and passive managements in a portfolio**
- 60 **How the CRA Regulation will impact the asset management industry**
- 64 **Hong Kong**  
Towards a new paradigm?
- 72 **Fair Value Pricing Survey, Twelfth Edition**  
Positioning for the future
- 80 **2015 Alternative Investment Outlook**  
Complex grounds, new frontiers
- 94 **Do you really know where your assets are, and if they are safe?**
- 98 **Plans to reform the German Investment Tax Act**  
Overview and impact
- 106 **Link'n Learn**  
Webinars - Programme 2015
- 108 **Contacts**

# Foreword



A prominent philosopher, poet and statesman in Tudor England, Sir Thomas More has been described as “a man for all seasons”, which struck us as being a suitable theme for our leading publication—*Performance* magazine. While this issue coincides with the coming of spring (theoretically at least) here in the northern hemisphere, it naturally also marks the arrival of autumn in the southern hemisphere—from where we take the keynote contributions for this issue, with a focus on South Africa.

Our Deloitte colleagues, together with our valued external contributors from the envious location within sight of the stunning Table Mountain, share with us their thoughts on such diverse subjects as the ongoing debate on outsourcing: to outsource or not to outsource? There is also a fascinating focus on private equity investing in Africa, which is set to offer some of the most exciting prospects of coming decades and be a catalyst for the sustainable development of a truly African economy.

It is interesting to note, meanwhile, that a number of our European contributions focus on fiscal matters, in France, Germany and on a pan-European level—which in itself reflects the change from developing to developed world, along with the complications that can arise and the implications for growth.

From Asia, our own experts examine the wider opportunities for Hong Kong that recent innovation has brought and may bring in the future, this time to those in the shadow of the Peak.

Some subjects know neither season nor geography, and we trust that you will find the article on impact investing from the widely acclaimed Uli Grabenwarter as thought-provoking as we do, although we suspect that you will equally be drawn to the continuing onward march of ETFs as described by our contributors from Lyxor and Asset Protection as seen by BNP Paribas Securities Services from Germany.

No succession of the seasons would be complete without a perennial element, and in this case we revisit—alongside our U.S. colleagues—the issue of fair valuation, as well as the outlook for alternative investing.

Finally, to assist you in keeping track of the never-ending pipeline of regulatory change, we are delighted to include our new ‘regulatory agenda’ poster as a supplement to this edition.

We would like to thank all our contributors for the originality and depth of their contributions to this issue, and above all, to thank you for your attention and continuing support for the enclosed efforts in thought leadership.

Thomas More also wrote: “*An absolutely new idea is one of the rarest things known to man.*” Rare, but not unknown, and we trust you will agree with us that our ‘*Performance for all seasons*’ brings you a rich crop of just such ideas.

We wish you happy and enlightening reading.

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*“A disruptive innovation is a technologically simple innovation in the form of a product, service or business model that takes root in a tier of the market that is unattractive to the established leaders in an industry.”*  
Clayton Christensen

Investment management and its related markets are being disrupted at an alarming rate. Digital technology and innovation are creating significant opportunities for the industry. The traditional distribution markets are being challenged, and we need to keep abreast of the changes.

Emerging markets - and the pros and cons of these - are also high up on the agenda of most investment managers in pursuit of growth and higher returns. The current low oil prices and the related impact on economic factors are affecting the institutional and retail markets in a variety of ways.

Recent events in Africa include the democratic elections in Nigeria, which will hopefully lead that economy from strength to strength. However, the terrorist attacks at a university in Kenya may have a damaging impact on the country's economy, depending on how the aftermath is managed. The deep impact of high levels of youth unemployment remains a barrier to growth, and it is against this backdrop that markets are looking for sustainable growth at manageable risk levels.

The current environment provides opportunities for technology solutions in the risk management arena to ensure efficient asset management. This should benefit innovative asset managers who provide downside protection while tapping into unexplored growth markets and products.

The distribution reach of a fully integrated mobile technology has boosted the mobile money market. This has yet to have its full impact on the retail investment market, which may be a long process. There are definitely advantages for market players, especially in terms of support for the intermediated model and access to additional distribution channels.

The focus on innovation can largely be seen as either being value-creating through new products and services, or as a route to cost savings and more efficient ways of doing things. The trend in the industry has been to become more efficient from a back office point of view, and to ensure that any back office risk is minimised for both the investor and the business.

This edition of *Performance* magazine with its focus on Africa will be an interesting read. It highlights some of the opportunities this market offers, and attempts to provide a high-level insight into some of the current challenges.

Africa is a vast continent and will offer myriad opportunities as markets are opened up, regulations become more rigorous and growth rates outstrip those of more established markets. New entrants into this market will have to be vigilant as they seek to secure their share going forward.

We will see disruption, innovation and all the related changes, and it is important for us to assist our clients with a guiding hand through this process.

We hope that you have a 'disruptive' read.



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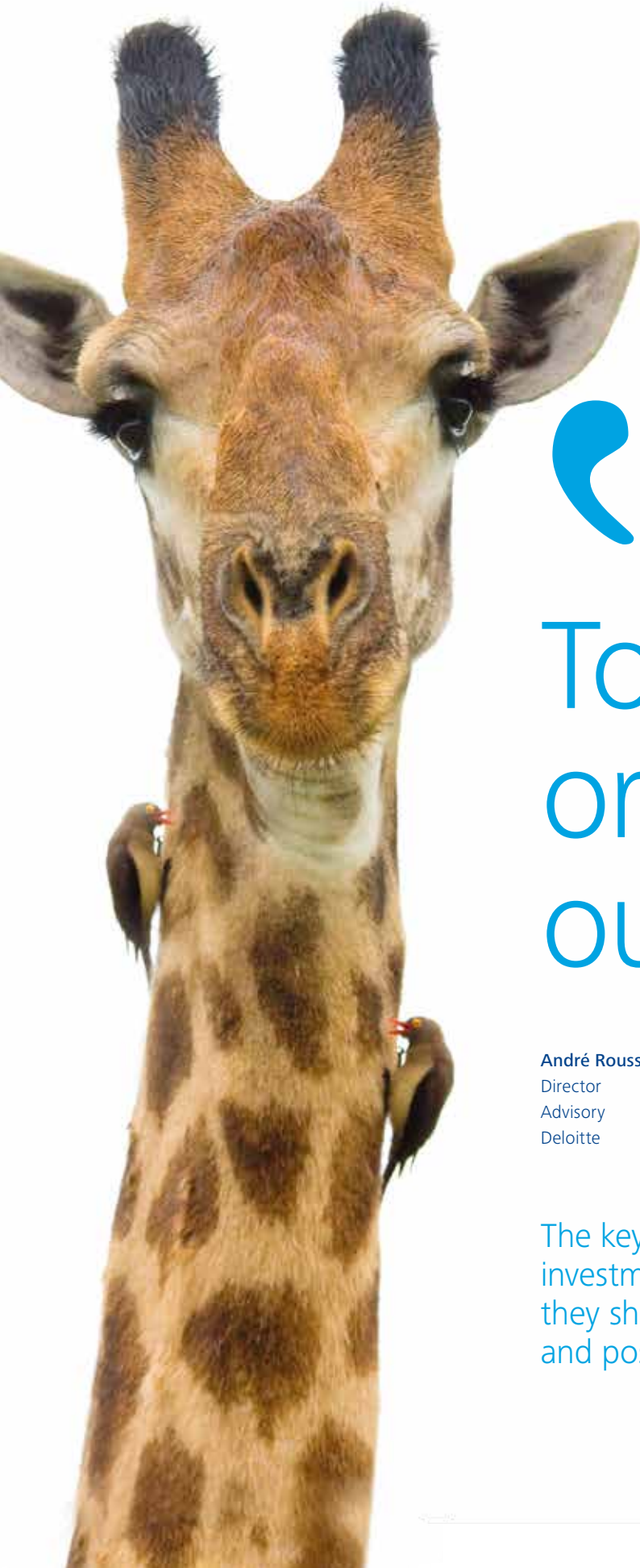
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In focus



# To outsource or not to outsource

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The key question for many players in the investment management industry is whether they should focus on their core business only and possibly outsource their administration.

Outsourcing is the process of delegating a company's business process to third parties or external agencies, leveraging benefits ranging from possible low-cost labour and improved quality to product and service innovation. There have been many different reasons driving this hotly debated topic on the market. Both the insourcing and outsourcing decision has a direct impact on the efficiency of the business and hence the bottom line and related control discussions. Deloitte has interviewed an outsourcing administrator in South Africa to understand their thoughts on the outsourcing model. In addition, we have had a discussion with an asset manager to get a better understanding of the overall picture.

## Questions to administrator

### *1. What would you rank as the top reasons for companies to outsource their back-office operations?*

I would say it is driven by cost reduction, although this should only be ranked in third place among the top reasons. The other top two reasons would be for asset managers to leverage large-scale benefits, such as making use of a larger pool of skilled resources, and lastly for the asset managers to be able to focus on their core functions.

If I had to rank the factors influencing the outsourcing thought process from the perspective of an asset manager, I would say firstly, an increased focus on core internal functions, secondly, being able to leverage large-scale benefits and lastly, reduction of operational costs such as technology overheads. Asset managers should be focusing on brand, product and distribution. Outsourcing providers focus on downstream operations, technology, infrastructure and people.

### *2. What is your view of risk outsourcing being one of the main reasons for companies to outsource?*

It is true that when outsourcing, the risk and accountability of inaccurate processing is transferred to the administrator. However, an administrator has to price this risk into the rate card, so although outsourced, the asset manager still carries some costs relating to risk.

To fully answer the question, it is important to understand the way in which the industry is split. There are institutional administrators and the larger retail/fund accounting companies. The liability for retail or fund accounting companies is large, meaning that if you get a price wrong on a fund, it translates into a potentially large liability for the business. You need to have a decent balance sheet to back up that level of risk. Liability for institutional administrators is far smaller. It is limited to trade errors and the biggest risk lies with the platform business. Liability related to the process of balancing model portfolios is larger than that of pure administration, but this also does not run into the hundreds of millions since it is at a per-investor level. Also, on cash transactions, an incorrect distribution and pay-out could occur, but this is recoverable and there is therefore limited liability.

If outsourcing is driven by a desire to outsource risk, it is best to look for outsourcing providers who have a decent balance sheet and comprehensive insurance cover.

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## Some clients expect to outsource the relationship with the investor

*3. Most provider selection processes go through formal RFIs and RFPs (Requests For Information/ Proposal), and clients start off with a long list of potential providers and conduct proper due diligence before they make decisions.*

*a) What are the main 'value-add' activities that you offer to clients?*

*b) What differentiates you from the rest of the outsourcing providers?*

The 'value-add' or differentiating factor is first and foremost our reputation within the market. Above all, we strive to deliver on our promises. Other aspects include the fact that we own our own technology in-house, meaning our clients are not exposed to dollar-based pricing on technology; the scale of our business and our company's track record; and the quality we deliver, i.e. our low error rates. We are also sufficiently confident about our quality that we do not benchmark on price, but on quality. Our error rate is less than 0.5% for unit trust clients and less than 1.5% for platform clients.

*c) What are the critical areas of success for outsourcing investment back office operations?*

The asset manager's business model is one of the most important aspects. The complexity of the investment products and broker relationships should be understood and carefully considered. Client relationships are also key, identifying the critical touch points for communication to drive proper change and a full transition. Another is pure data; the data conversion should be accurate and precise to ensure a start on the right foot.

Lastly, I would mention integration—this is very important as part of a 'black box solution' offered to clients. Nowadays, clients expect this box to include fully transactional web services, integration to banking systems and other group components as well as communication with the client's large-scale broker bases to bring in flat files, etc.

*4. One of the main considerations that prospective clients look at is the amount of capital outsourcing providers spend on investing in system improvements and process innovation.*

*a) What percentage of the annual budget is spent on system improvements and process innovation?*

In order to answer the question, it is important to understand that the percentage of revenue budgeted for system improvements and process innovation needs to consider the influence of regulatory changes, which translates into costly process and technology changes. Another key factor is the volumes required to drive sufficient turnover for investing; we invest between 5%-10% of turnover on system improvements and process innovation per annum.

*b) In terms of investing in system and process innovation, how do you measure return or cost savings?*

Measuring cost saving is first of all being able to achieve more with the same or smaller amount of people. This should result in a lower cost and increased revenue output. To this end, however, administrators must embrace Straight Through Processing (STP) and invest in seamless integration and automation to remove repetitive, redundant and manual intervention. Any innovation should further reduce the total cost of ownership of a system which includes possible direct and indirect costs.







**5. In an era of record regulatory fines, there is focus on asset managers to have effective oversight and supervision of the outsourcing service provider's operations.**

*a) Do you find the oversight of asset managers on your business processes to be a burden?*

We view transparency and trust as a standard part of our service delivery. It is therefore not viewed as a burden, rather an area of competitive advantage.

*b) What is required from you to provide them with an effective oversight and supervision model?*

We provide clients with peace of mind through objective reviews and proper internal controls. This is enforced through high quality internal audits, transparency of external audits and adherence to standards for internal control. Our internal audits are comprehensive and objective, which is evident in the fact that they are not performed by our own internal audit team but by an audit team provided by our clients.

*c) How do you manage this relationship?*

We manage this by providing total transparency and ensuring a 'total trust' relationship with our clients. We take every effort to ensure quality audits which should bolster trust relationships. We require auditors to have good industry insight and knowledge of our company and aim to have continuity in this regard.

**6. In general, what liability does the outsourcing service provider carry, in terms of:**

*a) 1) transactional errors, and 2) reputational damage?*

An outsourcing provider should always limit its liability in contractual clauses. We contract out our third-party liability therefore only direct asset management clients have recourse to us. Recourse amounts are capped and linked to between 50% and 100% of the annual fee.

**7. Finding the right staff seems difficult, especially with outsourcing providers claiming that they specialise in fund administration.**

*a) How difficult is it to find and retain experienced staff for your business?*

The current availability in the market is good, but it is also clear that resources are much more qualified today than in the past. In the early days, the average administrator just had a high school certificate whereas today, the average administrator is better qualified. Subsequently, the expectation from staff has also increased. It has become more difficult to retain the newer, younger generation resources as they join the administrator to make a high impact in a short time in order to gain sufficient experience to possibly move on. We attract good resources quite easily as we are a well-reputed employer. This is largely due to the steep learning curve experienced by staff. The major trade-off is that larger banks are aware of this and inevitably offer our staff positions once they have experience.

**8. What are the assets under management of the clients that you would consider outsourcing?**

The amount of assets under management of clients looking to outsource varies. There is, however, a minimum bracket applicable to clients with whom administrators will engage in business. Generally speaking, our operational efforts are split approximately 50/50 between clients with AUM of less than R50 billion, and clients with AUM of more than R50 billion.

**9. Looking at your clients across the spectrum, how many transactions are required to reach profitability?**

The exact number of transactions differs from client to client, however a general rule of thumb is that if profits do not show within the first 18 months of a relationship, cost, risk and liability should be reassessed.

**10. How does your pricing model compare with or differ from an AUM fee pricing model?**

We don't charge an AUM fee as a primary source of income. AUM fees are only charged if the complexity of the operations warrants it, which is normally related to platform products. In the unit trust business, which is becoming increasingly standardised, fees are transaction based. The reason for this is that our risk is transaction based, i.e. based on the number of people and amount of technology required to perform a trade transaction. We also found that a growing number of asset managers are reluctant to pay an AUM fee as they are keen to marginalise the cost per transaction.

**11. What are some of the myths you find clients believe or challenges due to incorrect perceptions?**

Up-front clients believe "outsourcing will be much cheaper". Although some direct administrative costs are cut, it is not necessarily cheaper. That said, asset managers definitely gain a great amount of value through outsourcing. Clients believe outsourcing instantly simplifies their current complex processes. They forget the trials and tribulations encountered with administration in-house; and try to outsource their problems. The greater number of human interventions can result in error and/ or create complexity at some point.

They also believe that outsourced operations will make their technology investment costs disappear. This is not true; although the client does not physically own and maintain the technology, there will always be investment in technology. This enables clients to pay a fraction of what other companies pay for technology.

Further to the myths mentioned, there are also some challenges between the outsourced provider and the client. Clients' expectations that processes should be faster, irrespective of the added complexity and constraints, become unreasonable. Clients outsource a product's administration, for which they remain the custodian, but they themselves do not fully understand the complexity surrounding the administration of such a product.

Some clients expect to outsource the relationship with the investor. For example, platform products have complex distribution channels, which require a customised approach and specific attention. This remains the responsibility of the asset manager, thus nurturing the relationship with the investor.

**12. What are some of the main issues/softer touch points that need to be addressed when clients are transitioning to outsourcing?**

Simply put, clients struggle to let go of the past. The way in which administration is carried out in-house versus outsourced will change during outsourcing and therefore, a relationship of trust must be built. A major touch point is around ownership by the right people and at the appropriate levels to be able to make key decisions. Transition to outsourcing require visionaries and change agents. Otherwise, processes and systems are just customised to produce the same old results, which led to the decision to outsource in the first place. More often than not, change is owned at too low a level, or by individuals who are not geared towards the strategic growth of the company. Lastly, I would stress the importance of understanding the reasons behind the outsourcing decision to make sure the outsourcing agreement meets the client's expectations.

We have succeeded in creating relationships across the range of management levels and role players. We provide control and transparency as a default. Client confidentiality and data security is an area where we have made major investments, and this is taken very seriously. We consider ourselves to be ahead of the curve in this area, employing various data intervention and scrambling techniques, penetrations tests, cyber security, IT audits and data oversights, etc.



### **13. What do you think is the biggest threat to Investment Administration Outsourcing?**

I think one of the biggest threats to outsourced administrators is technology automation where the way of the future is simply an online switch. Data processing hubs can only survive if automation is low and market uptake for technology is slow. Currently, asset managers and brokers are just not sufficiently feeling a price squeeze to fully utilise electronic channels and remove manual processes such as the manual forms and OCR (Object Character Recognition). Subsequently, other specialised technologies simply do not work as well as intended in a complex, rule based environment. The other threat, closely linked to technology, is Straight Through Processing (STP). STP dramatically reduces cost per transaction, but is dependent on electronic data feed channels.

Besides threats to outsourcing administration, the investment management industry as a whole is also looking at a major threat: getting hold of new money. Presently, the churn rate is only increasing with increasing competition, competitors are stealing each other's investors. Investors are paying an increasing amount of switching fees for limited performance in a flat market. Where will the 'new money' come from, if the 'currently unbanked' are not investing?

As an end note regarding market appetite, the appetite for outsourcing unit trust (mutual fund) administration is far greater than that of platform products. Unit trust administration is seen to be an arm's length activity and distribution is not complex. It is rather fund and fund performance management that sells the product. The LISP (Linked Investment Service Provider) industry is immature and many of the old complex investment products are still in the market, making administrative standardisation very difficult. This in turn reduces the inclination to outsource the function. As the new LISPs of the world come into play, the appetite for outsourcing LISP administration should also grow.

### **Questions to Asset Manager**

**1. Outsourcing is a viable option for many asset managers looking to grow their operations and networks, but there are many aspects to consider in determining whether this is the right choice.**

*a) What are some of the main barriers that asset managers should consider when deciding whether to outsource?*

First of all, the smaller asset managers don't actually have a choice as they do not have the capital to invest in infrastructure to operate their own fund administration. Also, recruiting the right staff is a challenge and if an asset manager is located in a remote area, they will find it difficult to attract the right staff with the required expertise. Larger asset managers can actually perform fund administration at the same cost as outsourcing, but their decision would be driven by their focus on core business rather than cost.

*b) What made you consider outsourcing?*

Due to standard processes around settlements and transactions, etc., outsourcing is becoming a hot topic and the outsourcing provider actually focuses specifically on these commodity-type services. There is an expectation that outsourcing providers have the expertise to perform these services effectively, and this allows us to focus on our core business functions. Also, having to spend capital on resources, training and system upgrades, etc. is making us reconsider the effort and capex versus the actual benefit that we get from keeping these functions in-house. These are unnecessary issues that just distract our focus.

*c) What are the key principles that you look for when selecting an outsourcing provider?*

One of the key principles is definitely the need to buy into the outsourcing provider's operating model, as our core business should not be impacted when outsourced. What is also important is their adaptability to regulatory changes and how effective they are at dealing with sudden changes imposed by regulators.

Process transparency plays a huge role as this determines the effectiveness of our relationship with them, and the ability to negotiate bespoke processes. Lastly, we also look at the experience of their staff and their ability to retain staff - as we know from experience that this is a challenge.

**2. A well-developed support service for asset managers can leverage capabilities, reduce cost and increase agility to deliver sustainable business value.**

*a) On a scale of 1 to 10, how effective and efficient is your in-house support service (back office processing)?*

I would give our in-house support service a 5 out of 10 and this is largely due to the special admin complexities that increase the risk of handling the administration of funds. There are various bespoke processes and workarounds that need to be created to manage issues, and this also adds to the risk and complexities.

*b) Does your back office support service deliver true sustainable business value or is this more of a burden (cost centre) to you?*

Most of the fund administration is standardised and assists the core business, but it is the bespoke processes that you create around older and weaker systems that end up being a burden to the business. As mentioned

earlier, keeping up-to-date with all versions and upgrades requires great amounts of capex and this can distract from the business' core focus and eventually result in decisions being made not to upgrade. This in itself creates downstream issues and complexities and ultimately turns your support service into a burden or cost centre.

**3. In an era of record regulatory fines, there is a regulatory focus on asset managers to have effective oversight and supervision of outsourcing service providers' operations.**

*a) What effective risk measurements and in-house processes do you have in place to monitor the outsourcing service provider's operations?*

Well, the FSB (the Financial Services Board) requires that you have sufficient processes in place to monitor the outsourcing provider since the overall liability still sits with us as the asset manager. This again requires additional capex to recruit the right staff with adequate experience to monitor the outsourcing provider. The main challenge lies in recruiting and retaining the right staff as the competition in Johannesburg is high. If you don't have staff with the right experience or sufficient staff capacity to monitor and oversee these processes, you will lack a stringent oversight and supervision process.



**To the point:**

**Strategic reasoning behind outsourcing:**

- A drive to focus on core activities and enabling the redirecting of key resources to core activities
- Trying to unlock operational efficiencies by collaborating with an existing outsourced solution platform
- Accelerating the enablement and possible migration to new technologies
- Possible savings from reduced overheads and certain direct costs
- Staffing flexibility and possible mitigation of talent shortages required from the asset manager
- Possible outsourcing of risk management from a process point of view. The reputational and client risk, however, remains the responsibility of the client facing asset manager/wealth platform

**Established myths:**

- Outsourcing will solve all the internal problems of the asset management company
- Outsourcing will always make you save money
- Outsourcing companies will always perform the function better than what the asset manager could

The decision of outsourcing should be based on the right reasons and inevitably managed through a stringent vendor selection process. The relationship should be fully collaborative and transparent to ensure a trusting business relationship. There are many advantages of outsourcing, but these can easily be negated by not having measurable controls in place with fully agreed accountability metrics.



# Private Equity Investing in Africa

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Private equity in Africa dates back to the mid 1980s, with the emergence of the first South African based and South African focused funds. The footprint of private equity funds has evolved over time—from starting out in South Africa to now being located across most of Africa.



Economic growth projections for Africa are expected to remain relatively high, sparking intense interest among global investors. Investors are chasing the few available deals in Africa and expecting double-digit growth rates and super-returns on their investments.

