

Performance Magazine

Issue 36

September 2021

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FOREWORD

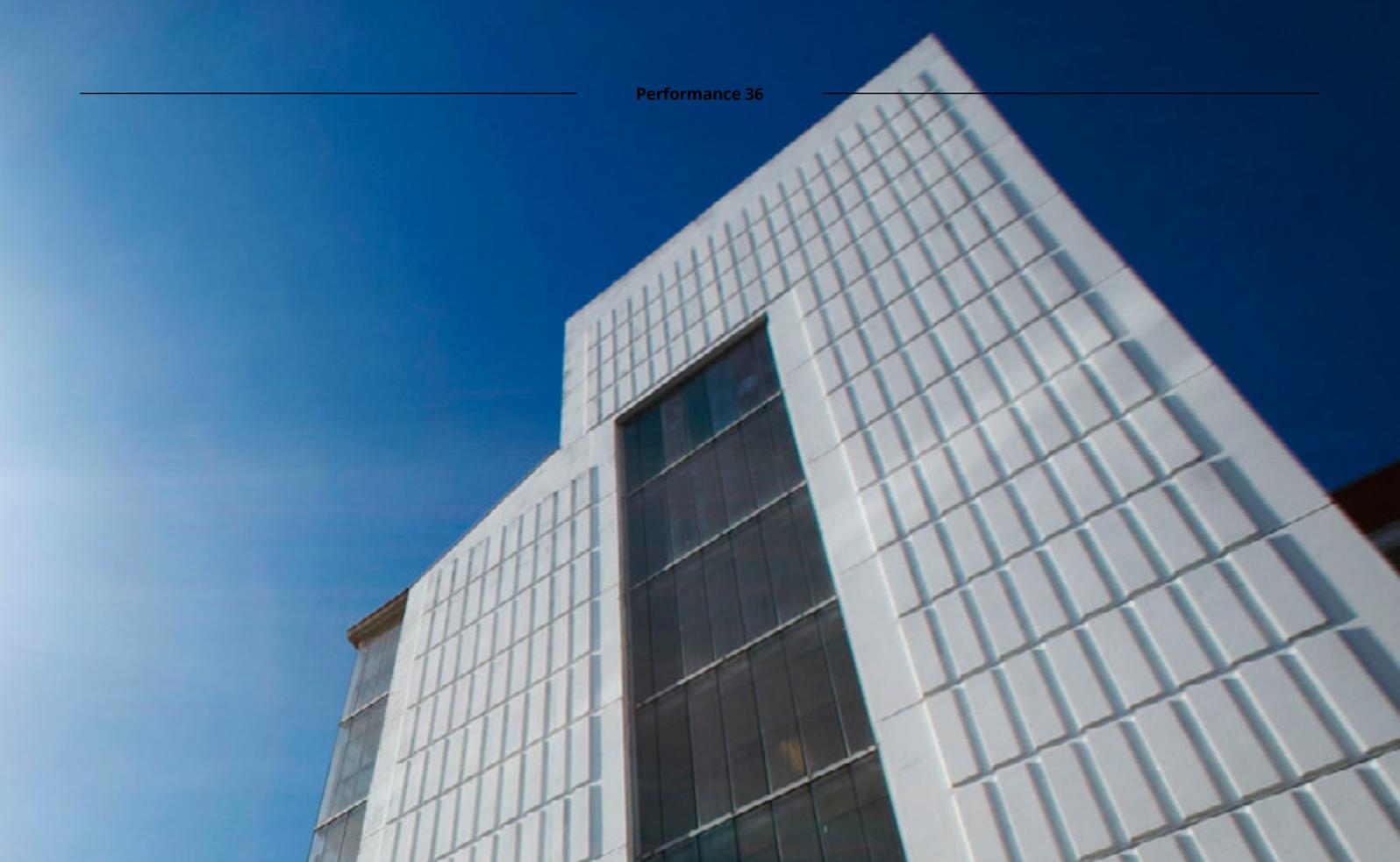


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As we tentatively emerge from beneath the cloud of the pandemic, feeling our way through new working norms and recovering markets, we seek to analyze and discuss the latest trends in the asset management industry, an industry which, like any other, has been affected by the global health crisis. And with summer giving way to autumn, it's time for us all to get back to work and focus on the ideas and technologies which look set to evolve and grow our business.



In this latest edition of Performance, we move from sustainable digital transformations and repercussions of the latest regulations, to assessing the value delivered by investment funds with articles and views from our colleagues around the globe.

From the team in Luxembourg, we review how artificial intelligence and natural language processing looks set to rescue us from the mundane. In light of the CSSF requiring fund managers to painstakingly review funds' prospectus documents, read how automating this task can mitigate operational risk. Encouragingly, this AI-driven product still allows fund managers to remain in

the driving seat by requiring validation of results, while simultaneously offering greater traceability and compliance.

We also take a look at the proposed Corporate Sustainability Reporting Directive (CSRD), the cornerstone of the EU's sustainable finance strategy. As EU Member States are expected to transpose the directive by the end of 2022, we examine what these latest proposals mean for companies concerned.

Maintaining our gaze on regulation, our colleagues in France discuss the new PRIIPs RTS which will apply to all products including UCITS funds that were previously exempt. Come July 2022, the RTS will deliver several changes to the way costs, charges, and

performance scenarios are calculated, so take a look at what you need to know for a successful migration.

Interested in how smart beta, a rules-based portfolio-building process, is revolutionizing the asset management industry? Then read on to see how expanding into smart beta ETFs can enrich your value proposition to institutional investors and generate additional revenue.

From the UK team, we review the lessons learned from the recently conducted FCA review of asset management firms' value assessments. Since value for money is a key focus within many jurisdictions, there is useful information to be gleaned for asset managers globally.

Then we fly 'across the pond' to the States with an article on responsible and sustainable digital transformation. As the pandemic hit and offices the world over were required to work remotely, financial services firms faced and solved operational issues out of necessity. As the emergency subsidies, our colleagues in the US consider how responsible transformation can yield positive results leading to a higher bottom line.

Plenty to digest and deliberate!

We hope you enjoy this 37th edition of Performance.



EDITORIAL

The asset management industry has been active for decades—and yet it has evolved at a surprisingly slow pace. History tells us, however, that external shocks to its system has helped it move a little faster from time to time.

For instance, the crash of 1929 and The Great Depression were instrumental in the development of modern day mutual funds. (Although, it should be noted that the original idea surrounding mutual funds was posed by merchant and broker, Adriaan van Ketwich back in 1774, only confirming the somewhat long R&D cycle of the industry).

Similarly, the economic downturn after the first oil shock of 1973 helped with the emergence of indexing, a practice which now accounts for more than US\$15 trillion of assets under management worldwide.

These examples show that change may indeed seem slow, but real change in this industry can materialize in an impactful way.

Today, new regulations, the extension of digitalization to many steps in the asset

management value chain, the development of AI, the necessary focus on climate and social risks, and the impact of COVID-19-induced volatility, as well as developments in academic research are the ingredients for