A growing middle class, greater disposable income and lower oil prices are spurring the corporate and retail sectors. This, together with the need to invest in infrastructure—including transport, electricity, telecommunications as well as social and welfare infrastructure on the Government’s side—is where investors or private equity funds see opportunities for real growth and sustainable returns.

Africa is definitely on the map and on the minds of many investors. Nevertheless, South Africa, which according to the World Bank is currently the continent’s second largest economy, is expected to face a number of tough economic challenges going forward.

Some of the factors hindering the potential GDP growth of the South African economy are commodity prices, labour policies, electricity, rail infrastructure and the lack of a technologically advanced manufacturing sector.

Also, uncertainty in Nigeria—the largest economy in Africa—in the run-up to the pending elections as well as threats by Boko Haram, leakages in the economy and falling oil prices could have a major, negative impact on economic growth.

As governance structures and the regulatory environment improve, there will be a big push for private equity to plug the infrastructure gap in Africa. Infrastructure is seen as a high-quality asset for diversifying the risk and return profiles of funds.

### How does private equity work in Africa?

Private equity funds in Africa typically follow a commitment and drawdown model, which means that investors commit a certain pool of capital at the launch of a fund and are only requested to transfer cash to the private equity manager as investments are identified or costs are incurred.

The track record and reputation of the manager enhance the capital-raising process.

Once the funds have been raised, the manager invests in specific portfolio companies over a period of five to ten years. After identifying and purchasing assets, the aim is to enhance the value of the company over a period of five to seven years and then sell the asset at a much better price than was originally paid. The targeted returns of funds are generally between 20% and 30% over the term of the fund. Some form of leverage is utilised to obtain capital efficiencies during this process.

These funds typically return capital during the course of the fund's life as investments are realised.

Private equity fund managers need to deliver a net return that compensates investors adequately for the lower liquidity and higher risk in the asset class.

Importantly, the private equity incentive model creates superior alignment between investors and fund managers. Fund managers only participate in the fund's returns after investors have received their capital back, plus a hurdle return. This means fund managers typically only start to share in the profits of a fund at the end of its life.

The combination of having to outperform liquid benchmarks over the long-term and incentive structures makes for an excellent ownership model that aligns investor, fund manager and portfolio company management interests around building portfolio companies into fundamentally better businesses.

### State of the industry

#### South Africa

South Africa is no longer the destination of choice for private equity houses in Africa, with more funds going to Kenya and Nigeria.

The private equity industry in South Africa is increasingly more stable and established, but some of the portfolio companies are unable to match the expected returns in East and West Africa.

In fact, South African corporates are also going north in search of growth and returns. Certain private equity houses in South Africa are looking towards their investee companies to provide some traction and opportunities in the rest of Africa.

The returns provided by this asset class nevertheless remain higher than those on listed equities and bonds. Moreover, this is a sophisticated market that continues to offer opportunities for the private equity industry.

Another observation in South Africa is that fundraising once again seems to be going very well, and General Partners (GPs) are able to close their funds with support from local pension funds, insurance companies, asset managers and even global investors. Though it has taken them longer, General Partners with a good track record have closed their funds.

The challenge in the past 24 months has been the deployment of capital and identification of investments that offer value to both the seller and private equity houses. The private equity houses have not been able to get investments at asset spreads that made sense for them to do the deals. The price difference between buyer and seller has been too wide. This has improved in the last 6 to 12 months, and a few investments have been made.

The structure of deals and amounts of leverage are also more important to ensure value generation and growth in the investee companies. General Partners are now



spending more hands-on time with investee companies to extract value in the longer term. They are looking to provide strategic direction, capital and growth opportunities to investee companies.

There is also more focus on infrastructure related assets. Larger pension funds are getting more sophisticated and are looking to support government initiatives for infrastructure growth and sustainable energy projects. Infrastructure bond and related money market assets are also attractive as an asset class offering good returns and security.

This is having a positive impact on investments in asset classes that will stimulate growth in sustainable asset classes and provide more active input in asset allocations.

Another interesting trend is the direct investments by Limited Partners (LPs) in certain investee companies. This has positive impacts in that there is a skills and experience transfer between GPs and LPs. LPs are building a skill set they previously did not have.

Funds and GPs are also looking at other ways to efficiently manage capital commitments and their own balance sheets and, at the same time, diversify their revenue streams.

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Africa is definitely on the map and on the minds of many investors



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## The positive spin-off for growth in African economies is evident, as it includes growth for the sectors in which investments are made, job creation, as well as other economic stimuli

### East Africa

New investments are increasingly targeting growth SMEs in consumer-driven sectors. There is activity across infrastructure, real estate, healthcare, agribusiness and green energy. Additionally, players are keen to see how the evolving regulatory space (especially in Kenya) will open access to pension funds as a source of capital. Private equity players have continued to stress the importance of having a professional association. Investors would like to have a unified voice and an avenue to share insights on the opportunities and realities of investing on the ground. One of the initiatives that have been put in place in this respect is the founding of the East African Venture Capital Association (EAVCA).

The current and expected growth in African pension funds with asset bases, due to rising incomes, will likely make these players look beyond traditional asset classes to diversify their portfolios. Given the long-term nature of private equity (the typical lifecycle of a fund being eight to ten years), this asset class is an obvious choice. The prudential requirements to safeguard members' assets and the confidence to manage risk, return and liquidity of private equity as an asset class will be important considerations when pension funds allocate funds to private equity houses.

In more developed markets, private equity and hedge funds are classified as alternative asset classes in the prudential regulations and given a much higher asset allocation than is currently the case in Africa.

Several countries in Africa have seen changes in pension fund regulations to allow a higher proportion of assets to be allocated to alternative classes of investments (e.g. Private Equity and Hedge Funds). We have also seen increasing regulation for the private equity and hedge fund markets.

Given the sophistication of most private equity houses in terms of fundraising, investment deployment, the provision of strategic guidance to investor companies, stringent mandates and adequate investment controls as well as due diligence, there is an opportunity to have some structure and reassurance in these asset classes. The positive spin-off for growth in these economies is evident, as it includes growth for the sectors in which investments are made, job creation, as well as other economic stimuli. An added benefit is the improvement in the skills and knowledge base, as private equity houses aim to enhance their brand and reputation for future funds.

In their search for higher returns and blended risk fundraising for East Africa, funds have been very successful and are expected to be more buoyant in the near future. Confidence in private equity houses and their ability to beat targeted returns has seen the number of funds increasing significantly year on year. Once the funds have been raised, the GP needs to identify and deploy investments.

Large companies have traditionally been owned by extremely wealthy families that receive backing from local banks. They have strong market insight and flexibility and the necessary relationships to do deals quickly. The opportunity for the GP lies in getting to know the market and environment in which it wishes to invest and attempting to use local expertise to support this. Investing in companies from afar will not work, as it is too easy to lose sight of the investments.

Proper due diligence covering financial, tax, regulatory and operational aspects of investee companies will be the safest way to deploy capital and then maximise investments.

## Mauritius

Mauritius is still the preferred jurisdiction for investment into Africa. The South African International headquarter company regime, recently launched by the South African Revenue Service to compete with Mauritius into Africa has not been that successful, particularly in relation to private equity, as there are a number of restrictions on investments and shareholdings that are inconsistent with private equity.

According to statistics from the African Venture Capital Association, around 165 private equity funds are currently registered in Mauritius. The general view is that Mauritius has the most conducive enabling environment in Africa for private equity funds in terms of investment climate, perceived low political risk and availability of financial services providers backed by skilled professionals and enabling legal, regulatory and institutional frameworks.

Mauritius has emerged as an international financial centre due to its strong regulatory framework in line with international initiatives to fight money laundering and the financing of terrorist activities.

In addition, Mauritius has signed 42 double taxation agreements (DTAs) with both developed and emerging economies around the world. Six more DTAs, which are based on the OECD model, are awaiting ratification. Mauritius has become a reliable and competitive hub, where investments are structured and managed. It has positioned itself as the preferred jurisdiction for investing in Africa. Furthermore, the island has entered into Investment Promotion Protection Agreements (IPPAs), with 26 countries around the globe, in particular with eight African countries: Burundi, Egypt, Madagascar, Mozambique, Republic of Congo, Senegal, South Africa and Tanzania—thus opening a new window of opportunity. Moreover, agreements with 14 additional African countries await ratification, namely Benin, Cameroon, Comoros, Gabon, Ghana, Guinea Republic, Kenya, Mauritania, Nepal, Rwanda, Swaziland, Turkey, Chad and Zimbabwe.



Mauritius has established itself as one of the most successful financial centres because it has created a business-enabling environment that is internationally competitive and will continue to attract Private Equity Funds (PEFs) operating in Africa. The key features of this competitive, enabling environment include an established legal, regulatory, financial and institutional framework, as well as expertise in PEF administration. PEFs and other financial service firms focused on Africa are drawn to this, leading to a financial services sector that accounts for 10.5% of the country's GDP.

### To the point:

- There are many opportunities for private equity funds seeking superior returns in Africa.
- Funds need to understand the local markets and industry in which they would like to invest.
- Earnings growth will be the key driver of private equity investments in the next few years.



## A client perspective: Rohan Dyer Head of Investor Relations, Ethos Private Equity

Ethos Private Equity is a leading private equity fund manager in South Africa.

### *What are the current issues affecting asset classes?*

In South Africa, revisions to Regulation 28 introduced more flexible limits on retirement fund allocations a few years ago. This has widened investors' opportunity set significantly. Regulation 28 now stipulates that retirement funds can allocate up to 10% of assets under management to private equity. Many funds are still well below this limit.

Consequently, the industry is likely to benefit from substantial inflows in the coming years, as it is regarded as an attractive asset class in its own right. It is a productive contributor to the development of the local economy. In addition, diversification into private equity is a sensible strategy at a time of elevated valuations for listed markets.

### *What are your views on current returns?*

Ethos is the most experienced private equity firm in our region. Established in 1984, we have made 102 investments since then and have exited 89 of them. We have a long track record of superior returns. The average internal rate of return on our realised assets has been 32% in dollar terms. We have achieved a 2.7x average multiple of cost on these investments, again in dollar terms.

### *What is the value proposition in private equity for Ethos?*

Corporate social responsibility is a cornerstone of our value-adding model, especially as we operate in emerging economies. From day one of our investments, we build these elements into our investment thesis to drive the appropriate behaviour and goals within our portfolio companies. We do not view this as a box-ticking exercise; it makes good business sense, and it results in more sustainable, more attractive assets on realisation.

In South Africa specifically, we view Black Economic Empowerment as a deal enabler. It enhances our origination capacity. We have significant depth of experience and expertise in structuring and creating value for all stakeholders from such transactions.

### *What are your views on Africa?*

The outlook for Sub-Saharan Africa (SSA) is optimistic, and growth is likely to surpass the global average by a good margin in the coming years. The IMF is forecasting GDP growth for SSA of 4.5% for 2015 and 5.1% for 2016.

There is a substantial amount of dry powder to be deployed by private equity firms across SSA in the coming years, which raises the likelihood of elevated entry multiples and disappointing returns for funds of this vintage. According to EMPEA's<sup>1</sup> statistics, fundraising in SSA totalled \$4 billion in 2014, which was almost double the previous record year (2008).

The case for using South Africa as a gateway for investing in opportunities across SSA remains a convincing one. Although the local economy is not likely to grow as quickly as the SSA average in the next few years, it has significant advantages that compensate for that. The country is a hybrid of Developed Market corporations, financial institutions and infrastructure, with many industries exhibiting emerging market growth characteristics and return profiles. Furthermore, South Africa has a number of compelling private equity enablers: standards and execution capabilities are world class and access to debt and ease of exit both help to enhance returns.

In the 2015 edition of The World Bank report on 'Doing Business – Comparing business regulations for domestic firms in 189 economies', South Africa compared favourably with its African peers on the two criteria that we believe are the most important for private equity investors. Firstly, it ranked 43<sup>rd</sup> in the world on 'Ease of doing business', which was well ahead of Ghana (70<sup>th</sup>), Kenya (136<sup>th</sup>) and Nigeria (170<sup>th</sup>). Secondly, South Africa was 17<sup>th</sup> in terms of 'Protecting investors', which was also significantly higher than Ghana (56<sup>th</sup>), Nigeria (62<sup>nd</sup>) and Kenya (122<sup>nd</sup>).

A number of South African private equity firms are well positioned to take advantage of growth opportunities across SSA by growing the interests of their South African-based portfolio companies north of the border. Within South Africa, those firms with substantial value-add capabilities should be able to achieve good returns by enhancing portfolio company performance despite the macroeconomic headwinds.





# Customer centric journey within Asset Management

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The asset management industry in South Africa has witnessed significant growth over the last ten years. Markets have generated excellent returns, changing regulations have created new investment opportunities and substantial inflows of foreign money have moved into South African funds.

The South African market is one of the most developed Asset Management markets from both an African and global perspective. However, challenges may be on the horizon due to changing market conditions and legislative implications.

### Challenges facing the industry

Asset management companies in South Africa may face four key challenges:

#### 1. Legislative changes

The South African market is likely to be affected by changes to the legislative landscape in some shape or form, and both the market and asset managers must be prepared for this.

#### 2. Margin Squeeze

Cost and fee pressures continue to have a significant impact on the investment management industry, affecting everyone from financial advisers, asset managers through to administrative companies. Lower fees are no longer a negotiable factor. The asset manager's focus on core activities will be increasingly important in the future.

#### 3. Access to information has changed customer interactions

With information being more readily available through digital channels such as the internet and social media, customers are able to source key information from unbiased, reliable, trusted sources to easily compare performances and portfolio holdings. This is affecting the manner in which investors interact with both the asset manager and the financial advisor.

#### 4. Market performance

Investors are currently experiencing varying returns on investment, due to volatility in global markets.

### Globally, the 'face' of the investor has changed

Globally, the asset management industry has achieved strong growth in the years following the financial crisis and continues to rank among the most profitable industries. However, despite this recovery, asset managers continue to face challenges brought on by turbulent structural changes in the financial industry. To navigate this challenging environment, asset managers will have to take into account increased globalisation, more demanding investors with a growing preference for non-traditional assets, increased competition and regulatory changes.

#### 1. Legislative change has created a more agile and adaptable Asset Management market

- New regulations will affect asset managers, their clients and distributors, requiring managers to continually adapt to new rules in multiple markets
- Greater compliance burdens will increase operational complexity for firms and present strategic challenges on issues including product innovation, international growth and reporting standards

#### 2. Globalisation

- Better informed investors are starting to pull more levers at their disposal
- Demand for greater diversification is accelerating globalisation as investors seek exposure beyond their domestic markets
- The global scale and complexity of a multi-country organisation will require a carefully designed operational model that enables asset managers to adapt product offerings to local regulations, distributors and the needs of local investors



**3. Innovation within digital and data allows for greater company-wide integration and optimisation:**

- Digital technologies and data innovation are rapidly transforming operational aspects of asset management, becoming a valuable source of competitive advantage with an increasing focus on data fluency
- The benefits of more advanced enterprise-wide data management have become an increasingly critical focus for asset managers, particularly in terms of:
  - Single view of the customer
  - Organisation, legislation and governance
  - Analytics and "Next Best Action" capabilities
  - Data fluency and standardisation
  - Infrastructure and processes

**4. Investors' appetite for non-traditional assets:**

- Shifting investor preferences and volatile market factors are boosting the growing appetite for specialty investments
- Specialty solutions include absolute return and foreign large blend funds, multi-asset capabilities, and passive products
- Rather than seeking performance relative to a benchmark, investors are demanding investments specifically oriented to their needs

**5. Increasing competition to satisfy customer's appetite for non-traditional assets:**

- Specialised alternative managers that provide non-traditional assets such as hedge funds, private equity and private debt are increasingly serving traditional clients
- Alternative asset managers are leveraging their client relationships and reputation to expand their product offering into products historically provided by traditional asset managers
- Traditional managers are slowly building these capabilities but that will take time





### African and South African trends in Asset Management

#### 1. South Africa as part of Africa:

- As the African growth story continues, South African asset managers are ideally placed not only to take advantage of the greater flows of assets directed towards the continent, but to serve the enormous potential clientbase north of its borders

#### 2. Population longevity:

- Populations around the world are living and working for longer. This means that traditional asset management models about when people retire and how long they are retired for will have to be reviewed
- Increasing average life expectancy will have a huge impact on the industry where people will have longer investment horizons; the industry needs to migrate from a product-based investment approach with fixed benchmarks to that of a tailored, solution-based approach

#### 3. The mass market:

- Perhaps the biggest opportunity for the local asset management industry lies in the mass market. All of the major banks and insurers in South Africa now offer low cost products for low income earners, but asset managers have done little to attract this sector of the population

#### 4. Changing demographics:

- A more inclusive financial approach is important
- For the most part, the Asset Management industry in South Africa has served a very narrow demographic
- The investor base is becoming broader, more culturally diverse and far more interested in technology-based solutions that are more personalised and immediate
- *"The investor is looking for customised solutions that are easily accessible, driven by the new-era 'savvy investor' who is well-informed and would rather use digital interfaces than wait for physical interactions."* André Rousseau, Director, Deloitte, South Africa

#### 5. Intermediaries:

- The gap that exists between asset managers and the owners of the assets they manage creates a space ripe for disruption. The drive towards the Omni channel experience marks the start of a disruptive market, both in terms of interaction with the client and supporting the financial advisor in their work



#### 6. Regulation:

- Increasing regulation has an impact on all parts of the financial services industry worldwide. In South Africa, the majority of reforms have been positively received as they fulfil the need to protect the client
- However, additional regulation comes with additional costs associated with compliance, and those businesses that are able to manage costs most effectively will undoubtedly be at an advantage

#### 7. Consolidation:

- There is growing consensus in the industry that the number of products available to investors has ballooned to the point where it is difficult to make an informed selection
- There are now over 1,000 collective investment schemes registered in South Africa, making it increasingly difficult to identify the best options
- If, as is widely expected, investment returns decline in the coming years, this may inevitably lead to the closure of funds that do not offer an attractive value proposition
- At the same time, some larger players have spoken about reducing the number of funds they offer in order to make their product ranges simpler and more attractive, which will help in providing tailored solutions that will serve the specific needs of the customer

#### 8. Faith-based and socially-responsible investing

- There is already growing demand in South Africa for products that comply with Shari'ah principles, and asset managers that offer these solutions may also be positioning themselves to take advantage of opportunities beyond borders
- Environmental, social and governance principles will become a lot more mainstream and part of the investment process rather than a specialist area, especially with younger investors

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However, challenges may be on the horizon due to changing market conditions and legislative implications

### The Customer-centric Journey

A clear understanding of the investor's needs and behaviour will help drive growth strategies that are profitable within the Asset Management (AM) company. It is imperative to understand the customer journey as this will lead in the Asset Management company having an endearing relationship with the investor who will evolve from being indifferent to an advocate of the organisation. This will result in the AM company forging a relationship with the investor, who will become more responsive to the organisation's representatives.

The investor will not only prefer to purchase more products and services from the AM company that they trust but will also refer other potential investors to this organisation. In order to build both a profitable and sustainable business, asset managers, Exchange Traded Funds (ETF) providers and insurers need to deliver both an exceptional and personalised experience to the investor.

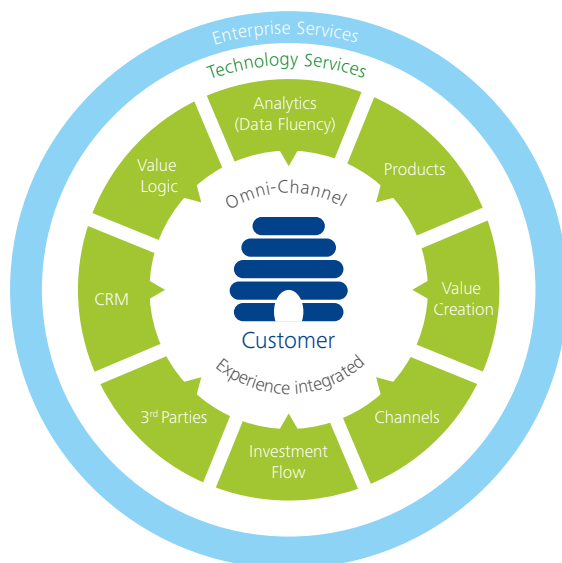
To enable the investor to make informed choices, the products need to be simpler and more transparent (e.g. through education and real-time reporting in

a mobile App environment). To achieve this, the operating model of the AM company needs to change to become more customer-centric. This will mean that the following key pillars (including both internal and customer-facing pillars) within the AM company need to develop in line with the investor's requirements:

- Marketing & Communication
- Sales & Service
- Product
- Customer Experience
- Customer Intelligence
- Innovative Processes
- Strict Governance and Controls
- Ethos/DNA of the organisation
- Optimised IT landscape

This will ensure that the organisation is able to align their value proposition to meet the investor's needs and expectations, especially in terms of transparency and information. A customer/investor-centric focus within the AM company will also allow for easier adherence to new regulations, which will in turn, provide a competitive advantage over other organisations within this industry.

### Deloitte - Customer Centric View



The goal is to evolve from a product-centric to a customer-centric operating model that will fundamentally disrupt the existing Asset Management industry.

In essence, analytics will be used to understand the value logic in terms of identifying the investor's needs to create the expected value (tailored solutions), which will be communicated and enabled in real-time through the investors' preferred channel.

Understanding the lifetime value of an investor will provide the asset manager or advisor with the ability to identify high value investors to ensure that they are provided with exceptional servicing. AM companies need to introduce contextual servicing to build an enduring relationship with the investor – this encompasses the following elements:

- Tailored solutions at Moment of Truth<sup>1</sup>
- Product customisation
- Real Time experience
- Proactive risk management

An example of contextual servicing includes the use of analytics per customer segment to build real-time insights so that tailored solutions can be offered proactively to the investor/customer. This will encourage the building of an interactive relationship between the asset manager/advisor and the investor.

The journey towards becoming customer-centric needs to start with an assessment of the current landscape of the AM company's key customer capabilities and identifying the target state that it would like to achieve. This will pave the way for customer centricity and will facilitate the identification of critical milestones along

this journey. It is important to understand that this journey may take a few years to achieve, due to its complexity (i.e. total redesign of the operating model, culture, customer experience & relationship) and the level of investment required. In addition, it is equally important that this journey be supported by the senior management of the AM company, which will need to promote this strategy to the rest of the organisation so that the transformation meets little or no resistance. It is important for the Asset Management industry to keep up with the fast-changing environment and evolving investors/customers if it is to achieve sustainable top-line growth. Embarking on this customer-centric journey will become a crucial game changer in building investor loyalty and confidence for an AM company.

The 'New Age' customer demands a full service suite from the asset manager. This includes competitive pricing, being well-informed, interactive communication and access via a digital platform to allow for faster access to products or specific asset classes. A strong and efficient back office, strengthened by analytics with the asset manager, is crucial as it allows for a quicker turnaround and lower fees, which will translate into a more personalised experience for the investor.



<sup>1</sup> *Moment Of Truth: In service, the instance of contact or interaction between a customer and a firm (through a product, sales force, or visit) that gives the customer an opportunity to form (or change) an impression about the firm.*



# Will impact investing save our souls?

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Social impact investing has come to the fore in the debate about financial markets and how they can more responsibly serve the sustainable development of society. The Impact Investing Task Force of the G8 identified impact investing as a possible means of overcoming major societal challenges at national level, dealing with the aftermath of the global financial crisis and addressing global social disparities.

The emergence of impact investing has set in motion actors along the entire social action chain, from philanthropists to charities, foundations, social sector organisations, NGOs, public sector actors, social sector financial intermediaries and asset managers and, last but not least, the emerging community of social enterprises.

The question of what precisely is to be understood by social impact investing is no longer at the heart of the debate among those various stakeholders, even if differences in the definition of this market space continue to exist. Consensus has emerged that social impact investing seeks to realise concrete societal objectives and requires transparency and accountability from the various actors along the social value creation chain.

#### **Impact metrics that drive decision-making**

The debate has moved on to how best to ensure transparency and accountability, which ultimately converges in the requirement for meaningful social impact metrics. Also, substantial progress has been made in this area of impact measurement, despite the still prevailing disagreement on specific impact metrics to be used. Whatever system and metrics approach is taken, stakeholders increasingly agree that the relevance of performance indicators for a specific social action must not be sacrificed for the sake of a claimed comparability or aggregation of social impact performance across various projects, activities or sectors.

An important sign of the progress in this debate is reflected in concrete examples where impact metrics go beyond the mere tool for transparency and become genuine drivers in economic decision-making and the associated distribution of financial value:

- Investment vehicles have been launched whereby the financial performance incentive for the investment manager is linked to social impact performance metrics alongside financial performance
- New corporate structures that link dividend pay-outs to shareholders to the social performance of the business have entered the legislative process
- Increasing number of payment-by-results structures such as social impact bonds are using social impact metrics for defining the payment streams between a commissioner of social services, the executing social sector organisations and the investor community that provides the funding

#### **Moving on from metrics to pricing social value**

This extended use of social impact indicators in the economic decision-making and performance-monitoring process has revealed a new dimension that so far has not been addressed in a conclusive way: the pricing of social value. If social action moves away from a philanthropy-based funding approach (where impact metrics at best serve the monitoring of efficient capital allocation in pursuit of a given social goal) and enters the space where social impact becomes the substance of economic trade, the question of how to attribute economic value to social impact becomes central.

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This extended use of impact indicators in the economic decision-making has revealed a new dimension for social impact metrics: the pricing of social value



The debate on this topic has so far been largely avoided. Social impact inclined stakeholders such as philanthropists, charities and foundations have dodged it, possibly because it feels ethically uncomfortable to attribute financial value to social benefit. The basic assumption in a socially-focused mindset is that social value is beyond the notion of money.

On the other hand, stakeholders seeking benefits from social service delivery (such as e.g. commissioners of social impact bonds) have been happy to skirt around the issue of pricing social value because to do so result in cost savings, offering an easy, if not to say cheap, way of offering social value in lieu of financial return to investors investing for social purposes. Under the pretext of a new form of investment return concept, investors were invited to look at the combined return of social outcome and financial profit rather than just at financial profit alone.

### **The true cost of failing to price social value**

Considering social value alongside financial return may well be what we aspire to in terms of a new financial market logic, but in order to arrive at this ideal such thinking must be accepted along the entire social value creation chain.

Yet, this is far from being the case: how else can we explain that the pricing of social value used in social impact bond structures, for example, is still almost exclusively based on the cost structure of the social sector organisation delivering the underlying social service and largely dismisses any reasonable expectations of a financial return for the investors funding such an activity?

It is strange to observe that investors in the social impact space are urged to look at their combined return, aggregating social and financial value creation, when other stakeholders in the ecosystem still refuse to do so.



Isn't it counterintuitive that we accept it when "traditional" markets trade goods and services at their market value (rather than at a price equivalent to the cost incurred by the supplier), yet fail to apply a similar value-based logic when contracting social goods and services?

This inconsistency is one of the major threats to the development of a market space for social enterprises that clearly depends on a shift in the mindset of how social value is assessed.

If social enterprises, because of our “traditional thinking”, are only compensated for the cost incurred in fulfilling their social mission, we implicitly accept that they will be prevented from growing, be it organically or through external funding. And in doing so, we won’t be able to raise impact investing to an asset class in its own right.

Not surprisingly, the most frequent argument put forward in preventing social enterprises from becoming profit-seeking actors of the economic system is to say that the pursuit of financial objectives diverts the attention from the pursuit of social impact and consequently, endangers the enterprise’s social mission.

Whilst this thought may be strongly anchored in our minds and most certainly has its roots in the unethical excesses of capitalism, we cannot deny being at a historic crossroads where a number of important choices are to be made.

### **Finding new alliances for saving the welfare state concept**

With the fallout from the financial crisis affecting state finances, it has become clear that the concept of the European-style welfare state is unsustainable in its pre-crisis form. If we want to maintain the concept of community solidarity, we must forge new alliances between the private and the public sector in the delivery of social services.

This shift in social service delivery requires a new understanding of the various stakeholders in their respective roles, including the one of social enterprises taking on parts of what was previously the responsibility of the public sector. However, if this shift is supposed to become a reality, the public sector can no longer be a tax-funded provider of social services but needs to accept a new role as a market participant in a social impact market. Being a market participant, however, requires that public service commissioners move beyond considering only the cost of a product or service and instead find ways for compensating social enterprises for the value they create.

Of course, the debate on what exactly is the value of a social service is ongoing as is the debate on what “fair” return social impact bond investors should be entitled to. Nonetheless, the principle must be accepted that investors taking on the execution risk of social enterprises and their funding have a legitimate right to seek a return commensurate with the risk they accept. If we are ready to accept the cost of capital of a social enterprise as being part of the “production cost” of the product or service it delivers, linking this to common sense market logic can’t be too big a leap to take.

Unaddressed societal issues grow at a faster pace than the philanthropic money available to cure them. Hence, new sources of funding are needed to address these challenges. In the absence of new philanthropic resources and in the light of a virtually disappearing margin of manoeuvre in public finance, the future of our welfare system depends on the ability to attract private sector investment.

Such a shift is unlikely to happen by converting the institutional investing community into philanthropists. However, growing in financial markets of the need for a social equilibrium as a prerequisite for economic prosperity offers an opportunity for a new, economically sustainable welfare state concept.

We have spent decades blaming the financial markets for their lack of responsibility towards society by single-mindedly focusing on financial returns. Now that financial markets are finally starting to comprehend social impact as an integral component of economic life by accepting economic risks linked to social outcomes, we cannot respond to the dawn of this new market logic by an equally short-sighted and unidimensional attempt to shift responsibilities for no reward. There is a wealth of insight to be gained from impact investing when defining a new financial market logic if we can simply get past the perceived contradiction between financial return and social value: if the wisdom of separating financial return from social benefit left us with the 2008 crisis, we might as well take our chances and try an approach that seeks to reconcile the two going forward.

**To the point:**

- As impact investing gains ground in the investment space, the purpose of impact metrics evolves towards driving economic decision-making
- As transparency is no longer the sole purpose of impact metrics, their use for enabling the pricing of created social value gains increasing attention
- Social enterprises still suffer from the fact that traditional remuneration models compensate only for the cost of social action, not for the value it creates
- A new pricing logic for social value has to emerge if impact investing were to play a meaningful role in solving societal issues

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The growth of the social impact investing market is unlikely to happen by converting the institutional investment community into philanthropists



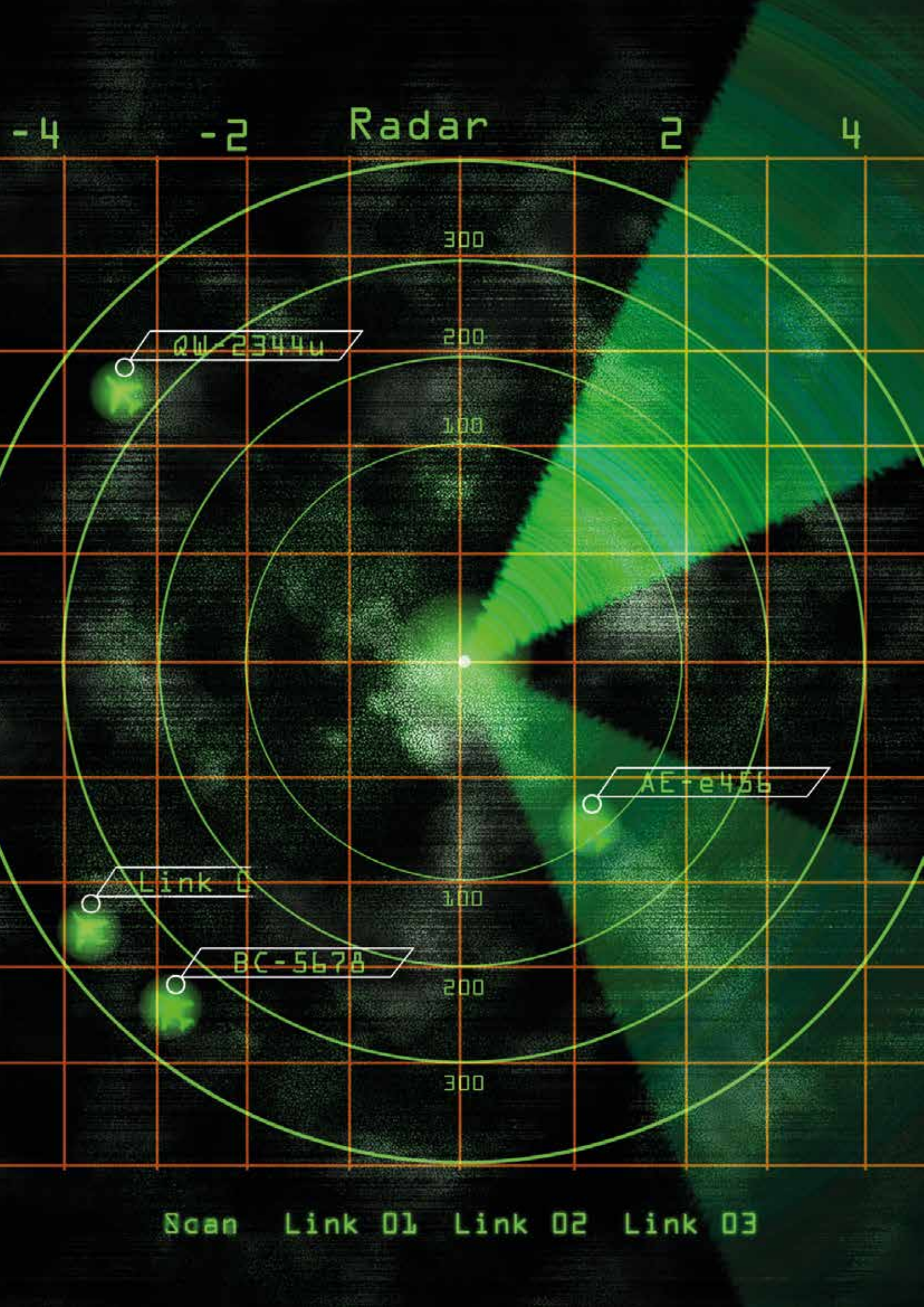
# DAC vs EUSD

## Conceding the battle to win the war (against tax evasion)?

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On 24 March 2014, after a six-year discussion on how to close existing loopholes in the current text of the EU Savings Directive and prevent tax evasion more effectively, the EU Council of Ministers finally adopted a broadened version of the EU Savings Directive (EUSD). The amended EUSD was however destined to be short-lived, as the intended repeal of the EUSD was announced in October 2014.



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In the meantime, OECD member countries (including EU member states) had endorsed the Common Reporting Standard (CRS) for implementing the automatic exchange of information in tax matters. Any concerns over potentially lengthy discussions at EU level to implement the CRS in the European Union were also quickly put to rest through an extension of the Directive on Administrative Cooperation (DAC) during the ECOFIN meeting in October 2014. The revised DAC (including the CRS requirements on mandatory automatic exchange of information) was approved shortly thereafter, on 9 December 2014. The speed of the process mainly stems from the fact that the CRS was inspired by the FATCA Model 1 Intergovernmental Agreements (Model 1 IGAs) signed by many countries worldwide (including most EU member states) with the United States. The move towards tax transparency that accelerated sharply after the financial crisis now seems to have become a reality on a virtually global basis.

#### **The OECD at the origin of the CRS and the link with FATCA**

Legally, the CRS is based on the OECD Convention on Mutual Administrative Assistance in Tax Matters (the Convention). The Convention had previously been developed by the OECD and the Council of Europe in 1988. In response to the G20 held in London in April 2009, the Convention was amended by Protocol in 2010.

The Convention provides for all possible forms of administrative cooperation between states in the assessment and collection of taxes, and became the new international standard for the automatic exchange of tax information. Also in this area, the OECD developed a Competent Authority Agreement (which can be used as the standard convention between partner jurisdictions), and the Common Reporting Standard for exchanging tax information automatically.

Currently, over 80 countries have signed or declared that they are willing to sign the Convention, including all G20 countries, the BRICS, most OECD countries, a number of other financial centres and a growing number of developing countries.

The OECD based the CRS on the FATCA Model 1 Intergovernmental Agreement. The principles and methodologies for classifying individuals and entities and the reportable data are consequently similar to FATCA; however, with some significant differences, which are discussed below.

Within the EU, the CRS very quickly crystallised through Council Directive 2014/107/EU of 9 December 2014 (amending Directive 2011/16/EU) as regards the mandatory automatic exchange of information in the field of taxation (the DAC), applicable from 1 January 2016 (reporting in 2017 on 2016). By 19 March 2015, Switzerland and the EU had initialled an agreement regarding the introduction of the CRS from 2017 (reporting in 2018) to collect account data from 2017 and exchange it from 2018, once the necessary legal basis has been created. Further jurisdictions should quickly follow suit.

#### **CRS/DAC improvements compared to the EUSD**

The EU Commission has taken steps to favour a replacement of the EUSD by the DAC over the survival of both regimes. As the reporting scope of the CRS, introduced by the DAC, is significantly broader than the scope of application of the EUSD, the latter was to become obsolete and will be abolished. We have summarised the main comparative criteria for the EUSD, the amended EUSD and the CRS as introduced by the DAC (See table on the next page).

	Current EUSD	Amended EUSD	CRS according to the DAC
<b>Relevant income</b>	<ul style="list-style-type: none"> <li>Interest and similar income (distributions/redemptions from certain UCIs invested in debt claims)</li> </ul>	<ul style="list-style-type: none"> <li>Interest and similar income (distributions/redemptions from all regulated investment funds invested in debt claims)</li> <li>Certain life insurance products</li> </ul>	<ul style="list-style-type: none"> <li>All types of income (including interest, dividends, gross sales proceeds), as well as account balances are reportable</li> </ul>
<b>Payer subject to requirements</b>	<ul style="list-style-type: none"> <li>EUSD paying agent; i.e. the last active economic operator securing payment for the benefit of qualifying beneficial owners (essentially banks, and transfer &amp; register agents for funds)</li> </ul>	<ul style="list-style-type: none"> <li>EUSD paying agent; i.e. the last active economic operator securing the payment for the benefit of qualifying beneficial owners (essentially banks, and transfer &amp; register agents for funds, certain insurance companies)</li> </ul>	<ul style="list-style-type: none"> <li>Reporting financial institutions as defined in the DAC (including banks, investment funds, certain insurance companies, certain non-supervised entities)</li> </ul>
<b>Reportable person</b>	<ul style="list-style-type: none"> <li>Individuals resident in an EU member state (or certain dependent &amp; associated territories), and certain entities (residual entities)</li> </ul>	<ul style="list-style-type: none"> <li>Individual residents in an EU member state (or certain dependent &amp; associated territories), and certain entities (residual entities defined in a broader way, and blacklisted non-EU entities, trusts, foundations)</li> </ul>	<ul style="list-style-type: none"> <li>Tax resident individuals and entities of another EU member state, and persons controlling certain types of EU and non-EU entities (controlling persons of passive NFE)</li> </ul>

The differences in the text of the CRS compared to FATCA might, however, lead to certain operational complexities when implementing the requirements

As a result, the individual/entities concerned by the DAC will essentially be the same as those covered by FATCA, and the DAC will extend the scope of reportable income to all types of financial income. The scope of 'reporting financial institutions' under the DAC is broader than the definition of 'paying agents' under the EUSD. Under the DAC, it includes a large number of investment funds that were not considered paying agents under the EUSD (their transfer agent/register agent may have been the EUSD paying agent though), certain insurance companies (whereas insurance is excluded from the scope of the current EUSD, and the amended EUSD would only have targeted very specific life insurance contracts), and a larger number of non-supervised entities (certain holding companies). Furthermore, while EUSD reporting was limited to interest income, DAC reporting will include all financial income, as well as the reporting of balances, irrespective of income attribution or transactions. For example, in the case of capitalisation funds, an investor's units/share values held in the funds would be reported annually even if that investor makes no acquisitions or redemptions.

As a result, the EU Commission will repeal the EUSD (and the amended EUSD), causing a collective sigh of relief among financial institutions. Many market players had expressed their concerns on the survival of both the DAC and the partially overlapping EUSD regimes in parallel, which would have required a costly duplication of data, systems and processes.

The EU commission now needs to start discussions on the practicalities of phasing out the EUSD, especially due to Austria's specific situation regarding the DAC (whereby CRS reporting will start from 2017 for Austria, instead of 2016 as for all other member states). The procedures for this repeal and the operational impacts on the market players will also have to be analysed. However, this is not the most pressing challenge for market players, who are currently focused on finalising their FATCA projects, in the hope that they can leverage their FATCA experience when implementing the CRS under the DAC.

EU market players should also be aware that additional CRS reporting requirements for countries other than EU member states will enter into force in the (near) future, as and when the EU or certain states within the EU conclude bilateral or multilateral agreements with other partner jurisdictions to implement CRS reporting.

### **Main differences and similarities between CRS and FATCA**

The CRS has been developed on the basis of Model 1 IGAs negotiated for FATCA purposes, and should, in theory, not differ substantially from the FATCA provisions. Nonetheless, the CRS is understood to be a "minimum" standard, and may give some leeway to partner jurisdictions to request additional data to be reported. Reporting processes may therefore have to be updated and extended regularly as new partner jurisdictions are added, and each country may negotiate a certain (and hopefully limited) degree of customisation of the standard reporting schema. The results of future negotiations between states and the extent of such customisation can only be guessed at. The EU member states should at least find a compromise between themselves, since they agreed on the text of the DAC. The differences in the text of the CRS compared to FATCA might, however, lead to certain operational complexities when implementing the requirements.

### **Which financial institutions are impacted by both regimes?**

The definition of financial institutions is broadly the same under FATCA and the CRS. However, certain exemptions for low-risk entities that existed under FATCA have been removed under the CRS (e.g. certain small institutions), and there will be fewer categories of deemed-compliant status available for investment funds, leading to an increased number of investment funds with reporting obligations under the CRS.

### **Are there different registration requirements?**

While 'reporting financial institutions' need to register on the IRS portal for FATCA purposes, there are no specific registration requirements for CRS purposes. It is possible, however, that some jurisdictions will decide to implement specific (additional) local registration requirements for FATCA and/or CRS purposes. This will need to be dealt with locally.

### **What will financial institutions have to report?**

A 'reportable person' under CRS should be an individual or entity (other than a financial institution or certain exempt entities), tax resident within one of the participating jurisdictions. On the other hand, the purpose of FATCA was to identify and report 'specified' US persons (including US persons residing outside the US). It is therefore possible that the same person will



be a reportable person both for FATCA and CRS purposes. Multiple CRS reporting is also not excluded, as the CRS contains indicia, similar to those defined under FATCA, which, if not remediated, will result in the same person being reported on to various tax authorities.

Moreover, an important difference for entity clients is related to the fiction under CRS that all investment entities in non-partner jurisdictions are considered 'passive' non-financial entities (Passive NFEs). Consequently, controlling persons of such entities that are tax residents in a partner jurisdiction are reportable. For example, a Panama entity could qualify as a 'participating foreign financial institution' (FFI) for FATCA purposes, and an account held by that entity with a Luxembourg bank would not be reportable. But for CRS purposes, as Panama is not a partner jurisdiction (yet), and assuming the entity is an investment entity under the CRS definitions, the same bank should identify the 'controlling persons' of this entity who are tax residents in a partner jurisdiction, and consequently report on these persons.

#### **What are the documentation and due diligence requirements?**

Due diligence for CRS purposes is based on tax residence criteria. If this information is not available, financial institutions will be able to carry out a search on the same criteria as those applicable for FATCA purposes. The CRS will rely even more on self-certification than FATCA; although, under the DAC, member states have the option to introduce some flexibility to rely on AML/KYC documentation.

Regarding the documentation, many jurisdictions are trying to implement self-certification forms that would be compliant with FATCA and CRS. However, some market players are currently using US forms (e.g. the W-8 or W-9 forms), which are only FATCA-compliant. In addition, as banks are also 'qualified intermediaries' (QIs), they will need to collect these US forms for QI purposes in certain cases, leading to a potential duplication of the required documentation. It should be noted that, for CRS purposes (and contrary to FATCA), there are no *de minimis* thresholds applicable for individuals' accounts that would enable FIs to exempt certain low-value accounts from review, and that the *de minimis* thresholds for entities are defined in a slightly different way under the CRS than under FATCA.



#### **What is the proposed timing for the reporting?**

The reporting for FATCA purposes is phased reporting. The reporting due in 2015 (on the 2014 financial year) will be a simplified version: in addition to the information on account holders, only the balance and value of the accounts will need to be reported. For reporting on 2015 in 2016, FIs will need to add information pertaining to the income paid on the account. The reporting due in 2017 on 2016 will also include, in addition to the above, any gross proceeds paid to the account. The content of the CRS reporting will be the same, but there should be no phased-in implementation: the first reporting on the calendar year 2016 will immediately include the full-scope reporting of balances, income and gross proceeds.

#### **What is the penalty for non-compliance?**

Another major difference between the CRS and FATCA is the absence of punitive withholding tax under the CRS (although in IGA Model 1 countries, punitive withholding tax under FATCA would only occur in very exceptional cases). Of course, local laws transposing CRS obligations may contain certain sanctions for non-compliance; in most countries in the form of administrative fines. This should be monitored on a country-by-country basis.

### Key 2015 challenges and requirements to anticipate

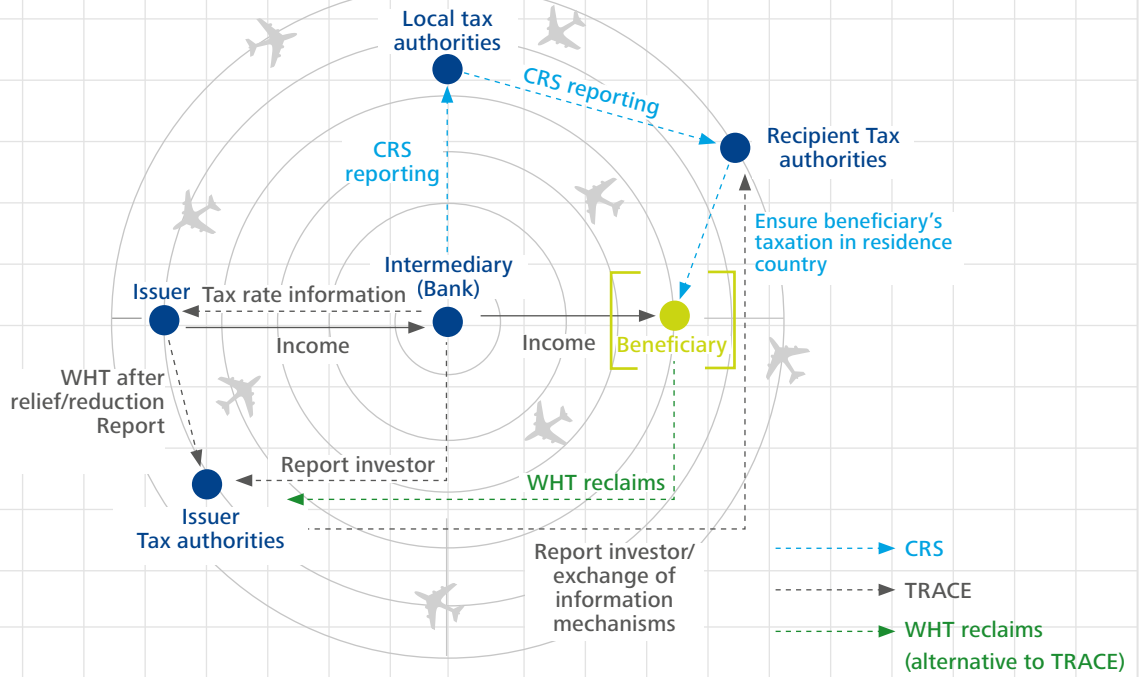
Several actions need to be undertaken now in order to ensure that FIs are ready when CRS reporting under the DAC enters into force (i.e. by December 2015). CRS projects (especially gap analyses with FATCA) should already have begun, and the following considerations need to be addressed:

- Strategic decisions taken for FATCA purposes need to be revisited in view of the CRS: for example, the use of the *de minimis* threshold exemption for FATCA needs to be assessed, taking into account that these thresholds will be different for FATCA and CRS purposes, thereby leading to the increased complexity of due diligence. Due to the increased volume of reporting expected for the CRS compared to FATCA, the need for an automation or an outsourcing solution for reporting needs to be considered
  - Classifications of investment funds and 'in-scope' products need to be assessed in view of the available CRS status types (which is an important point for investment funds having opted for a deemed-compliant FATCA status other than CIV status, but also for the assessment of insurance products, for example, where slight differences exist in the definitions and exemptions used for FATCA and CRS purposes)
  - Legal and regulatory documentation (general conditions, onboarding documentation, fund prospectuses, subscription forms and agreements, etc.) need to be updated again in view of the CRS requirements. The same applies to internal procedures for handling FATCA and CRS classification and reporting obligations
  - A due diligence exercise on account holders and investors will need to be run again to assess reportable status (or not) from a CRS perspective
- Another challenge will be client communication. A number of clients may have been contacted recently to provide documentation in respect of their FATCA status (e.g. evidence relating to US indicia detected in their file). Financial institutions may have to contact clients again very soon afterwards to request additional information in respect of their CRS classification and possible remediation of additional CRS indicia identified in their files. The EU DAC also confirms certain information obligations towards account holders, in respect of data protection. The extent of such account holder information is still subject to discussion
  - For fund service providers, data, systems and processes will also need to be updated so that they can process and centralise this new set of information

In order to ensure a successful CRS implementation project, the following key actions need to be undertaken as a matter of urgency:

- Launch an impact analysis, which makes the link with the FATCA implementation project. This impact analysis should assess the implementation costs, and whether the organisation would self-develop its CRS reporting systems, look at integrating an external package into the organisation's systems, or consider an outsourcing solution of FATCA and CRS reporting
- Train the existing FATCA taskforce on CRS-specific requirements, focusing on the delta between FATCA/EUSD and CRS
- Revisit the FATCA/automatic exchange of information strategy, taking into account CRS requirements
- Organise the communication strategy (for internal and external purposes)
- Identify new classification/remediation criteria and workflows applicable to CRS

How the TRACE regime is intended to work:



**To the point:**

- With the adoption and commitment to adopt the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters (including the CRS standard) by more than 80 jurisdictions, an important milestone has been reached in enhancing tax transparency on a virtually global basis. The countries that have committed to it include all EU member states, as well as jurisdictions from all continents such as Argentina, the British Virgin Islands, the Cayman Islands, the Channel Islands, China, India, Indonesia, Japan, Korea, Nigeria, Russia, Saudi Arabia, Singapore, Switzerland and South Africa. Market players need to act rapidly; in a first stage within the EU for implementation of the CRS under the DAC, and then with ongoing follow-up of additional legal instruments imposing CRS reporting with additional partner jurisdictions, and subsequent updates of client classification and reporting systems.
- Nonetheless, some further measures should be expected in order to improve CRS implementation and efficiency. As the US legislator did before FATCA with the QI regime (with which FATCA has been aligned), the next steps considered by the OECD are a withholding tax relief system ensuring relevant application of the correct amount of withholding taxes (including reduced rates under double tax treaties), depending on the identity of the beneficial owner. The OECD will therefore encourage the enforcement of the TRACE (Treaty Relief and Compliance Enforcement) initiative (which has returned to the table as CRS implementation gathers pace), with a view to giving an incentive for investors and account holders worldwide to provide sufficient relevant information to financial institutions. In October 2014, the OECD committee on fiscal affairs stated that: "TRACE will improve the quality of information collected by financial institutions for purposes of the CRS, as it provides an incentive to investors to provide complete and accurate information to their financial institutions."
- Consequently, tax regulatory compliance costs are likely to increase in the future, but should be counterbalanced by new opportunities, as investors and account holders will need increased assistance to reconcile global investment and/or account information with amounts that they need to report in their own tax returns. A greater number of market players are therefore considering providing specific investor tax reporting, in order to inform investors of the tax qualification of their realised income, depending on the rules applicable in their tax residence, and consequently facilitate compliant filing of their local tax returns.

# Trust in CRS?

## The Common Reporting Standard reporting obligations in the context of trusts

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*The CRS, due to start applying in 2016, will impose reporting obligations and exchange of information standards that will radically change the world of international tax planning. Trusts have been particularly targeted and may be obliged to report information in relation to their beneficiaries, settlors, protectors and trustees. In certain instances this would include the value of settlors' and beneficiaries' interests in a trust.*

In recent years there has been a global movement towards greater tax transparency between countries with the aim of reducing tax evasion. The automatic exchange of information in relation to tax residents between different jurisdictions has come into being as a direct result. The most recent, and most drastic development on this front is the OECD's creation of the Standard for Automatic Exchange of Financial Account Information in Tax Matters, generally referred to in its abbreviated form of the Common Reporting Standard (CRS).

Trusts are flagged at the very outset in the introduction to the CRS. Emphasis is laid on the fact that reportable accounts include accounts maintained or held by entities which are trusts. The institutions (often including the trust itself) responsible for reporting on these accounts are also required to look through passive entities to report on individuals that ultimately control these entities. It is clear that there is an agenda in the CRS to ensure that trusts cannot be used by individuals as a shield against reporting requirements.

Section 1A of the CRS states that "each Reporting Financial Institution must report [certain] information with respect to each Reportable Account of such Reporting Financial Institution".

Whether there is a reporting obligation, and the content of that obligation, will to some extent vary depending on the nature and residence of the reporting institution involved, as well as other factors such as the residence of its account holders, or, in the case of a trust, the residence of the beneficiaries, settlor, protector, etc.

A trust would in most cases be classified as either a 'Reporting Financial Institution' (FI) or a 'Passive Non-Financial Entity' (Passive NFE). If a trust is an FI, the trust or its trustee will have an obligation to report to its local tax authority in respect of the trust's reportable accounts. Where the trust is a Passive NFE, its trustee may be required to disclose information to an FI (e.g. a bank) with which the trust holds a reportable account, so that that FI can file its report with its local tax authority.

It is therefore clear that the reporting obligations applicable in the case of a trust that qualifies as an FI differ from the disclosure that a trust that is a Passive NFE might be required to make to an FI with which it holds an account. Care should be taken not to confuse the basis for, and content of, the separate sets of obligations. When determining the reporting obligations applicable to a trust, therefore, a crucial first step would be to establish whether the trust is an FI or a Passive NFE.



### Trusts as FIs

In general, a trust will be classified as an FI if it has a professional corporate trustee, i.e. a trustee which, as its primary business, invests, administers or manages the assets for trusts or other customers. It is also necessary that the trust's gross income that is attributable to investing, reinvesting or trading in financial assets is more than 50% of its total gross income.

#### Reporting obligations of a trust which is an FI

As FIs, trusts have an obligation to report on any 'Account' that is held by a 'Reportable Person' (i.e. a 'Reportable Account') as defined in the CRS. A 'Reportable Person' is any entity or individual who is a resident of a CRS signatory state. An 'Account Holder' is any person who, in relation to a trust that is an FI in the form of an 'Investment Entity', has an 'equity or debt interest' in the trust.

Under the CRS, *"an Equity Interest is considered to be held by any person treated as a settlor or beneficiary of all or a portion of the trust, or any other natural person exercising ultimate effective control over the trust."*

According to the CRS Commentary, beneficiaries who are purely discretionary beneficiaries (i.e. have no vested interests in the trust) should only be considered to be Account Holders in relation to a particular reporting period if there has been a distribution to them during that reporting period.

In the case of a trust that is resident in one of the early adopter countries, distributions made to a discretionary beneficiary in 2015 may already trigger disclosure obligations in the course of 2017, because accounts will be categorised as 'pre-existing' by looking at the position in December 2015.

It is important to note that a person who is a

beneficiary as well as a settlor of a trust that is an FI (qualifying as an Account Holder in both instances) would be treated as having two accounts with that trust. These will need to be assessed and reported on separately.

Any person who has made a loan to a trust is also an Account Holder, holding a 'debt interest'.

#### Reportable information

The information to be reported about a Reportable Account includes the Reportable Person's name, address, tax identification number, date and place of birth, and the total gross amount paid or credited to the account in respect of the relevant reporting period and the account balance as at the end of the relevant reporting period. The closure of any account held by a Reportable Person must also be reported.

The CRS does not provide any guidance in relation to the determination of the value of the interest of a beneficiary, settlor or person exercising ultimate effective control. The question therefore arises as to what values should be attributed to these parties' interests in an FI trust (i.e. the value of their 'accounts') for reporting purposes.

The value of a vested beneficiary's interest in the trust is likely to be linked directly to the value of the vested interest. In the case of a discretionary beneficiary, the value of their interest in the trust is likely to be equal to the aggregate amount of distributions in their favour in any given reporting period.

Difficult questions arise as to what the value is of a settlor's interest in an irrevocable trust compared with a revocable trust. Similarly, in the case of a person exercising ultimate effective control over the trust (for example, a trustee or a protector with significant powers), should the full value of the trust be attributed to that person?

### Trusts as Passive NFEs

If the trustee of a trust is not a professional corporate trustee, the trust may not be an FI. It would therefore be classified as an NFE, and be either Active or Passive. The CRS contains a closed list of categories of Active NFEs. If a trust, which is an NFE, does not fall into one of the specific categories of Active NFEs, it is classified as a Passive NFE. The categories of Active NFE are such that, in most cases, a trust set up for wealth protection and which is an NFE will be a Passive NFE.

The CRS also defines a Passive NFE to include any 'Investment Entity' that is resident in any country that has not signed up to the CRS. The effect is to require FIs, which maintain accounts for trusts that are resident in a non-CRS country, to identify the 'Controlling Persons' in relation to those trusts and report on those Controlling Persons where they are resident in a country that has signed up to the CRS.

### Reporting obligations in relation to trusts that are Passive NFEs

A Passive NFE does not have reporting obligations under the CRS. Nevertheless, in almost all cases it will have financial accounts, perhaps bank accounts, with other entities, which do have CRS reporting obligations. The FIs with which the Passive NFE has accounts will also be subject to pre-existing anti-money laundering and know your client due diligence obligations (AML/KYC obligations), which will require the FI to have identified the 'Controlling Persons' of that Passive NFE. The AML/KYC obligations will be extended by the CRS to oblige FIs to collect additional information regarding their account holders, for example, regarding tax residence and tax identification numbers. Passive NFEs make disclosures to FIs pursuant to these obligations, and as requested to do so by the FI, as an Account Holder of the FI.

Where requested by an FI with whom it holds an account (typically a bank or investment account), a Passive NFE must supply information relating to any of its 'Controlling Persons' who are resident in a CRS jurisdiction. If it fails to do so the sanction may include the categorisation of the account in question as 'Reportable'.

The term 'Controlling Persons' is defined in the case of a trust as meaning "*the settlor, the trustees, the protector (if any), the beneficiaries or class of beneficiaries, and any other natural person exercising ultimate effective control over the trust*".

From this definition it is clear that a person can be a Controlling Person of a trust without exercising any control over it (e.g. a beneficiary). Care should therefore be taken not to assume that Controlling Persons are only those who exercise ultimate effective control over a trust.

It is likely that, as in relation to an Account Holder of an FI trust (above), there will be scope for drawing a distinction between the discretionary and vested beneficiaries in the context of their being Controlling Persons. Thus, only those discretionary beneficiaries that receive an award will be treated as Controlling Persons.

Protectors and trustees are also expressly brought within the Controlling Persons definition. This is to be distinguished from the position of a trust that is an FI where trustees and protectors are not automatically included as Account Holders, although either might be persons exercising ultimate effective control over a trust.

The net effect of this is that any trust that is a Passive NFE that has an account with a bank which is resident in a CRS signatory state, may have to supply such bank information in relation to all its beneficiaries, settlors, and protectors who are residents of a CRS signatory state. And as we have seen above, this would include trusts regardless of their jurisdiction as well as trusts that might otherwise be Investment Entities in a non-CRS jurisdiction.

Thus, a person who is a resident in a CRS signatory state may well be subject to reporting under CRS in relation to a trust in a non-CRS country. If such a trust maintains an account with a bank which is resident in a signatory state, the bank would be obliged to identify the Controlling Persons of the trust and to report accordingly to its local tax authority.

### Reportable information

The information to be reported by an FI (bank) in relation to the account of a trust that is a Passive NFE is the name, address and place of birth of each Controlling Person of the trust who is resident in a CRS signatory state. In addition, the FI will report the value of, and movements on, the account it maintains for the trust. The same account may be reported multiple times, in relation to multiple Controlling Persons. Unlike in the case of a trust which is an FI, the report filed by an FI regarding a Passive NFE trust does not reflect the value of the Controlling Persons' interest in a trust.

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Thus, a person who is a resident in a CRS signatory state may well be subject to reporting under CRS in relation to a trust in a non-CRS country

### Trust in CRS?

At the time that the US Foreign Account Tax Compliance Act (FATCA) was created as part of the US Hiring Incentives to Restore Employment Act (HIRE), there was nothing to suggest (including in the legislative history) that trusts would be treated as foreign financial institutions and thereby bear the full weight of FATCA due diligence and reporting obligations. Nor would one reasonably have expected this to be the case. Nevertheless, the drafters of the detailed FATCA regulations to implement HIRE clearly trusted the FATCA ideal to deliver their objective of worldwide transparency when they fitted trusts into the detailed regulatory framework. The various intergovernmental agreements seemingly followed that approach without question, as has the CRS. But what a tight fit it is turning out to be. While the official CRS Commentary has made progress in explaining, for example, how the concept of a financial account applies to a trust, it has clearly been an effort, and there remain a number of challenges in applying the CRS regime to trusts. Only time will tell whether those challenges can be overcome.

#### To the point:

- Trusts administered by a professional corporate trustee will in most cases have to report on the value of its beneficiaries' and settlors' interest in the trust
- The value of discretionary beneficiaries' interest in a trust will only be subject to reporting if a distribution has been made to them
- In relation to discretionary beneficiaries, distributions in 2015 may already trigger some disclosure obligations
- A trust which is a Passive NFE will have to disclose to Reporting FIs with which it holds accounts information in relation to its settlors, protectors, beneficiaries and trustees where they are treated as Controlling Persons
- If a trust is a Passive NFE, there will be no reporting requirements in relation to the value of beneficiaries' or settlors' interests in the trust
- The FI with which a trust that is a Passive NFE holds a reportable account will report on the full value of the account together with details of the trust's Controlling Persons

# Legislation changes and clarifications impacting investment funds

## A French update

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A couple of clarifications impacting investment management were introduced by the Finance Bill for 2015. In addition, the much commented “Bill for Growth and Activity” (Loi Macron) also introduces a new investment fund dedicated to capital investment.





### Withholding Tax Exemption on dividends — Update for non-EU Funds

Until 17 August 2012<sup>1</sup>, dividends distributed by French companies to foreign undertakings for collective investment (UCIs) were subject to a withholding tax levied at a rate of 30%<sup>2</sup> (possibly reduced on the basis of applicable tax treaties). Further to the ECJ's judgment<sup>3</sup> sanctioning France for infringement of the freedom of movement of capital, the legislator has introduced an exemption for dividends paid to foreign UCIs comparable to French UCIs.

For collective investment funds based in states outside the EU, under the provisions of the 2012 Bill, the exemption was applicable only to the extent that the state had concluded a Convention on Mutual Administrative Assistance with France. However, in practice, the French Tax Authorities (FTA) considered that non-EU UCIs were not comparable, based on their statement of practice dated August 2013. The Amending Finance Bill for 2014<sup>4</sup> states that the Convention on Mutual Administrative Assistance must effectively enable the tax administration to obtain the

information necessary to verify that the UCI complies with the conditions provided for the exemption and thus could benefit from it.

#### Current practice: no tax exemption for non-EU UCIs despite EU law

Article 63 of the Treaty on the Functioning of the European Union (TFEU) provides that "*all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.*" In the Santander Case, the ECJ sanctioned France in 2012 for infringement of the freedom of movement of capital. This led to the abolition of the withholding tax on dividends paid to foreign funds.

However despite the legislative change, the withholding tax exemption was still denied to non-EU funds due to a restrictive interpretation of the law by the FTA. This is not in line with more recent ECJ case law recognising rights to third-country funds (e.g. Emerging Markets Series of DFA Investment Trust Company vs. Dyrektor Izby Skarbowej w Bydgoszczy (C-190/12) 10 April 2014).

1 Rectificative Finance Bill for 2012 n° 2012-958 of 16 August 2012

2 Based on former Art 119 bis of the French Tax Code

3 ECJ, case C-338/11 to C-347/11, 10 May 2012, Santander

4 Article 58 of the Amending Finance Bill for 2014 n° 2014-1655, 29 December 2014



#### **Rectificative Finance Bill for 2014: more clarity?**

The Rectificative Finance Bill for 2014<sup>5</sup> has introduced a clarification regarding dividends distributed to non-EU UCIs by adding that the implementation of a Mutual Administrative Assistance Agreement must *"effectively enable the Tax Administration to obtain from the Authorities of the State in which the UCI is established on the basis of a foreign law [...] the information necessary to the verification"* of compliance with the conditions required in order to benefit from the withholding tax exemption.

This new provision creates an additional condition for non-EU funds to benefit from a withholding tax exemption for non-EU UCIs although, in practice, both their claims for withholding tax suffered in the past and their application to benefit from an exemption in the future are not dealt with. One may question the relevance and impact of this measure.

However, it is possible to assess this new provision in a more positive light. This addition tacitly implies that the non-EU UCIs cannot simply be excluded from the comparability analysis, contrary to what is mentioned by the current FTA's guidelines.

The parliamentary debates seem to support this analysis. In the context of the preliminary assessment of the measure, French deputies have indicated that the implementation of the scheme would involve the release of updated FTA's guidelines (BOFIP). However, the FTA's current guidelines already provide that *"compliance with the conditions must be verifiable by the French Authorities with the State in which the UCI has its headquarters."*<sup>6</sup> It is precisely this sentence that leads the FTA to consider that non-EU UCIs are not comparable, which is questionable.

Despite appearances, this text may be interpreted not as an additional condition but as an injunction made to the FTA to amend its guidelines and practice of excluding non-EU UCIs from the benefit of the withholding tax exemption. If this interpretation was to be adopted, it would allow the French regime of withholding tax on dividends to (finally) be compliant with the TFEU and the ECJ case law.

<sup>5</sup> Amending Finance Bill for 2014 n° 2014-1655, 29 December 2014

<sup>6</sup> BOI-RPPM-RCM-30-30-20-70 n° 100



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## Non-EU UCIs cannot simply be excluded from the comparability analysis

### Uncertainty around the effectiveness of administrative assistance

This requirement is subject to interpretation, which means that the FTA can argue that the administrative assistance clause is ineffective. However it is unlikely that this argument can be used for all administrative agreements. Until the tax authorities amend their Statement of Practice and/or start looking at claims introduced by non-EU funds, it is likely that foreign UCIs may still be subject to a withholding tax contrary to the EU law and may still have to challenge it to protect their rights.

### New favourable tax regime (PEA) for investments in small or medium-sized enterprises

As of 1 January 2014<sup>7</sup>, in parallel with the traditional French Plan d'épargne en actions (PEA, i.e. a share savings plan), the PEA SME has been introduced to promote investment in SMEs located in France or in other EU Member States (extended to Iceland, Norway and Liechtenstein). The implementing provisions of this additional PEA were laid down by decree on 4 March 2014<sup>8</sup>, and the French Tax Administration (FTA) published its first Statement of Practice on the scheme on 15 January 2015<sup>9</sup>.

### Key features of the PEA SME

The PEA SME generally works the same way as the traditional PEA, created in 1992. It allows a portfolio of shares to be managed on an income tax-free basis, provided that the taxpayer does not perform any withdrawal for five years and invests in eligible securities. Although based on the same mechanism, the PEA SME must be regarded as a different scheme so that individuals, resident in France for tax purposes, may hold both a PEA and a PEA SME.

### Eligible securities

Securities eligible for the PEA SME are the (listed or unlisted) shares, investment certificates and cooperative investment certificates, shares in a limited liability company (SARL) or in companies with equivalent status and equity securities of cooperative companies. The issuer must be liable to corporate income tax (or equivalent tax) and be located in one of the aforementioned countries. In addition, unlike traditional PEA, these securities must be issued by a SME, i.e. a company that does not employ more than 5,000 people and with a turnover of up to €1,500 million or a balance sheet total of up to €2,000 million.

<sup>7</sup> Finance Bill for 2014 n° 2013-1278 of 29 December 2013

<sup>8</sup> Decree n° 2014-283 of 4 March 2014

<sup>9</sup> FTA's guidelines BOI-RPPM-RCM-40-55



#### **Intermediated investments & funds of funds**

Moreover, securities held indirectly through a collective investment fund may also be eligible for a PEA SME. These are shares in investment companies with variable share capital (SICAV); units in mutual investment funds (FCP), including venture capital mutual investment funds (FCPR), Innovation-focused mutual investment funds (FCPI) and real estate investment trusts (FIP); and units or shares of coordinated European UCITS, having at least 75% of their assets comprised of securities in SME companies (quota), among which at least two-thirds consist of eligible securities (sub-quota).

Money invested in a PEA SME may also be invested in a collective investment fund, referred to as an organisme de tête (i.e. holding entity), which itself invests:

- in units of French funds (FCPR, FCPI and FIP)
- in units or shares of other funds investing in securities of SMEs, directly or via a "master-feeder" system<sup>10</sup>

It should be noted that following the initial wave of enthusiasm after this mechanism was discussed, and a few months after its implementation, the market feeling towards it is rather mixed.

<sup>10</sup> System in which "feeder" coordinated UCITS invest at least 85% of their assets in "master" coordinated UCITS pooling the managed assets

### A new contender in the international race for investment: The Open Partnership Company (*Société de Libre Partenariat* or SLP)

Introduced through an amendment<sup>11</sup> discussed in January 2015 in front of the committee in charge of the preparation of the Draft “Bill for Growth and Activity” (the “Macron” Bill, named after the Finance Minister), the open partnership company (*Société de Libre Partenariat* or SLP) aims to be an effective response from the Government to the competition faced by the French financial sector from Luxembourg, Germany and the United Kingdom.

It is largely admitted that—in a post AIFM context—it has become difficult to raise capital, and it is therefore necessary to facilitate investment in non-listed entities for large institutional investors (particularly foreign ones). These investors, due to a lack of clarity, could be tempted by Germany, Luxembourg and the United Kingdom and the choice of vehicles such as the *Société en Commandite Spéciale* in Luxembourg, or the English Limited Partnership.

Consequently, Article L.214-54 of the Monetary and Financial Code should be amended<sup>12</sup> to add, next to existing common funds (FCP) and investment companies with variable share capital (SICAV), the open partnership companies, which, from a legal point of view, would consist in *société en commandite simple* (i.e. French limited partnership), incorporated as alternative investment funds.

The idea is to offer foreign investors flexibility comparable with that of Limited Partnerships, in particular with regard to the rules of governance and operational organisation. This includes investor information, or clauses designed to improve the balance of power between managers and investors (“no-fault divorce clause”).

From a tax standpoint, the SLP would be transparent, which would allow the company to be recognised as transparent beyond borders in many European states (Germany in particular), while maintaining the same tax treatment as the one applied to French common funds open to professional investors (FPCI).

It will be interesting to see what the take-up for such a vehicle will be in the future.

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The idea is to offer foreign investors flexibility comparable with that of Limited Partnerships

<sup>11</sup> Amendment n°SPE864 of 8 January 2015

<sup>12</sup> The French Senate starts its works on the Bill as from 11 March 2015



# Combining active and passive managements in a portfolio

**Nicolas Gausse**

Chief Investment Officer  
Lyxor Asset Management

**Arnaud Llinas**

Head of ETFs & Indexing  
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In recent years, established ideas on portfolio construction have been called into question. Investors can now choose from a range of 'smart beta' strategies, offering exposure to market risk premia in a systematic, transparent fashion. Where does the dividing line between active and passive fund management lie today? What is the future role of active managers? As indices evolve, how should standard, capitalisation-weighted benchmarks be used?

In this Expert Opinion, Nicolas Gausse, Chief Investment Officer at Lyxor Asset Management and Arnaud Llinas, Lyxor's Head of ETFs and Indexing, share their views on these important questions.

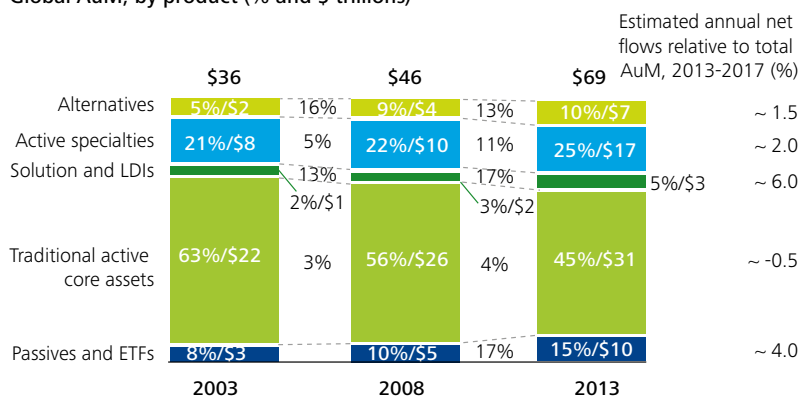
### Traditional "core" active management is shrinking

**Nicolas Gausse:** One trend that has dominated asset management since the turn of the millennium is the shift in assets away from traditional, "core" active mandates. Investors worldwide have been moving away from traditional active management into alternatives, dedicated active mandates, solutions and liability-driven investment (LDI) schemes. There has also been a big rise in passive funds within allocations, including exchange-traded funds (ETFs).

- Passive and active funds are complementary for portfolio construction.
- Future portfolios will include a substantial allocation to smart beta, as well as to traditional beta and to active management (alpha)
- Combining traditional beta, smart beta and alternatives in a portfolio offers investors effective solutions
- Passive funds provide investors with extensive access to a wide range of asset classes with cost advantages

### The Shrinking Core

Global AuM, by product (% and \$ trillions)



We are witnessing a polarisation of the asset management market: increased demand for specialist active management, on the one hand, and growing demand for passive mandates on the other. Traditional active managers are under increasing pressure to justify their roles.

Active core assets are expected to shrink to about 40 percent of global AuM by 2017.

### Passive funds are growing

**Arnaud Llinas:** Based on commonly observed market practices, we noted that passive mandates and ETFs had grown from \$3 trillion to \$10 trillion in assets under management between 2003 and 2013, this market segment is expected to continue growing healthily.

We think there are four explanations for this trend.

**First**, active managers continue to perform below their benchmarks in aggregate. According to a recent study by Marlène Hassine, Lyxor's Head of ETF Research, only 21% of active funds on average outperformed their benchmark over the last 10 years. The evidence indicates that there is little consistency in performance over time: managers that beat the benchmark in one year thus have a poor chance of doing the same the next year. (See Figure below)

**Second**, passive funds, including ETFs, have a clear cost advantage over active funds, leading many investors to decide that they would prefer to track an index rather than try to beat it. Of course it's fair to point out that passive funds don't replicate their indices exactly. Other things being equal, they will trail it by their annual management costs. However, passive funds' costs are relatively low and have been decreasing steadily.

**Third**, passive funds now offer access to a broad range of asset classes with a high degree of granularity, offering investors significant choice. Passive funds are typically highly diversified, giving wide access to individual market segments.

**Fourth**, smart beta investment strategies, codified as indices, allowing replication in a systematic, transparent method—is an increasingly important phenomenon.

### 10-year performance/volatility comparison between active funds and the index

	Performance		Volatility		% Active funds outperforming the benchmark
	Index	Active funds*	Index	Active funds*	
France Large Caps	5,4 %	4,9 %	16 %	16,5 %	16 %
France Smid Caps	8.8%	8.7%	18.1%	16.7%	38%
UK Equity	6,7 %	6,7 %	13,8 %	14,3 %	34 %
EUR Large + Mid Caps	6,3 %	6,3 %	14,4 %	15,3 %	31 %
Europe Small Caps	10.2%	9.4%	18.5%	18.0%	26%
US Large + Mid Caps	6,1 %	5,6 %	12,9 %	13,6 %	13 %
Japan Equity	2,0 %	0,3 %	14,3 %	15,0 %	13 %
World Equity	6,0 %	5,8 %	12,5 %	13,7 %	20 %
Value Equity	5.7%	6.2 %	13.0%	13.9 %	27%
Global Em Equity	10,6 %	8,8 %	19,5 %	20,0 %	27 %
China Equity	12,3 %	12,3 %	23,4 %	21,6 %	13 %
EUR Govies	4,7 %	4,0 %	4,1 %	3,9 %	24 %
EUR Corporate	4,7 %	4,3 %	3,9 %	4,3 %	21 %
EUR High Yield	N/a	n/a	n/a	n/a	n/a
Emerging Debt	8,7 %	5,1 %	9,0 %	9,2 %	0 %

Source: "Active Funds vs. Benchmark", Marlène Hassine, Head of ETF Research, Lyxor AM, November 2014. Research based on Morningstar data and fund categories from 30/6/2004 to 30/6/2014.

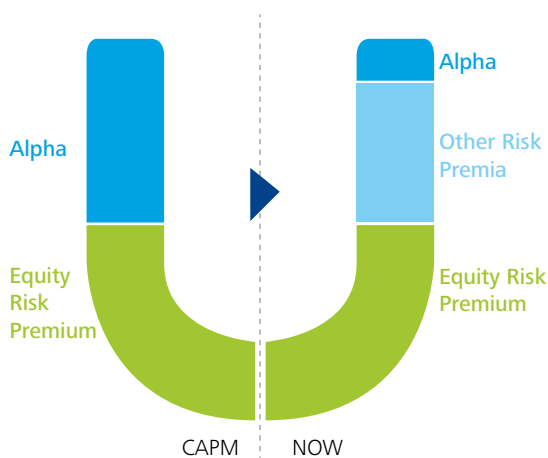


### Smart beta expands the definition of Passive

**Arnaud Llinas:** Smart beta is expanding the traditional definition of passive investing, offering a valuable new tool to investors. Various types of traditional portfolio strategies by active investment managers can now be replicated efficiently and at low cost via smart beta indices. In other words, passive funds are increasingly being used to give exposure to strategies that were historically offered only in an active format. To some extent, smart beta is also likely to replace some of investors' traditional allocation to passive funds, tracking indices weighted by market capitalisation.

In a recent Expert Opinion from Lyxor<sup>1</sup>, Thierry Roncalli, Lyxor's Director of Research, provided an overview of the concept of risk factors. Risk factors help us understand the performance of equities and other asset classes, and an increasing number of smart beta indices offer exposure to individual risk factors. There are other popular types of smart beta indices, including those focusing on the reweighting of index constituents, on particular investment styles or on specific risk outcomes e.g. minimising volatility. In the future, we think that many portfolios will include a significant allocation to smart beta, as well as to traditional beta and to active management alpha.

### Smart Beta Gains Ground



Source: Lyxor AM, for illustrative purposes only.

### Alternatives offer uncorrelated risk premia

**Nicolas Gausse:** It may seem paradoxical that the demand for alternative asset management structures, such as hedge funds, has been increasing in the midst of this boom for indexing and passive solutions—yet investor inflows into alternatives have been very strong. Another study, conducted by Cliffwater and Lyxor, found that the weighting of alternatives in U.S. state pension funds has more than doubled recently, from 10% in 2006 to 24% in 2013<sup>2</sup>. Despite a period of great volatility in asset markets and negative headlines associated with some hedge funds, investors continue to be attracted by alternatives' ability to generate attractive risk-adjusted returns. Over the period between 2001 and 2014, U.S. equities (the S&P 500 index) and U.S. government bonds (the Citigroup US GB 7-10 year index) and hedge funds (in the form of the HFRI index) all gave total returns of around 6% a year.

But while U.S. equities had annual volatility of around 15% over the period, hedge funds had bond-like volatility of around 6%. Hedge fund returns were also negatively correlated to bond returns, and only weakly correlated to those of equities. These statistics reinforce the central attraction of alternatives: they can act as an effective portfolio diversifier, offering uncorrelated risk premia—the result of hedge funds' exposure to non-traditional asset classes.

### Risk/Return of Equities/Bonds/Alternatives

31/03/2001 -31/08/2014	S&P 500 TR	Citigroup US GBI 7 to 10 year	HFRI
Return	6.22%	5.88%	6.21%
Vol	15.06%	6.79%	6.04%
Sharpe	0.29	0.59	0.71

Correlation	S&P 500 TR	Citigroup US GBI 7 to 10 year	HFRI
S&P 500 TR	1	-0.34	0.6
Citigroup US GBI 7 to 10 year	-0.34	1	-0.33
HFRI	0.6	-0.33	1

Source: Lyxor AM, for illustrative purposes only

1 [http://www.lyxor.com/fileadmin/PDF/20141106-EXPERT\\_OPINION\\_RISK\\_FACTOR RONCALLI\\_GB.pdf](http://www.lyxor.com/fileadmin/PDF/20141106-EXPERT_OPINION_RISK_FACTOR RONCALLI_GB.pdf)

2 According to a study by Cliffwater and Lyxor AM.

### Alternatives as true active management

**Nicolas Gausse:** Alternatives are increasingly seen as the true home of active asset management. Hedge funds are often relatively unconstrained in the investment positions they are allowed to take. By contrast, in many traditional core active management mandates performance is measured relative to an index benchmark, and managers may be reluctant to depart too far from index weightings. The difference between traditional active mandates and hedge funds is also supported by extensive academic research.

For example, in 2009 professors Goetzmann and Schaefer reviewed the performance of the active management of the Norwegian Government Pension Fund, which was largely based on traditional mandates<sup>3</sup>.

The researchers concluded that a significant proportion of the fund's historical returns could be explained by exposure to systematic risk factors rather than active manager skill. It's increasingly possible to access these risk factors via transparent, low-cost index solutions, rather than paying extra to access them via active mandates.

In another study, published in 2012 and focusing on the period from 1990-2008<sup>4</sup>, academics Aglietta, Brière, Rigot and Signori showed that active management had contributed nothing to U.S. pension funds' returns within the equity asset class and very little to the funds' returns in fixed income. In fact, most of the equity and fixed income returns earned by U.S. pension funds came from broad market exposure—something the funds could have achieved by indexing. However, the researchers found that active management played a much more significant role than market movements in explaining pension funds' returns in hedge funds and other alternative asset classes.

### Definitions of Alpha and Beta are changing

**Arnaud Llinas:** As 'beta' expands to encompass not just traditional, capitalisation-weighted market indices but also smart beta indices, which embed different investment strategies and risk factor exposures, 'alpha' may also change its definition.

There is likely to be much greater scrutiny of the extent to which active managers truly add value, for example by studies focusing on managers' 'active share' against their performance benchmarks. Also, those benchmarks may be more tailored to managers' individual styles. For example, if an active manager specialises in small-cap U.S. value stocks, why not measure his performance against the relevant smart beta index, rather than against the broad market?

### Passives and Alternatives are complementary

**Nicolas Gausse:** We often see passive and active management described as fighting each other for investors' assets. I don't think this is the right way of viewing things.

Instead, index-based portfolio solutions (such as passive funds and ETFs) and truly active funds (in the form of alternatives) should be seen as complementary. In fact, in Lyxor's view these portfolio approaches can by themselves provide a full solution for the average investor.

Broad-based ETFs and other index products, typically tracking capitalisation-weighted indices, are well-suited to the portfolio core. They capture market risk premia and offer effective diversification at low cost.

<sup>3</sup> <https://www.regjeringen.no/globalassets/upload/fin/statens-pensjonsfond/eksterne-rapporter-og-brev/ags-report.pdf>

<sup>4</sup> [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1948726](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1948726)

## Smart beta is expanding the traditional definition of passive investing, offering a valuable new tool to investors

ETFs are ideal for tactical asset allocation, since they offer high granularity of exposures, ease of implementation and low execution costs. Such tactical positions could include ETFs based on strategy and factor indices. Alternative assets can then form the active part of the portfolio, based on the principle of uncorrelated exposures and unconstrained investment mandates.

A typical portfolio could be split 60/20/20 between core ETFs and index products, tactical exposures using ETFs and the active component, represented by alternatives.

### Combining active and passive

**Nicolas Gausse:** Asset allocation approaches are evolving to take into account the broadening range of low-cost, index-based solutions and the growing evidence that alternatives are the true form of active management. We believe that combining traditional beta, smart beta and alternatives in a portfolio provides a very effective and powerful solution for the average investor.

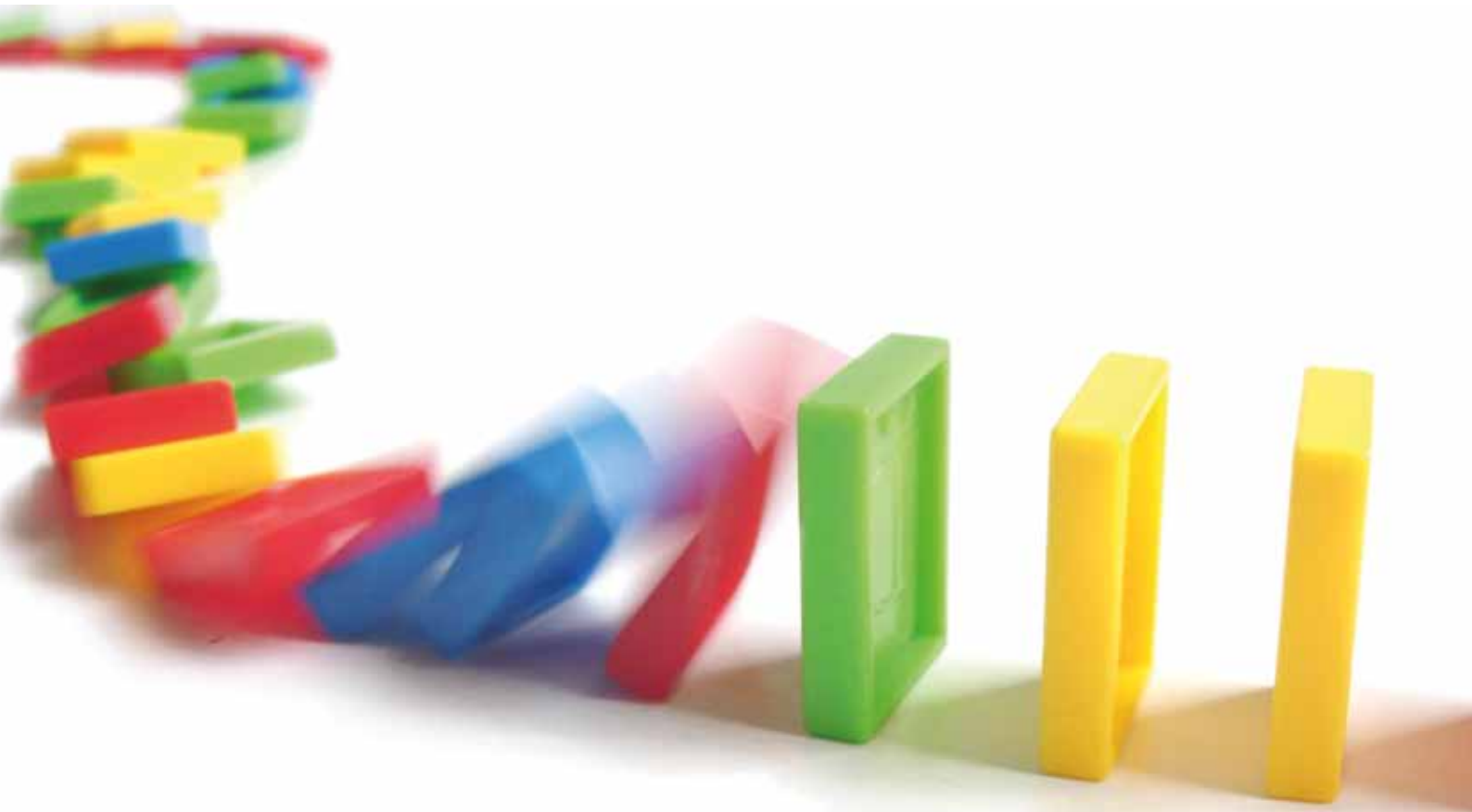
### Sample Asset Allocation

	Investor need	Key benefits		%	Investment vehicles
	Core allocation portfolio	<ul style="list-style-type: none"> <li>• Capture market risk premium</li> <li>• Diversification</li> <li>• Cost</li> </ul>	▶	60 %	ETF Index products
+	Tactical allocation portfolio	<ul style="list-style-type: none"> <li>• Granularity of offer</li> <li>• Speed and flexibility of implementation</li> <li>• Execution cost</li> </ul>	▶	20 %	ETFs
+	Alternative portfolio	<ul style="list-style-type: none"> <li>• De-correlation / diversification</li> <li>• Manager breath of action</li> </ul>	▶	20 %	Alternatives

Source: Lyxor AM, for illustrative purposes only.


#### To the point:

- Passive solutions are tools that help active managers to generate alpha, and are used to complement the equity or bond picking
- With the coming-up of risk factor ETF, assets allocators and active asset managers will be able to generate alpha by selecting specific regional risk premium



# How the CRA Regulation will impact the asset management industry

**Eric Bertrand**  
Deputy CIO – Head of Fixed Income  
CPR Asset Management

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- What is the credit rating agencies (CRA) Regulation?
  - Why has it been introduced?
  - Implications for the asset management industry
  - Challenges for the customer, custodian and audit firm
  - Risk or opportunity for asset managers?

The new regulation applicable to the credit rating agencies (CRA Regulation) states that the EBA, EIOPA and ESMA “shall not refer to credit ratings in their guidelines, recommendations and draft technical standards where such references have the potential to trigger sole or mechanistic reliance on credit ratings by the competent authorities” (Art. 5b(1) Regulation (EU) No. 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No. 1060/2009 on credit rating agencies).

In plain language, it will no longer be possible for credit ratings to be the only factor used to define an investment universe, a level of risk, a dispersion ratio, a level of capital charge per rating, etc. The impact will not be insignificant. For many years, credit ratings published by rating agencies have represented a ‘common language’ for assessing credit risk in a portfolio or a balance sheet. Asset owners and asset managers use credit ratings to define an asset allocation, set limits and authorise counterparties for the purpose of calibrating credit risk. The same applies to controls made by the custodian. Furthermore, under Solvency II, insurance companies can no longer base their portfolio selections solely on credit ratings.

Asset managers, insurers and banks will have to broaden credit risk assessments of their assets with a non-exclusive and non-systematic reliance on credit ratings. Firms will have to define a credit risk scale and methodology based on an internal approach to credit risk. Credit ratings may be an input of this methodology, but others must be included.

The CRA Regulation was a result of the shock wave triggered by the subprime crisis. The credit rating agencies were singled out for a number of reasons. First and foremost, many credit ratings given to structured products were clearly too high compared to the same rating for a corporate issuer. An AAA-rated collateralised debt obligation (CDO) was not as secure as an AAA-rated corporate bond, misleading investors.

Furthermore, some issuers defaulted despite being rated as investment grade at the time of default or a few days before. Some issuer ratings may have been too ‘friendly’. Moreover, it has been suspected that the ‘issuer pays’ model (i.e. the issuer pays to obtain a rating from an agency) may, in certain cases, lead to a conflict of interest. The leading position of credit agencies in evaluating credit risk in the market was a matter of concern.

The rating agencies came under fire again a few months later during the euro crisis for downgrading some government ratings, possibly at the worst moment for the market. Many investors had credit rating limits within their own risk frameworks, which forced them to sell government bonds that had been downgraded. It could be argued that this triggered the massive 'disorderly sell off' on the Eurozone government bond market. In some cases, these downgrades started a vicious circle generating further downgrades. Strict reliance on credit ratings to define an investment universe was thus generating a systemic risk.

While some of the criticism aimed at the credit agencies concerning their rating of structured products was valid, it could also be said that this very new sector did not have the benefit of a historical approach.

Now that the CRA Regulation is here, asset managers will have to implement it in their organisation: first, by modifying all the fund prospectuses that used to include a reference to credit ratings to define their investment universe, allocation process, selection methodology and risk limits. In each case, credit ratings have to be removed and replaced by an internal methodology to assess credit risk, which will increase the cost of credit coverage and IT support. The new regulation will raise the barriers to entry for new players in the credit market and may cause problems for small asset managers.

Furthermore, as asset managers are moving towards their own assessment of credit risk, the junction point between the customer and its custodian will have to be redefined. A large number of institutional investors are still following rules based solely on credit ratings from agencies. Under the typical business model involving the asset manager (AM), customer and custodian, the main credit risk limits were defined in the fund prospectus, and the custodian checked that the AM was following the rules.

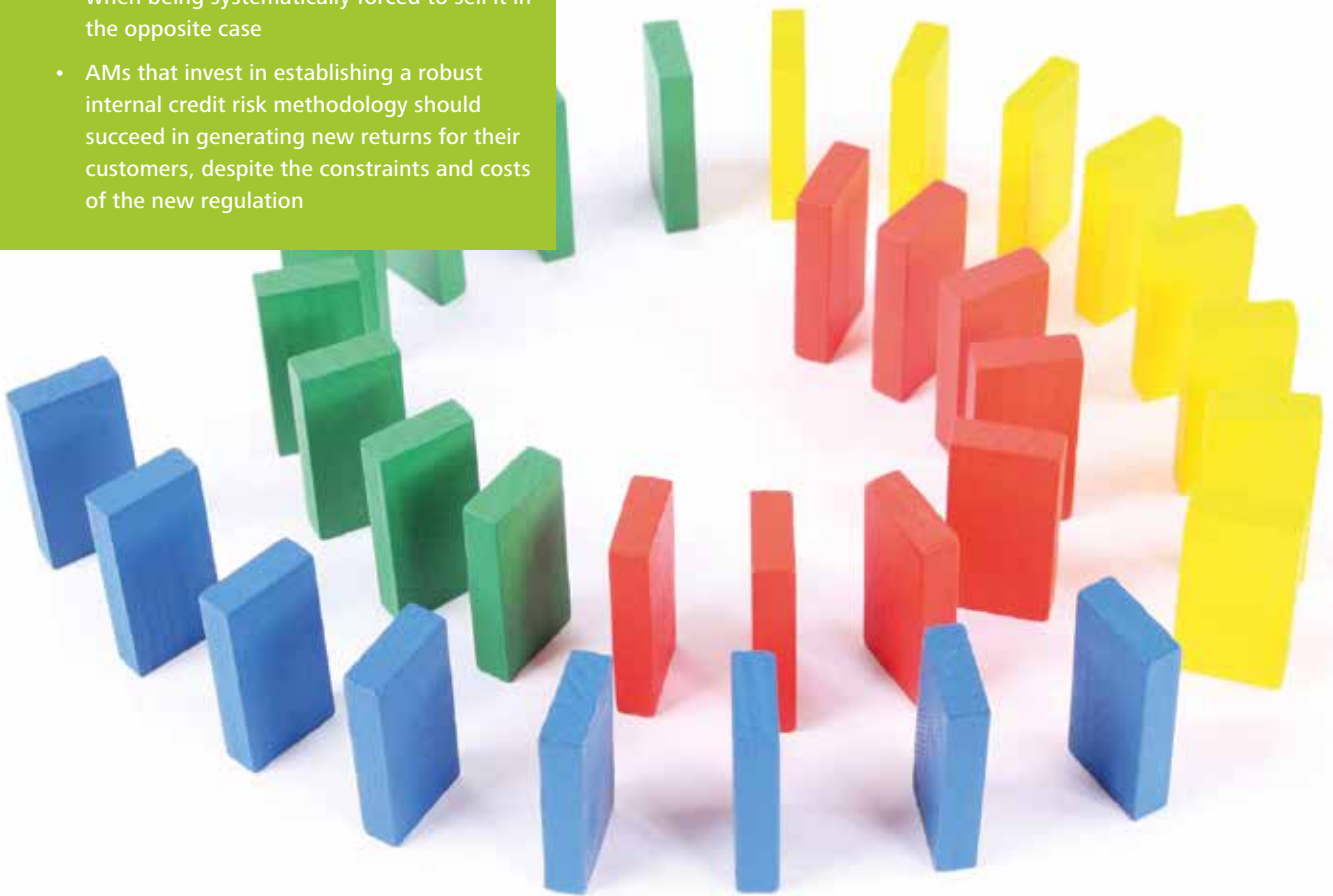
The CRA regulation will require a new system to be put in place. For dedicated funds, limits based on credit ratings can no longer appear in the prospectus. If a customer wants to keep the old credit rating-based risk framework, this will have to be stated in the delegation agreement, and the custodian will have to carry out controls on both the prospectus and the delegation agreement (leading to new costs and controls). Otherwise, the customer will have to endorse the AM's credit risk methodology (as is the case for open funds) meaning, at the very least, new controls of the asset manager and new due diligence. This may ultimately mean that an asset owner will have as many methodologies to control as delegated AMs. Meanwhile, audit firms will have to carry out controls on AMs, using the prospectus based on the internal approach of each AM, thereby creating new controls and requiring a new approach for each AM—with further cost implications.

To the point:

- The CRA Regulation will lead to structural changes in the way credit risk is managed in the asset management industry
- The relationship between the customer and custodian will have to change, generating more flexibility yet also more risk of misunderstandings
- From a purely investment standpoint, the CRA regulation will create attractive opportunities. For instance, an AM (investment grade only) may invest in a BB+ issuer before an upgrade (if it considers it to be an investment grade issuer) and receive excess returns, instead of losing money when being systematically forced to sell it in the opposite case
- AMs that invest in establishing a robust internal credit risk methodology should succeed in generating new returns for their customers, despite the constraints and costs of the new regulation

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The new regulation will raise the barriers to entry for new players in the credit market and may cause problems for small asset managers





# Hong Kong Towards a new paradigm?

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“The best time to plant a tree was twenty years ago. The next best time is today.” - *Chinese proverb*

Hong Kong, with its towering peak, its buzz of commercial activity and its mercantile DNA is a place where change may seem a constant. In such an environment it is perhaps strange to speak of ‘game changers’, and yet with the most recent developments in Hong Kong, that is precisely the case.

Hong Kong has always stood at a crossroads—both by its geography and its hold on place and time. The trading hub is as it ever was, possibly more vibrant, possibly enhanced by the competition that other Chinese cities create for it. The cultural window into China is as rich and perplexing as ever, with the melting pot of Chinese cultures and their interaction with the world beyond. Now, however, profound changes are also afoot in the financial infrastructure of Hong Kong. It will be interesting to see if Hong Kong will be able to take a place on the world asset management stage.

For many years, global asset managers viewed Hong Kong as a distribution centre. It has long been an important location for the European investment management industry: it was one of the first jurisdictions to embrace UCITS as an industry standard. This furthered the progression of UCITS at a crucial time when the Hong Kong preference for an OECD domicile carried local interest towards the European brand to replace previous BVI and Cayman products. Hong Kong is one of the first markets that come to mind when discussing the success of UCITS beyond the confines of Europe.

Indeed, it is probably fair to say that Hong Kong deserved better from UCITS, or rather, those responsible for their evolution; even today, the way in which UCITS legislation changed rapidly and without consultation still rankles, and is probably behind some of the longer-term initiatives that are now drawing our attention.

Talk, or at least serious talk, of Asian passports originated largely as a result of the implementation of UCITS III and its extended asset eligibility criteria. Certainly, there were good reasons for extending that eligibility; the rationalisation of the market, the increased use of the product by institutional investors, the added focus on performance that institutional investors brought with them—all these elements were features that, in hindsight, should have been appropriately articulated and discussed. Unfortunately, they were not, and significant reticence remains, especially on the permitted use of derivatives. This reticence was reinforced during the financial crisis by the use of such instruments inappropriately in other non-fund products. In addition, when UCITS, from being a stable and known quantity went through further iterations of UCITS IV and V in rapid succession, followed by talk of UCITS VI and a bewildering number of changes to be communicated to investors, some in Hong Kong felt that enough was enough.

At the same time, those who follow events and patterns in Hong Kong have noted a growing trend towards more regional activity in the Hong Kong market in recent years. While UCITS remain a staple, there have been signs—small at first perhaps, but growing—that there are also other forces at work. The number of Hong Kong domiciled products continues to increase year on year. Certain Hong Kong products such as Islamic funds enjoy unique positioning within the region, and the growth in popularity of ETFs has caused many to consider Hong Kong as a prime potential location for domiciling ETFs for regional distribution.

Accompanying these developments, which may almost be considered organic or natural evolutions to adjust to market circumstances, there have been other changes, at one and the same time political in inception, and responses to market needs and requirements. And it is those initiatives that are today giving a new dimension to Hong Kong's role and boosting its growth.



Two of these initiatives stand out as indicators of what the future may look like. These are “mutual recognition” and “Hong Kong-Shanghai Stock Connect”.

Mutual recognition may be regarded as perhaps the first concrete initiative towards a ‘passport’ in Asia, and in this case it concerns Greater China. (There are other passport initiatives in Asia with greater geographic ambition, but their progress is likely to be slow and painstaking. Mutual recognition is the only one to involve China, and the one that has the potential to bear fruit almost immediately.) Put simply, mutual recognition is an initiative whereby funds domiciled and managed in Hong Kong may be distributed in China, and funds domiciled in the PRC (People’s Republic of China) may be distributed in Hong Kong.

Mutual recognition may be considered as old news by some. The first announcement of its imminent arrival was made over two years ago, but it has still to see the

light of day. Nonetheless for something that has yet to materialise, it enjoys an immediacy that has few equals.

We may well ask what the catalyst was for the initiative in the first place. Was it, for example, a purely Chinese initiative in the context of the evolving relationship between Hong Kong as a special autonomous region and its larger parent, or was it a response to ham-fisted changes in foreign products such as UCITS? Certainly—as mentioned previously—a good deal of resentment was created by what was perceived as a rather high-handed approach to UCITS product evolution. Even as it became clear that mutual recognition is likely to one day become a reality, concerns arose from outside China over whether UCITS could benefit from the scheme in some way via master feeders or similar structures, and whether mutual recognition could potentially be extended to UCITS in general—rather than focusing on how asset managers should adapt to be a part of this new system.



The details have been slowly worked out and have emerged over the intervening period, and by definition they were not simple to formulate. By virtue of the diversity of funds that may be domiciled in Hong Kong, not all funds would be appropriate for an initial pilot in mutual recognition. We still do not know exactly which funds in each domicile will qualify, and what criteria will apply.

It has been interesting to see the international response to mutual recognition. Clearly, the draw of the PRC market, both for its current—but especially for its potential future size—is a powerful one. Given the success of UCITS in Asia, there has long been an aspiration, even a belief that in time, mainland China would open its doors and embrace UCITS as a standard, and it may still do so—one day. In the short term, however, it came as a shock and a reality check for foreign promoters, and foreign promoters of UCITS products in particular, to see a scheme gradually emerging that might exclude them from an opening up of the market in mainland China, and which would promote an alternative range of products ‘over their heads’.

Although UCITS asset managers were slow to grasp the implications, clinging to the belief that UCITS would be eligible under the scheme at some point, the message is increasingly clear. If you want to participate in mutual recognition, then you need to both be in Hong Kong and manage Hong Kong domiciled products. The rest is detail.

There has been talk of an extension of mutual recognition to encompass UCITS. There are several stumbling blocks but the main ones are semantic and legal. Mutual recognition is what it says—first and foremost ‘mutual’—the price for UCITS to be included in the scheme would be access to EU retail markets for Chinese-domiciled funds. The EU is certainly not

yet ready for that, especially at a time when it is only just getting to grips with the issues surrounding the potential extension of the AIFMD passport for institutional or professional investors.

At the same time—also from an EU perspective—there is a major problem for products from one domicile to be included, and not all EU UCITS — this is a legal constraint. Member states are not entitled to conclude such agreements, which within Europe would infringe the freedom of the right of domicile. For Europe and UCITS it has to be all or nothing.

Although, as implementation of mutual recognition continues to be delayed, it is likely that talk of inclusion will continue, but it is feared that this will remain talk. To benefit from mutual recognition when it comes will require both presence and product in Hong Kong. Some asset managers have recognised this and are investing in establishing appropriate products already in the shadow of the Peak.

As mentioned above, mutual recognition has been long in the making (or relatively long, given the complexity and the potential impact of the undertaking), and at the time of writing there is still uncertainty as to when it will finally go live. There has been some speculation that one of the reasons for this delay has been to allow Hong Kong-Shanghai Stock Connect to start up first, with regulators and other stakeholders unwilling to have more than one major initiative going live at the same time.

Hong Kong-Shanghai Stock Connect was something of the opposite of mutual recognition. It seemed to emerge almost from nowhere, gather a momentum all of its own, and move so swiftly from concept to implementation that many in the market were taken by surprise. Stock Connect is an infrastructure solution that allows inward investment into China A shares

listed on the Shanghai exchange via orders placed with Hong Kong registered brokers (the 'Northbound route') and for investors going through the Shanghai Stock Exchange to invest in the components of the Hang Seng large and midcap indices and other H shares not included in these indices.

In terms of the Northbound route, provided compliance with infrastructure requirements around custodial arrangements can be met, Stock Connect offers almost free access to the Shanghai market in China A shares for all comers, without the need to comply with RQFII and QFII requirements.

When considered in tandem with the depth of the offshore renminbi market in Hong Kong, via which Stock Connect investors can cover their purchases, and Hong Kong asset managers can hedge share classes to renminbi for the PRC market, Hong Kong has quite suddenly moved from being a mainly distribution-oriented hub to having the potential to become a fully-fledged asset management centre—when mutual recognition kicks in.

The two measures, taken either in isolation or in conjunction, do not truly constitute a policy or strategy. Indeed, it wouldn't be unreasonable to ask if there is any link between the two, save perhaps an overall and guiding intent to reinforce and develop Hong Kong as a financial centre. One is oriented towards the creation of a capacity—for asset management; the other is the provision of a favourable or necessary infrastructure.

However, there is a link, at least to some degree—if only in effect. From the standpoint of global asset managers, mutual recognition and Stock Connect have almost at the stroke of a pen put Hong Kong front and centre in terms of both inward and outward investment in China, while also acting as enhancements, rather than competitors, to other pilot schemes and initiatives to bring China closer to the fully accessible capital markets of the world.

### Where next for Stock Connect?

If we follow the logic that Stock Connect is the pilot for a more general liberalisation of foreign access to Chinese markets and could follow the incremental route taken by the QFII and RQFII systems, what are the next steps that may be anticipated?

The first of course is straightforward and is not even subject to conjecture: Shanghai is only one of the trading venues in China for A shares, and not all companies are listed there. The other major, and relevant, exchange is Shenzhen. An extension of Stock Connect, or perhaps a 'second' Stock Connect is in the making to encompass Shenzhen, and the general manager of the Shenzhen Stock Exchange has said it will include representative stocks from the main board, the small and medium-sized enterprises board and the ChiNext growth board. At present, it is thought that the scheme could be approved in the first half of this year for implementation in the second half. The design of the scheme is understood to be complete and awaiting approval from central government.

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To benefit from mutual recognition when it comes will require both presence and product in Hong Kong

There is no 'one approach' to China, of that Hong Kong is well aware. There are other initiatives pending full implementation, or waiting to take their place in the development of China's cross-border investment aspirations. These include the QDLP (Qualified Domestic Limited Partner) and the QFLP (Qualified Foreign Limited Partner) schemes, both of which may open up alternative routes for distributing fund products in China, and neither specifically reserved to Hong Kong. However, Hong Kong is also conscious that it is uniquely placed as one of the privileged routes for inward and outward investment into China. At a time when RQFII and QFII quotas favour direct contact with the mainland, Stock Connect in its current and future form gives Hong Kong unique access. And at a time when QDII finally offers a way to distribute UCITS in China, mutual recognition will place Hong Kong in a uniquely privileged position.

None of these advantages will be written in stone—but Hong Kong can be relied upon to maximise the benefit that may arise from even a temporary advantage. In the same way as we can expect to witness the rise of Chinese banks and asset managers as a force to be reckoned with on the world stage, we will also see Hong Kong develop its own asset management industry

to be the 'alternative force' in the region. Hong Kong is still a part of China, and still aligned with the overall aspirations and intentions of China, but it is also unique, flourishing and has its own special role to play.

Hong Kong has been a magnet for traders for decades – even millennia. The vastness of the territories just across a narrow stretch of water, the endless horizon of the Middle Kingdom, and that indefinable sense of promise that seems to rise above the towering Peak are as much of a draw today as they were when traders first discovered Hong Kong. And if those traders were attracted by the deep waters and safe anchorage of the natural harbour beneath the Peak back then, they will now seek to navigate other deep waters towards a safe haven in an increasingly complex world of global investment.

An extension of China, a part of China, or a special and autonomous region with its own future charted before it, Hong Kong can be many things to many people.

What it represents for asset managers worldwide is an inescapable signpost on the global asset management map that it will be increasingly difficult to ignore.

The question that each has to answer is: what is the best way to participate in this new dynamism and the opportunities it offers?

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Stock Connect offers almost free access to the Shanghai market in China A shares for all comers, without the need to comply with RQFII and QFII requirements



**To the point:**

- Hong Kong has a special relationship both with China and with the world – it is not exclusive in many ways but it is unique
- The strengthening or creation of a thriving asset management industry in Hong Kong is a key objective
- Reinforcing the trading architecture through Hong Kong in both Stock Connect and renminbi trading is another key objective
- The two initiatives Mutual Recognition and Stock Connect represent a significant milestone in the development of Hong Kong as a fully-fledged financial centre
- Stock Connect will be extended to include Shenzhen – possibly this year already
- There will be other Chinese initiatives – not all will involve Hong Kong
- Hong Kong will have to fight for its place in the sun. It intends to. Mutual Recognition and Stock Connect will give Hong Kong some of the weapons it needs







# Fair value pricing survey, twelfth edition

## Positioning for the future

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In the aftermath of the enforcement action against an investment company's Board of Directors and related settlement, the mutual fund industry enjoyed a comparatively quiet year on the valuation front without any formal valuation guidance issued by the U.S. Securities and Exchange Commission (SEC). The lone exception came as our survey was closing in July, when the Money Market Fund Rule (the Money Rule)<sup>1</sup> referenced several aspects of valuation and fund governance.

<sup>1</sup> <http://www.sec.gov/rules/final/2014/33-9616.pdf>



Up until then, the relative calm had as much to do with the market's persistent rise as it did to the lack of SEC activity or another high-profile enforcement case. The Standard & Poor's 500 Index ended 2013 up 30% , and it has enjoyed mostly smooth sailing again this year. Fixed income markets have participated in the rally as well, owing to supportive easy-money policies enacted by global central banks. Perhaps the best gauge of the current even-keel environment rests in the Chicago Board Options Exchange Market's Volatility Index — or the "VIX" — which has remained extremely muted by historical standards.

Also, the kinds of "black swan" events that created valuation challenges in recent years, such as the Japanese typhoon or U.S. debt downgrade that roiled the markets, have mercifully dissipated. To be sure, there was no lack of headlines over the past 12 months, as the geopolitical landscape was rife with potential macro-economic landmines such as the turmoil in Ukraine, the emergence of ISIS in Iraq and Syria, and the economic slowdown in Europe. But, nearly without fail, the markets shrugged off these developments in the main, sending assets to record heights.

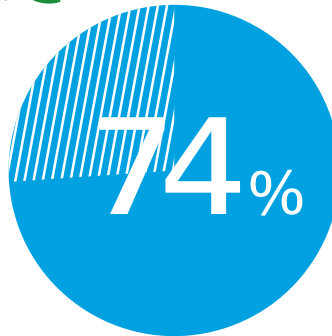
Nonetheless, no one would argue that the valuation process has become any easier. The responsibility of mutual fund groups to determine what they believe best reflects fair value for every investment has not changed, and the fundamental responsibilities of their Boards relative to valuation have likewise not lessened. What is different is the increased availability and interest in market data, transparency tools, automation and technological solutions, all of which allow mutual fund groups to do more in the same or perhaps even less time than before, resulting in more compelling analytics and data to support their decisions.

Against this backdrop, 92 mutual fund groups participated in our twelfth Fair Value Pricing Survey. The findings demonstrate that fair valuation remains a "top of mind" issue for investment managers, Boards and their stakeholders. To no surprise, change was the "name of the game" as 74% of the survey participants indicated that they had revised their valuation policies and procedures over the last year, finding opportunity to evaluate and enhance their valuation processes. The most common changes related to the addition of specific procedures for certain investment types, changes to pricing sources and enhancing language or details for



## Mutual fund groups

participated in our twelfth Fair Value Pricing Survey



## Survey participants

indicated that they had revised their valuation policies and procedures over the last year

certain hard-to-value investments. The percentage of mutual fund groups using a zero trigger in fair valuing foreign equities continued to grow as well, reaching nearly 50%, the highest level attained since we started the survey. Other survey participants continue to use the key valuation indicators, S&P 500 and/or Russell 1000, combined with thresholds, i.e., 50 basis points, to identify whether to make an adjustment to the closing exchange price of their foreign equity holdings.

### Board governance

The SEC surprised many people this year by issuing valuation guidance in July; only 5% of those participating in the survey actually expected the SEC to make such a move in 2014. What was surprising about the guidance was not only that it was issued at all, but also where it was housed, within the Money Rule. We all anticipated that the SEC would speak about the need to fair value money market fund holdings instead of using amortised cost, and it was anticipated that there would be some guidance suggesting how often shadow pricing should be performed. However, the SEC's comments on what non-money market funds using amortised costs for securities (with 60 days or less until maturity) were expected to consider each day was not anticipated, nor was the re-emphasis of the role of the board in considering how pricing vendors value investments.

Before then, the most recent SEC activity directed at boards was the enforcement action that settled in 2013. With that development as context, the 2014 survey asked questions designed to assess whether Boards had made changes to their oversight activities, and we noted the largest changes in the following areas:

- 40% of survey participants said they have changed the types of valuation materials provided to the Board, compared to 54% a year earlier.
- 39% of survey participants have changed the level of detail in the valuation materials provided to the Board, compared to 57% a year ago.

Knowing exactly what to receive and when to receive it is not always easy, as some materials are probably not necessary in all circumstances. One of the emerging trends in this year's survey was that 9% of survey participants indicated that the Board added valuation risk dashboards or key valuation indicators (KVIs) over the last year to assist in their oversight of the valuation process. Given the judgment required in knowing what reports are needed, and the regulatory guidance around the need for "continuous monitoring," we can envision Boards using tools like these more often in the future as a risk-intelligent way to determine when the environment has changed, when the level of price uncertainty is higher for a particular asset class, when Boards might want to increase their level of involvement, and what information they will need to receive to effectively do so.



### Use of market data

The price challenge process has long been an area of discussion in our surveys as it is a highly judgmental area and one where potential conflicts of interest often can arise. The process also calls for strong controls to ensure that management bias does not play into the valuation process. Mutual fund groups have long debated and executed price challenges based on market data and secondary vendor price comparisons, as well as news and events specific to the market, industry, and issuer.

However, there is little debate that a well-supported price challenge should include such market data. This allows the evaluated pricing provider to challenge its valuation process and determine whether relevant market data was considered as part of its evaluated price determination. Survey participants seem to agree, as 54% indicated that they challenge a price only when they have conflicting market data that would suggest the price is not accurate. This response seems to be aligned with the emergence of pricing transparency tools that enable mutual fund groups to study the inputs and market data behind an evaluated price.

In addition, there has been plenty of discussion as to the appropriate amount of documentation required of an affirmed price challenge by the pricing vendor. To this end, 41% responded that they document the nature of the pricing challenge and note that the pricing vendor affirmed its evaluation, and 43% answered that, upon receiving an affirmation, they reach back out to the initiating source, discuss the results of the challenge and conclude thereafter.

Finally, similar to the prior year's survey, 73% indicated that they may change the price if they feel it is inaccurate even if they do not hear back from the pricing vendor. This supports the use of market data as a trend, at least as far as the data helps mutual fund groups go beyond the pricing challenge process and contest the need for certain secondary source comparisons. It is also supporting determinations regarding the risk associated with valuations where little market data exists to support the underlying evaluation.



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## Investment managers and Boards took the opportunity to continue to evaluate and enhance their valuation process

### Valuation risk management

The formalisation of risk oversight continues to be a maturing trend, with 59% of the fund groups indicating that they now have a risk function. Also, as noted in prior surveys, valuation as an enterprise risk has continued to take root. In this year's survey, 48% of mutual fund groups identified risks associated with the valuation of certain investment types as part of their formal Rule 38A-1 or enterprise risk assessment process, compared to 51% in the previous year. Overwhelmingly, 95% of those survey participants have identified internal controls to manage the valuation risk, and 57% have identified valuation of portfolio investments within the risk charter and the related price challenge process as a valuation risk.

With valuation risk increasingly on funds' radar screens, KVIs may have broader potential applications than just in the board room, as management can use them to help determine where the greatest risks exist and on

which asset classes to focus precious time and effort. Ultimately, KVIs help identify when potential risks surface as real issues, and, in their ideal state, can highlight potential risk areas before they lead to a "code red" event.

Therefore, risk-based tools in the valuation process may be an upcoming trend. One notable finding is the 20% of survey participants who had developed risk management assessments such as asset and stress test liquidity tests, consistent with the SEC's January 2014 guidance (No. 2014-1)<sup>2</sup>, and used the results as part of their valuation process.

<sup>2</sup> <http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf>

### Looking ahead

Whether more risk-based metrics and tools will be incorporated into the valuation process in the future is yet to be seen, but we do know that regulatory risk has prompted perennial change for the industry when it comes to valuation issues. In the year to come, certain matters on the regulatory front bear monitoring:



#### Pricing vendor oversight

The SEC's comments in the Money Rule relating to Board consideration of pricing vendors may result in increased Board activities in this area or the development of greater linkages to how the Board performs its required duties. The guidance may also create an increased focus on evaluating whether or not prices of securities for both domestic and foreign investments (not just equities) are as of 4 p.m. EST, as the SEC specifically noted that Boards should consider how close the price is determined to the time that the mutual fund calculates its NAV per share.



#### Short-term debt valuation

The Money Rule also emphasised the need for fund management to ensure that it takes measures to assess whether amortised cost approximates fair value each day that it uses such a measure to value a security, even for non-money market funds. This may spawn more concrete procedures and documentation to demonstrate such, or, alternately, result in a movement away from amortised cost for such investments.



#### Alternatives sweep exams

During the year, the SEC's Office of Compliance, Inspections and Examinations conducted sweep exams focused on the use of alternative investments (e.g., derivatives, leverage) in the mutual fund industry. Clearly, the findings from these sweep exams could put added expectations on mutual fund groups and Boards to continue to elevate the bar for valuation processes.



#### Private equity valuation

Some mutual funds hold a small portion of their assets in private equity investments or other investments that are illiquid, and valuation can often be challenging because it requires considerable judgment coupled with a lack of public information. The SEC's examination of private equity fund managers led to comments in various articles and speeches over the past year regarding the valuation of private equity investments, such as the following remarks made at a forum in 2014<sup>3</sup>:

*"Some of you may be under the mistaken impression that when our exams focus on valuation, our aim is to second-guess your assessment of the value of the portfolio companies that your funds own ... to challenge that a portfolio company is not worth X, but X minus 3%. We are not, except in instances where the adviser's valuation is clearly erroneous.*

*Rather, our aim and our exams are much more focused. Because investors and their consultants and attorneys are relying on the valuation methodology that an adviser promises to employ, OCIE examiners are scrutinizing whether the actual valuation process aligns with the process that an adviser has promised to investors. Some things our examiners are watching out for are:*

- *Cherry-picking comparable or adding back inappropriate items to EBITDA — especially costs that are recurring and persist even after a strategic sale — if there are not rational reasons for the changes and/or if there are not sufficient disclosures to alert investors.*
- *Changing the valuation methodology from period to period without additional disclosure — even if such actions fit into a broadly defined valuation policy — unless there's a logical purpose for the change."*

<sup>3</sup> <http://www.sec.gov/News/Speech/Detail/Speech/1370541735361>

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## The survey results continue to show that mutual fund groups are making changes in how they use data in their valuation process

Although these comments were clearly directed at the private equity fund industry, it is possible that the SEC could apply them to those mutual funds holding private investments with valuations significant enough to affect the NAV per share of the fund. Such an outcome could lead to the need to evaluate the current disclosures in the prospectus and in shareholder reports.

Regulatory risk is not the only driver of potential change. In an environment where more data continues to become available, the ability to do more with it in less time is emerging as a differentiating strategy. The survey results continue to show that mutual fund groups are making changes in how they use data in their valuation process, as approximately 50% of survey participants either increased automation in the valuation process over the past year and/or conducted a study designed to find efficiencies in the valuation process. This finding is significant in that it shows mutual fund groups realise the need to continue to evolve so they can become more nimble. Finding a way to do so which still being risk conscious may be a difficult but important challenge.

All of us know that being able to understand the risks present when a crisis hits, as well as the exposure to them, is a critical capability for weathering the storm as

quickly and efficiently as possible. Six years may seem like yesterday, but that is exactly how long it has been since the credit crisis of 2008, and no one has forgotten how difficult valuations were to assess during that time.

While the fact that the last two significant economic downturns have occurred within about six years of each other does not necessarily mean another downturn is around the corner, it does serve to remind us of the importance of being prepared — taking care to evaluate the inputs in the valuation process and determining which ones might be most subject to volatility in a troubled market; revitalizing due diligence on brokers that may be able to supply prices on valuations where needed; revising internal controls relating to manual processes; and strategically making use of the technology available to assist in the valuation process.

Most importantly, fund groups need to always have one eye on the rear view mirror and consider the valuation lessons learned from 2008 and other circumstances marked by limited liquidity and market data. Valuation during times of relative calm is complex enough. When conditions are less than ideal and hidden risks may surface, being prepared is the best antidote.

### To the point:

- Findings demonstrate that fair valuation remains a “top of mind” issue for investment managers, Boards and their stakeholders
- Change was the “name of the game” as 74% of the survey participants indicated that they had revised their valuation policies and procedures in the last year
- Governance, use of market data and risk were at the top of the agenda for survey participants



# 2015 Alternative Investment Outlook

## Complex grounds, new frontiers

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In many ways, the alternatives industry is still among the most nimble and adaptive sectors of the financial industry, producing tremendous innovation across many aspects of the business.





The alternative investment industry looks ahead to 2015 as the broader market compiles an impressive performance streak. The performance of alternatives looks relatively weaker, causing some to question the long-term fundamentals of the industry. Others are pointing out that the very appeal of alternatives is that they are intended to be inversely correlated to the broader market and that it would be more of a concern if alternative investments were performing in lockstep with the broader indices.

From Deloitte's perspective, with a view of the industry across organisations of many sizes and shapes, there are both challenges and opportunities. The prevailing sense is that the alternative industry is strong overall, but rapidly evolving amidst existing and emerging complexities. In many ways, the alternatives industry is still among the most nimble and adaptive sectors of the financial industry, producing tremendous innovation across many aspects of the business.

Figure 1: Three focus areas for 2015



## The 2015 Alternative Investment Outlook focuses on three key issues:



1

### Globalisation

Increasingly, companies of all sizes are being affected by international markets, events and opportunities. Communications and travel technology continue to shrink the world, many foreign economies are expanding more rapidly than the U.S. economy is growing, and as a result, wealth is being created around the world. Conversely, Europe is facing many challenges and will see the U.S. dollar continue to appreciate against the Euro. This is generating tremendous opportunity for alternative managers in the form of both new investment opportunities and new investors. However, it is also dramatically increasing the complexity of running an alternative investment manager.



2

### Monetisation

Growing numbers of hedge funds and private equity managers are raising capital — or “monetising” their businesses — by selling stakes in their firms to institutional investors. This trend is creating opportunities for both buyers and sellers, but it is also raising dynamic technical and regulatory issues.

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Many industry observers believe that brand resilience and the management of reputational risk are becoming as important in attracting assets as investment performance



### Strategic brand risk management

Many industry observers believe that brand resilience and the management of reputational risk are becoming as important in attracting assets as investment performance. As managers become more risk-aware, more money will be spent to identify and mitigate risks. The concept of a brand narrative around any event impacting the firm, solid corporate communications providing information and transparency to investors and regulators, and the building of goodwill through these actions has become paramount. In the financial services industry, trust is essential, especially for alternative managers acting as fiduciaries. The loss of trust can be fatal, and trust is reflected in an organisation's brand.

The following pages explore these topics in more depth and highlight expectations for the coming year. While all topics are examined independently, it is prudent to remember that they are interrelated and interdependent as part of an increasingly complex industry.

## The global perspective

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### Focus on excellence and growth will come

Alternative investment managers are looking at the global investment landscape for two key reasons:

- First, managers are aware that significant wealth is being created around the world as emerging economies expand and developed economies recover, and they are very interested in managing that wealth. Extending into new geographies with new products gives managers access to these new investors.
- Second, with the cost of breaking even climbing, managers are entering new geographies for investment opportunities. By looking at investment opportunities on a global scale, many managers are able to participate in far more diverse and differentiated investment strategies. The global market offers a variety of ways in which alternative managers can participate. Some managers are setting up extensive local operations in the geographies they wish to serve while others are collaborating with local firms. Certain firms are choosing to handle the operations and technology internally while others are primarily outsourcing. There is no “right” answer; it all depends on the manager, the opportunity and the geography.

According to Deloitte’s 2014 Global Economic Outlook, the trend of weakness in developed countries and strength in emerging markets appears to be reversing. However, emerging markets are still growing at a faster rate than developed nations and their long-term prospects appear strong. There also appears to be a shift in capital flowing back to the United States now that U.S. monetary policy is changing.<sup>1</sup> The net result is that there continues to be a significant pool of international wealth that is interested in alternative investments. As discussed in the 2014 Alternative Investment Outlook, much of this money is coming from institutions, including sovereign wealth funds, pensions and endowments.

From an investing standpoint, having a global reach allows alternative managers the flexibility to take advantage of a wide range of opportunities. The marketplace has seen a dramatic shift in next wave of buyers and what they are looking for in products and services. Products continue to vary widely by institution and geography, but areas of

continued interest include credit funds, especially those that focus on distressed assets and energy.

This growth of investors and investments from a variety of geographies is adding significant complexity to the operations of alternative managers. Each new jurisdiction entered brings new legal, regulatory, tax, valuation and processing issues into play. This complexity is hitting the back office, increasing cost, and adversely affecting return on investment. Firms that do not fully understand and plan for the financial impact of global expansion might not receive the benefit they expect from an investment. In short, if alternative managers only evaluate opportunities by the same standards they use for their U.S. investments, they are unlikely to understand the full cost of owning investments outside of the United States.

For example, an alternative manager may see distressed real estate as an opportunity and decide to invest in single-family homes in a foreign market. By the manager’s domestic standards, the deal may look very attractive.

However, unless the manager has done similar deals in the same market, the manager could very easily underestimate the costs of day-to-day operations. These costs can include property management under local regulations such as eviction standards and the reconciliation of books and records across currencies. Managers should also take into consideration local laws, regulations and customs, which can vary widely by jurisdiction. In an example like this, it is possible that a manager’s assets and revenues could remain relatively stable while the net return could be lower than anticipated due to the structural complexity and associated costs of the deal. You take on unnecessary risk when you engage in activities you do not fully understand or have not appropriately evaluated. In 2015, the firms that prioritise due diligence and bring in tax, legal and regulatory advice up front are most likely to be satisfied with their global portfolios. Alternative managers that spend a little more time up front to ensure that they have a true understanding of what they are asking the back office to do, and the risks they are taking on, are likely to do better in the long term.

<sup>1</sup> Dr. Ira Khalish, *Global Economic Outlook, Q3 2014, Deloitte University Press.*

**Focus for 2015**

The largest asset managers are best able to participate in the global market. They have the scale and infrastructure to go almost anywhere and the resources to see that they do it well. Yet they are still able to be nimble, launch niche products, and respond quickly to opportunity. In many ways, they have the best of both worlds, and it is increasingly challenging to compete against them. Smaller firms will look to compete by leveraging partnerships and relying on outside expertise in areas such as distribution and operations. In addition, spending on up-front due diligence is expected to rise as managers seek to fully understand the implications of deals that they are undertaking. As one industry executive recently put it, *“You need to kick the bricks, ride the elevators, and understand the tenants”* in each deal.

**The bottom line**  
In order for firms to compete, they must continue to think globally. There is simply far too much wealth and far too many investment opportunities outside the United States to ignore. The complexity of alternative operations will continue to increase as firms expand globally across various jurisdictions and investments. Complex operations will continue to be a cost of doing business internationally, and the largest firms, which have the resources to address this complexity, have an advantage. Spending the time and effort to understand the full tax, regulatory, and operational implications of each deal may seem expensive, but it can mitigate surprises on the back end and should prove to be a good long-term investment.

**Figure 2: Going global adds complexity**

Opportunities for U.S. alternatives managers in other countries introduce challenges that can affect return on investment

**Global investments**

A significant pool of international wealth is interested in alternative investments — including sovereign wealth funds, pensions, endowments, high-net-worth individuals, and family offices.



**Regulatory**

Local laws regulations and standards can vary widely by jurisdiction.



**Global investors**

A global reach allows alternative managers flexibility to take advantage of a wide range of opportunities.



**Tax**

Firms that bring in the tax, legal, and regulatory expertise up front are more likely to be satisfied with their global portfolios.



**Operational**

When entering new markets, managers should be careful not to underestimate the costs of day-to-day operations.



Source: Deloitte Center for Financial Services analysis

## Monetisation strategies move forward

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### Monetisation transactions are expected to continue in 2015, although they raise important business and technical issues for both buyers and sellers

In 2014, a significant uptick occurred among hedge funds and private equity managers raising capital by selling a piece of their businesses. At the same time, that interest was matched by institutional investors seeking to make such acquisitions. Such “monetization” has created an active marketplace, where new entrants launching funds specifically to purchase minority interest stakes in alternative investment managers are joining a number of firms already in the space. These transactions are expected to continue at a healthy pace throughout 2015, although they raise important business and technical issues for both buyers and sellers, including agreement on the nature and extent of the relationship between the parties involved.

There are a number of reasons why monetisation transactions are so popular. Key drivers include personal issues for finance principals, such as succession planning and/or retirement planning, which require an “institutionalisation” of the business. The demographics of finance principals, many of whom are baby boomers, suggest that this trend is likely to continue for many years to come.

Another key driver is the desire of some alternative managers to raise a base of capital to expand their businesses. Having fresh capital to invest in the business allows managers greater flexibility in expansion planning. They can launch new products, diversify their investor base, expand their investment focus beyond its current footprint, improve their distribution capabilities, or do all of these at the same time.

Finally, as we saw in the late 2000s, some monetisation transactions may serve as a precursor to an initial public offering (IPO), allowing managers to establish a price point for a future offering. Given where the financial markets are today, it appears to be a good time for

sellers to consider monetising a piece of the business, while buyers appear to believe current valuations justify the purchase price based on future opportunities for growth. It’s no wonder that some industry participants refer to these monetisation deals as providing “acceleration capital” to managers, allowing them to take their businesses to the next level.

What do buyers seek in these transactions? Typically, they look for a manager who has a strong track record in his or her area of expertise, and usually, but not always, is committed to running the business for the foreseeable future. Buyers also look for a manager who has been able to build a business that is supported by a solid operational and compliance infrastructure and that has a stable investor base. In 2015, the growing complexity of operations and compliance brought in by increased regulation, cyber threats and product expansion, as well as the need for operational efficiency brought on by continued fee pressure, may indicate that buyers will place even more emphasis on the infrastructure side of the business. Managers seeking new and flexible sources of capital are finding it with investors who are looking for a stable organisation, strong leadership and a desire to create a franchise beyond the original founders of a fund.

From the manager’s perspective, it is important to identify a strategic partner with the resources to help implement expansion plans and build the business by launching new products, entering new geographies, and/or targeting new types of investors. Most managers want a strategic partner to make their business stronger. This long-term approach, where a manager looks for a partner able to help drive the future of the business, is expected to generate continued interest in 2015.



Like any other important business relationship, due consideration is appropriate on both sides before entering into a transaction. Of course, formal due diligence is important from both the finance and tax perspective, but the buyer and seller also need to be able to look each other in the eye and say, “Yes, I can work with this person or with this organisation.” To protect both sides, there should be an agreement outlining the level of participation that the strategic investor will have in the ongoing business. Some people will be comfortable with a passive approach while others, particularly on the buyer side, may be more interested in having an active role in managing and developing the underlying business. As one industry executive recently commented, “Don’t break the fabric of the culture -- be there as an advisor and a sounding board.”

It is impossible to say which approach is the better model for operating. It depends on the perspective of the buyer and seller. Again, it’s critical to have a mutual understanding prior to entering into the strategic relationship.

There are a number of obstacles to success in closing a deal. Valuation is one key area of negotiation. Just as calculating the fair value of a security held in a portfolio is an imprecise science, deciding the fair price for a manager can be a challenge. In addition, in times of transition such as the alternatives industry is experiencing currently, valuation becomes even more important — especially given the trend toward a more regulated environment and ongoing fee pressure. There are typically other negotiating points as well, including the allocation of purchase price, the right to claw back purchase price, earn-out provisions, and “key person” provisions.

From the buyer’s perspective, “key person” risk is of paramount consideration. Succession planning and due diligence are key. As discussed earlier, the existing management is often a critical aspect of the deal, and the buyer needs to be comfortable that the manager or the management team running the business will continue to be engaged. This often includes investor relations as well as the investment/trading side of the business. Speaking of investor relations, there must be mutual agreement on when and how communication to existing investors should be made, as well as when and how communication should be made to the public.

Taxes typically rise to the top of key considerations in a strategic transaction; it is important that both the buyer and seller understand the tax implications of the transaction they are contemplating. The buyer will want to ensure that the purchase price will be recovered through amortisation deductions. From the seller’s perspective, the objective typically is to maximise the long-term capital gain arising from the transaction. These two outcomes are not mutually exclusive, but care must be taken to optimise the result for both sides. Taxes paid by alternative asset managers is an issue that is being reviewed by the Treasury Department and is widely discussed in the media; as a result, possible implications, including government and media scrutiny, should be taken into consideration when evaluating a deal.<sup>2</sup> Finally, both sides must seriously consider exit strategies before entering into a transaction. Key issues include put options, call options, so-called “tag along” and “drag along” rights, and other exit-strategy issues that may differ depending on whether the exit strategy is an IPO, an effective redemption, or a sale to a third party. In addition, timing when these rights or obligations may be exercised is important to decide up front, as is a mechanism for establishing a valuation for the exit.

<sup>2</sup> Zachary R. Mider, “Treasury Is Weighing Action on Hedge-Fund Tax ‘Loophole,’” *Bloomberg*, September 11, 2014.

Figure 3: Riding the monetisation train



#### Focus for 2015

We expect that 2015 will bring more monetisation deals to the fore, provided the capital markets continue on an upward trajectory. The pace of deals may pick up a bit, but strategic buyers need to make sure to balance new transactions with the onboarding of managers on deals just closed. This onboarding, which would include sharing leading practices in investment research, trading, operational efficiency and risk management, is critical to the success of a deal. The deal sizes are also not likely to change, as most firms appear to be interested in similar types of targets. However, we may see more cross-border transactions as the globalization of the hedge fund business continues. Cross-border deals are by their nature more complex, and this may increase the time needed for onboarding even more.

#### The bottom line

As deal momentum continues in 2015 due to succession planning needs and the desire of managers to raise a stable base of capital for expansion, expect monetisation to continue. Done well, these transactions represent an opportunity for both sides of the deal and allow managers to “accelerate” the business. Monetisation deals reflect the continued maturation of the alternatives industry, and perhaps represent a harbinger of greater consolidation. However, it is essential that proper due diligence and business and tax planning be done up front, and that both sides see eye-to-eye and have realistic and reasonable expectations. It is also essential that managers carefully evaluate the investor relations and public relations aspects of the deal, and consider the potential impact of both on their brand and reputation.



## Embracing strategic risk management to protect and grow a business

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### An argument can be made that brand and reputation are at least as important as investment performance to the vitality of an investment organisation

Investment managers are very well acquainted with the concept of risk management. Alternative managers, in particular, understand that investment risk, if well-managed, can lead to enhanced portfolio returns. As such, alternative managers frequently embrace risk to generate superior investment performance. This management of investment risk has always been a key part of the value proposition of alternative managers: it is core to what they do, and, in many ways, it is the lifeblood of the alternative investment industry.

However, the management of other types of risks that the industry faces, including operational, technology and regulatory risk, has not always been viewed the same way as investment risk. This is not to say that these other risk types are not considered important by alternative managers. In fact, many alternative managers are allocating significant resources to managing these risks. For example, over the last few years, many alternative managers have incurred the cost of becoming registered advisers and dealt with the global regulatory focus on conflicts of interest. However, the spending to mitigate these other risks has usually been considered a necessary cost of doing business and a defensive strategy, rather than a proactive way to generate additional value for the organisation and its clients.

This traditional view of risk management is beginning to change as some alternative managers are realising that a "risk event," whether stemming from a valuation error, a conflict of interest or a data breach, can have a significant negative impact on their brand and their reputation.

They also understand that the trust of their customers, employees and business partners is essential to their future livelihood. In fact, an argument can be made that brand and reputation are at least as important as investment performance to the vitality of an investment organisation. Just as poor investment performance will usually lead to fewer assets under management, a negative headline can do the same. For example, cyberattacks in other industries have affected revenues of companies, harmed brands and cost senior executives their jobs.

This growing realisation of the importance of brand is causing some alternative managers to move away from the defensive view of risk management toward a more proactive and strategic approach. These firms understand that if managed correctly risk management is a competitive differentiator and can be transformed into an asset that drives brand equity and provides a measurable, positive return in the form of increased asset retention and new asset flows.

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*“In world-class companies, risk is positioned in strategy, not in compliance.”—  
Chief risk officer, Deloitte*

In 2015, it is expected that the alternative investment industry will increase adoption of some of the leading risk-management approaches that other industries are already using. While each organisation will have a different approach to risk management, there are three common building blocks that many firms are likely to adopt:

**Governance.** Proper governance entails getting the entire organisation, typically led by a chief risk officer with guidance and input from the CEO and board, to work together to make risk a strategic enabler. The board, executive management and business units each have individual responsibilities and are all accountable for collaborating across the organisation’s silos to continuously identify, prioritise, and manage risks. A standard cadence is established in which business unit risk leaders meet to discuss emerging risk trends and mitigation strategies, escalating key themes and concerns to the board and executive management as needed. Proper governance creates a more manageable and meaningful risk process within an organisation, setting the appropriate “tone at the top” and driving accountability and transparency. Risk management must become part of the very ethos of the firm in order to be truly effective.

**Standardised risk reporting.** Enhanced risk reporting creates better visibility into emerging risks and helps drive risk-based decisions during the governance process. To ensure effective risk reporting, the process must be fully aligned with the company’s strategic goals and objectives. The process must also filter out any irrelevant, excessive, disjointed or obsolete data. In the coming year, alternative managers are expected to make more use of risk-reporting dashboards on computers and mobile devices to capture emerging risks affecting the organisation’s strategy. By giving an updated view of vulnerabilities and their potential impact, dashboards are critical to effectively prioritising and mitigating risks. Dashboards must be updated

periodically — daily or weekly, depending on the risk — with an aggregated version prepared monthly or quarterly. A dashboard should also provide the board and executive management with the ability, at a glance, to evaluate the most relevant risks that could affect reputation, share price, corporate strategy, and, most importantly, assets under management.

**Risk sensing.** The ability to identify emerging risks and risk trends quickly and thus allow for a more nimble and effective response to risk is a critical skill in today’s complex financial environment. Known as risk sensing, this skill involves a combination of human analysis and sophisticated technology that continuously analyses massive amounts of structured and unstructured data in near real time. This can provide highly relevant information specific to strategic decision making that tries to help executives peek around the corner to see what is ahead.

Firms can build risk sensing into their operations by embedding it in the formal governance process and standardising the reporting resulting from it. Key decision-makers must be able to digest easily the information derived from risk sensing. Among other benefits, an operationalised risk-sensing capability provides an organisation with the ability to continuously adapt its risk management focus based on data from both traditional and social media, and to adjust its response accordingly.

Because risk sensing can help executives understand how customers, competitors, suppliers and regulators view the risks facing an organisation, it is expected that these capabilities will gain traction in the alternatives industry. It is even possible that once alternative managers become adept at using risk-sensing tools, they may be able to incorporate them into their investment management process. In other words, they may be able to gather data on companies that they own or are targeting, in order to understand the risk these companies face.



### Focus for 2015

One emerging reputational risk that can create irreparable brand damage for an organisation is a cyberbreach. The level of this threat continues to rise and is expected to be a key focus in the coming year. The impact of cyberbreaches in other industries is a leading indicator of the potential impact in the alternative investment space. It is difficult to overstate the importance of protecting proprietary and confidential organisation information as well as clients' personally identifiable information.

While much of the attention on cyber risk is focusing on outside entities hacking into systems, alternative managers are also expected to invest heavily in protecting systems from "insiders," including their employees, vendors' employees and independent contractors. This concern about the "inside threat" extends well beyond cybersecurity and into such areas as regulatory compliance, trade secrets and other confidential information.

### The bottom line

Organisations that view risk management as a strategic enabler are expected to have a long-term advantage in the alternative investment industry.

While an up-front investment is required, in return an organisation will be better prepared to withstand market disruptions, cyberattacks, regulatory scrutiny, and many other risks. Anticipating the risks of tomorrow and pivoting quickly in response is critical to every firm. In addition, managers who make risk management a part of the core value proposition of their firms will have a compelling story to share with current and prospective clients. In an increasingly competitive industry, it is very possible that this could lead to higher client retention and the attraction of new assets. For organisations that value long-term wealth creation, for both owners and their clients, strategic risk management can be essential to achieving that goal.



Figure 4: Building a brand and reputation risk management program



**Strategic impact**

- Identify opportunities to positively impact brand perception
- Strive to reduce or eliminate “traditional” crisis situations/ brand attacks
- Further differentiate the organisation’s brand from its competitors
- Create “what if” scenario planning to positively alter our strategic focus
- Link internal strategies with brand strategies to create differentiation

Source: Deloitte Center for Financial Services analysis



#### To the point:

- The alternative investment industry is in a state of transition. Many factors, including increased regulation and globalisation, are combining to make the industry more costly, more competitive and more complex than ever before
- Alternative managers must continue to think globally if they want to be relevant in today's worldwide economy
- Monetisation is expected to continue as owners look to retire and transition ownership of their firms or to raise stable capital for expansion
- In today's era of instant communication and social media, the risk to brand from one key operational, regulatory or technological mishap can be devastating.
- The alternative investment firms that take the time to be thoughtful about what the future holds, map that vision of the future with their key value proposition and have a willingness to invest in a plan of action are likely to lead

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In today's era of instant communication and social media, the risk to brand from one key operational, regulatory or technological mishap can be devastating



# Do you really know where your assets are, and if they are safe?

**Dietmar Roessler**  
Global Head of Client Segment Asset Owner  
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The 2008 financial crisis has changed the rules of the game for global custodians. Asset owners are now asking questions they would not have done previously, especially in an increasingly volatile and globalised world.

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## An asset owner's number one consideration is asset safety—cash safety and the safekeeping of assets held on his behalf

Until October 2008, most of the focus of institutional investors when appointing global custodians was on enabling - enabling global investments across all markets, enabling performance measurement and, last but not least, enabling performance-enhancing services such as securities lending and active cash management.

That focus has now changed. The discovery of 'black swans' (a disastrous but supposedly rare occurrence) and 'fat tails' (abnormal statistical behaviour) has forced investors with a liability horizon of 30-plus years to reconsider. What would have happened to my assets if Barings had not been quickly taken over by ING? What is the impact of assets being 'frozen' for six months until final ownership has been established? What is the impact of Madoff itself acting as asset manager, custodian and transfer agent?

More importantly, do I really know who keeps my assets safe and where they are? What is my legal position? How can I minimise the likelihood of asset loss? Do I really understand the risk being run by my managers: investment risk and systemic risk? What is the systemic legal difference between investing in UK, German and Asian assets?

Clearly, Madoff and Lehman changed the focus for everyone: investors, asset managers, regulators and custodians. Since these disasters, asset owners have started to challenge global custodians by asking fundamental questions. What is the real goal of asset owners, and what is the role of global custodians in achieving them? The answers to these questions are simple: asset owners invest for the long term, and the role of global custodians is to safeguard these investments.

The challenge facing the global custodian is to mitigate the risks of asset owners in a world of increased volatility and globalisation, compounded by incoherent rights of transfer of ownership and ownership.

Whether it is a pension fund, insurance or reinsurance company or even sovereign wealth fund, an asset owner's number one consideration is asset safety—cash safety and the safekeeping of assets held on his behalf. Where is my cash being held? Today, the discussion around cash is very much a traditional banking one: how does the bank hold cash?

Why is cash not held separately as client money? Prior to Lehman Brothers going into bankruptcy in 2008, people did not ask these basic questions—the assumption was that no major bank would ever go under. A global custodian is essentially a bank, and we are seeing a real return to basics. It is therefore not surprising that asset owners are looking in meticulous detail at a global custodian's balance sheet strength, its credit default swap (CDS) spreads, its credit rating, its net asset shareholder equity and the diversity of its business portfolio.

Financial strength is by no means the only factor considered in the selection process. Another significant consequence of recent upheavals is the emphasis now placed by clients on the strength of operational procedures and controls and the clarification of asset ownership.

Nothing is infallible. Even the strongest operational procedures and controls cannot guarantee 100 % accuracy. Whilst a global custody agreement might provide for recourse to the custodian in the event of a fault, a client must be assured of the global custodian's ability to pay for any liabilities incurred through operational losses—for example if the custodian loses securities, fails to subscribe to corporate events, or fails to convert bonds. The amounts involved are potentially huge, and clients are asking themselves whether their custodian can sustain such claims? If there are multiple claims, how many blows can my custodian absorb? So, whilst securities (unlike cash) do not sit on the global custodian's balance sheet, financial strength is as important for the safety of assets as it is for the safety of cash.

#### **Segregate to isolate**

Clients are demanding the clear segregation of their assets so as to be able to identify these through the entire chain - from the global custodian through the sub-custodian to the Central Securities Depository. The perception is that the identification and ring-fencing of client assets ensures these assets will not form part of the estate available to the liquidator in the event of the insolvency of a global custodian or that of any of its sub-custodians.

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The amounts involved are potentially huge, and clients are asking themselves whether their custodian can sustain such claims?

The global custodian's due diligence across its proprietary and sub-custodian network is vital for ensuring the safety of assets and making certain that they are clearly identifiable and segregated from the bank's proprietary activity in all of the owner's investment markets. With up to US\$30 billion initially tied up in the disentanglement of Lehman Brothers, it is no surprise that segregation procedures come a close second to financial strength in the selection process.

Segregation of assets by the global custodian contrasts with the 'prime broker' model used by hedge funds. Here the prime broker holds the assets on its own balance sheet, as security for finance provided, and is normally able to 'rehypothecate' or pledge them in order to raise finance. The problems with this model became apparent with the collapse of Lehman's and the continuing difficulties its hedge-fund clients are having in extricating their assets to enable them to continue in business.

Whilst the global custody model differs significantly from the prime brokerage model post Lehman Brothers, segregation nevertheless remains at the forefront of clients' minds. It must be stressed, however, that to date no major global custodian has gone into liquidation. Consequently, although there are legal opinions in place supporting the recoverability of assets in all client investment markets, there is no legal precedent proving that segregation will ensure the recovery of assets. Irrespective of the name on the sub-custody or CSD account, the account still belongs to the global custodian. This brings us back to the importance of the financial strength of the global custodian, and its proprietary and sub-custody network.

#### **The industry takes the lead**

While there may be uncertainty and divided opinion around the legal framework and no precedent to prove that clients will, unequivocally, be able to recover their assets in case of insolvency of a global custodian, market-driven changes are nevertheless making an impact.

To date, global custody models have primarily been based around co-mingled omnibus accounts, where similar clients are pooled in one sub-account. These days, asset-owning clients are increasingly demanding individual, segregated accounts.



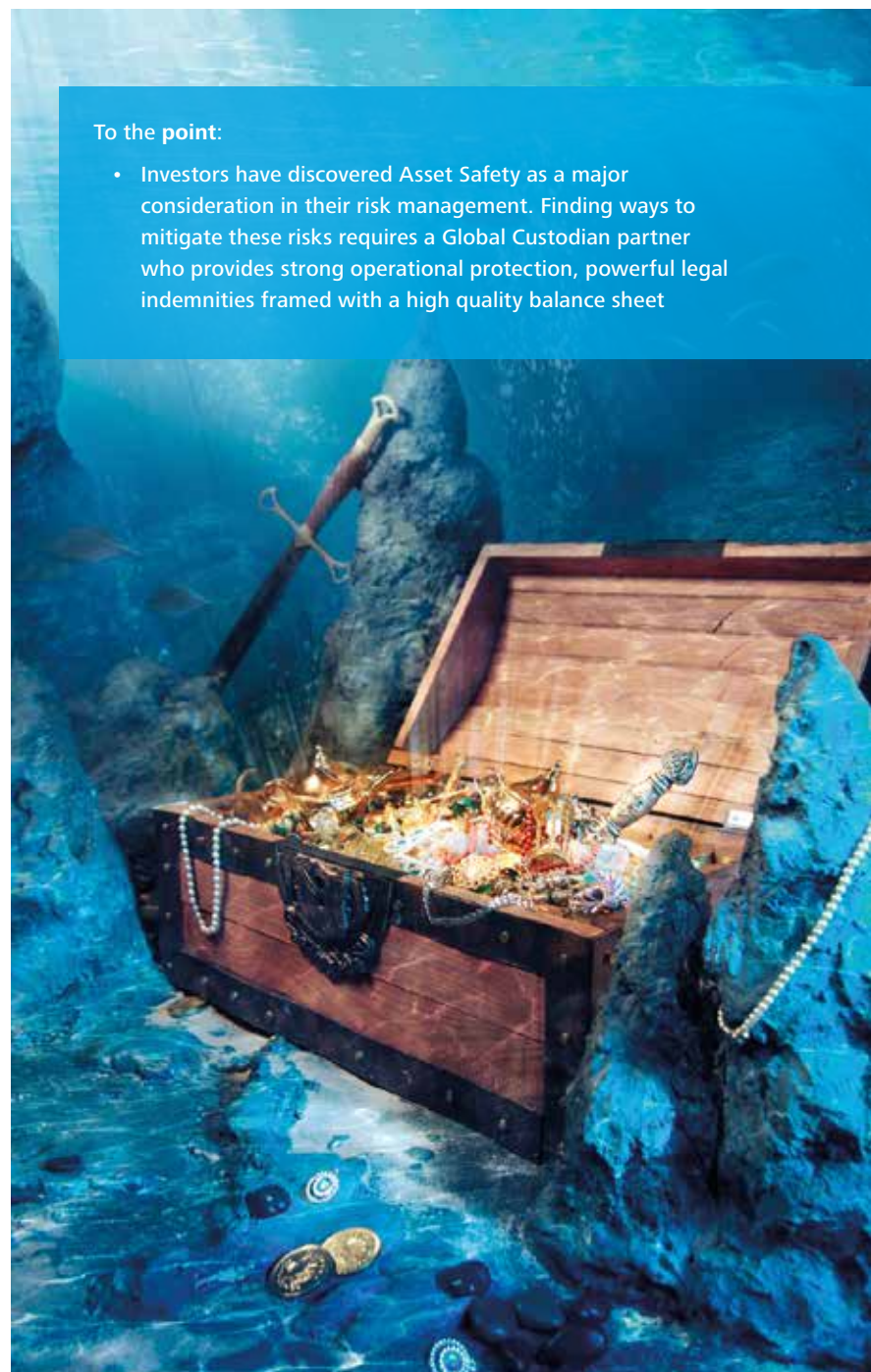
These moves require significant changes to an underlying global custody operating model that is currently based on pooled accounts, with implications for costs and therefore prices. That global custodians are ready to make this investment and clients are willing to pay an increased price reflects how the events of 2008 have changed our perceptions regarding the infallibility of financial institutions- perhaps for the better.

Similar requirements are being imposed through a storm of reform. Most new regulation is aimed at protecting retail or institutional investors and reducing counterparty and systemic risk. Whether it is the Alternative Investment Fund Managers (AIFM) directive, Undertakings for Collective Investment in Transferable Securities (UCITS V) directive, Foreign Account Tax Compliance Act (FATCA), European Market Infrastructure Regulation (EMIR), or many of the other ongoing regulatory changes, there should be increased transparency for both trustees and depository banks.

It is only now that we are starting to ask the question of what 'safe-keeping' really means, operationally as well as legally. The result is a strong increase in custodians' liability and due-diligence obligations, which will probably lead to a new round of consolidation among custodians.

The obligation to replace securities, regardless of one's own or third-party default, will lead to fundamental changes in the rules of the game within the global custodian industry. There is no reinsurance to pick up this heightened risk obligation, and investors will most likely only be partially willing to absorb the additional cost of security. Consequently, global custodians with an extensive proprietary sub-custody network will have a competitive advantage. They are most likely able to provide guarantees to asset owners within their own organisation and on their own balance sheet.

Contrary to the past, the new wave of industry consolidation will not be about size but about building the right operating model. This will allow the provision of guarantees to global asset owners along the lines currently being drafted in the AIFM and UCITS V directives.



**To the point:**

- Investors have discovered Asset Safety as a major consideration in their risk management. Finding ways to mitigate these risks requires a Global Custodian partner who provides strong operational protection, powerful legal indemnities framed with a high quality balance sheet

# Plans to reform the German Investment Tax Act Overview and impact

Alexander Wenzel  
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It is almost a legal tradition that the income earned by German taxpayers through an investment fund is taxed in accordance with the so-called principle of tax transparency. For some time, however, a number of ministries of finance have been pursuing a plan to reform the German Investment Tax Act to such an extent that the principle of tax transparency could be eliminated.

Should this initiative pass the legislative process, the new taxation regime would most probably have a significant impact on the business of asset managers when selling fund units to German investors.





### Starting point: principle of tax transparency

Under the current taxation system, German investors in an investment fund are taxed in line with the principle of tax transparency. Essentially, this means that profits as well as income generated by an investment fund are only taxable in the hands of the investor; the investment fund as such should not be subject to tax. The purpose of the principle is to make sure that the tax burden is more or less identical, regardless of whether an investment is made directly in the assets or indirectly through an investment fund. In other words, the interposition of an investment fund should neither lead to a higher nor a lower tax burden for the investor.

The principle of tax transparency requires the investment fund to publish certain tax bases in line with German tax laws; these are then used in order to arrive at the correct tax assessment of the investor. If the investment fund fails to provide these tax bases, the investor is taxed on a lump-sum basis. This, however, fails to take into account the actual financial position of the investment fund, which can lead to taxation even if the investment fund suffered a loss in value. Consequently, the so-called opaque investment funds are not usually marketable in Germany.

### Political environment

The plan to reform the taxation of income from investment funds was reflected in the coalition agreement between the Christian Democratic Union and the Social Democratic Party of Germany in 2013. Under the terms of the agreement, the parties joined forces and stipulated that the federal government would discuss the fundamental reform of the taxation of income from investment funds once again hoping to change the future tax treatment of capital gains from portfolio holdings in an open and unbiased way.

The general perception in the market is that the work on the new act has been completed. The remaining questions at the moment seem to centre on if and when the draft bill is going to be introduced into the formal legislative procedure.

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## The intention, therefore, is to drop the principle of tax transparency for such mutual investment funds, i.e. to eliminate any type of investor tax reporting and to replace it with a simple taxation system that can easily be managed

### Objectives of the reform

There are a number of arguments brought forward by supporters as to why a fundamental reform is considered indispensable. One explanation is that risks resulting from a potential violation of European Union law need to be precluded. In its 'Santander' judgment of 10 May 2012, the European Court of Justice (ECJ) found with respect to the French investment fund taxation system that it is not compatible with European Union law for withholding tax to be levied on dividend payments by domestic companies to non-resident investment vehicles while no tax is deducted when dividends are received by domestic vehicles. This is despite the fact that the legal situation in Germany is quite different given that, unlike the former French system, German investment funds are required to deduct withholding tax in the case of the distribution and accumulation of domestic dividends.

This holds particularly true in light of the recent ECJ case law 'van Caster und van Caster' dated 9 October 2014. In this judgement, the ECJ dealt with the question of whether or not it is in line with the law for investors in a non-German investment fund to be taxed on a lump-sum basis if the investment fund does not calculate and publish the tax bases in order to gain transparent status. Even though the underlying provision applies to both German and non-German investment funds, the ECJ decided that it is an unjustified restriction on the free movement of capital if the investor does not get the chance to prove the true tax bases himself.

The tax authorities are expecting an increase in the number of cases where taxpayers file applications aimed at consideration of self-assessed tax bases and that the work required on the part of the authorities will increase significantly. The concern is that, unlike today, there will potentially be a need to have specifically trained tax officers in each and every revenue office. It is said that the estimated expenses triggered by this development would most probably be out of proportion in relation to the expected amount of tax income.

Another point is that the fiscal authorities view the investment taxation area as being very prone to abuse because of its complexity and high asset volume. Even though known misuses have been eliminated by the AIFM Tax Adjustment Act, investment taxation requires reform in order to prevent or at least impede future abuse.

Furthermore, it is argued that the principle of tax transparency leads to a considerable administrative burden in practice. For example, each investment fund needs to calculate and publish up to 29 tax numbers upon each distribution and accumulation. Loss carry-forwards have to be separated into 12 categories.



Finally, the supporters of the envisaged reform criticise the fact that a review of the tax bases for all investors can only be carried out retroactively. Should errors be identified, a retroactive correction at the level of the investors is practically impossible due to the anonymous mass procedure. Investors in an investment fund are usually unknown and the investor composition changes frequently between the time when the error occurred and the time when it was detected. Instead of a retroactive correction, which would be appropriate from a substantive point of view, the current taxation system manages these cases by correcting the figures in the fiscal year in which the inaccuracy was discovered. As a result, investors who were not investing at the relevant point in time are hit by a correction, these investors can in turn claim a rescission of that error correction in their personal tax assessments. In the final analysis, the outcome is that a higher tax claim on the part of the tax authorities cannot be enforced.

#### **Main content of the envisaged tax system**

While the fiscal authorities are of the opinion that compliance even with complex rules can be safeguarded in the case of special investment funds, i.e. investment funds where the number of investors is limited to 100 and where investors must not be natural persons, it is said that the opposite is true with respect to mutual investment funds. The intention, therefore, is to drop the principle of tax transparency for such mutual investment funds, i.e. to eliminate any type of investor tax reporting and to replace it with a simple taxation system that can easily be managed. For special investment funds, the current taxation rules would, however, be retained and only minor changes would be made in order to eliminate any potential risks with regards to European Union (EU) law and reduce any scope for action.



### Investment fund level

The major change would be that German dividends as well as rental income and capital gains from German real estate would be subject to a 15% corporate tax at the level of a German investment fund. All other income (e.g. interest income, capital gains from the sale of shares and other securities) would still be tax-free. As a result, German and non-German investment funds would be treated equally in order to avoid distortion of competition.

An exemption from corporate tax would be possible to the extent that funds can prove that tax-exempt investors have invested (e.g. charitable investors such as churches and foundations). The same would apply if investors held investment fund units as part of their official retirement arrangements. The relevant circumstances shall be evidenced by a voluntary certification procedure upon the acquisition and redemption of investment fund units. Total exemption from corporate tax would be possible if the terms and conditions of the investment fund dictate that only tax-exempt investors are entitled to participate.



### Investor level

At the level of the investor, essentially any distribution would be entirely taxable regardless of the composition. In other words, even a repayment of capital would be subject to taxation. As an exception, investors would enjoy a tax exemption of 20% in the case of equity investment funds and 40% if they are invested in real estate investment funds. If the investment fund is primarily invested in non-German real estate, the tax exemption would go up to 60%. The partial exemption is considered necessary in order to compensate for the tax burden at the investment fund level.

In the case of a reinvestment fund or if the investment fund only distributes a very small amount of its income, the German investor would be taxed on the basis of a pre-lump sum. The amount of this pre-lump sum would be determined by the value of the investment fund unit at the beginning of the year, multiplied by the variable base interest rate pursuant to the German Valuation Act. The base interest rate is an average interest rate on government bonds determined by the German Central Bank once a year as per the first trading day of the year. In order to account for administrative costs at investment fund level, a discount of 20% on the base interest rate would be made.

The charging of the pre-lump sum would be capped by the actual increase in value of the investment fund unit. If there has been no increase in value during the calendar year, no pre-lump sum would be applied as tax base. The pre-lump sum would be deducted upon the sale of the investment fund unit, thereby reducing tax.

### Transitional rules

The plan provides for the new rules to commence on 1 January 2018. Investment funds having a fiscal year differing from the calendar year would have to form a short fiscal year as per 31 December 2017 to ensure a uniform transition for all investment funds and their investors.

Investment units acquired before 2009 are, however, grandfathered under the old rules, i.e. a capital gain stemming from the sale of the investment fund units would be tax-free. This protection is limited in such a way that only disposals before 1 January 2020 are tax-exempt. Thereafter, any appreciation or depreciation originating from 2018 and onwards would be taxable.



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## The envisaged comprehensive reform of the German Investment Tax Act would constitute a complete change of investor taxation

### Business impact

The envisaged comprehensive reform of the German Investment Tax Act would constitute a complete change of investor taxation. Notwithstanding the arguments put forward by the fiscal authorities, the reform would have far-reaching consequences for the asset management industry. Many market participants, including asset managers, associations and investors, have considerable concerns about the plans and believe the 'investment fund' product could be damaged. One of their arguments is that tax reporting for German investors has been well established since 2003, when the system came into force, while the envisaged taxation system would ignore any investor-specific circumstances. Indeed, the tax aspects of investment products have

become more and more important over the past years and it remains to be seen how investors and particularly business investors would react if the plans became reality. One scenario is that business investors would shift their investments into special investment funds and another is that the insurance business would significantly benefit from the reform.

In any case it is vital to keep a very close eye on further developments and to anticipate the consequences of the potential reform for the retail business. The impact can be quite different depending on the set-up of an investment fund and the composition of its investors. It will be advisable to consult a tax advisor in due course.

#### To the point:

- The German fiscal authorities are determined to reform the German Investment Tax Act to such an extent that the principle of tax transparency would be eliminated
- The arguments favouring a reform pertain to the fear of violating the European Union law, the conviction that the investment taxation area is extraordinarily prone to abuse, the considerable administrative burden as well as the fact that incorrect tax bases cannot be corrected retroactively
- The perception in the market at the moment is that a bill has already been drafted but the formal legislative procedure has not yet commenced
- For special investment funds, i.e. investment funds where the number of investors is limited to 100 and where investors must not be natural persons, the consequences of the reform would be moderate
- For mutual investment funds, the principle of tax transparency would, however, be dropped and investors would therefore no longer be taxed on the basis of their individual situation and the income of the investment fund but instead on the basis of generic assumptions
- German investment funds to the extent that they earn German dividends, German rental income and capital gains from German real estate would be subject to corporate tax. In addition, investors would be taxed on distributions and a pre-lump sum whereby certain tax exemptions would be depending on the type of investment fund
- Should the envisaged reform become a reality, the new taxation regime would most probably have a significant impact on the business of asset managers when selling fund units to German investors



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- MiFID II - 17 SEP
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# Outlook – Brightening, with opportunities for growth

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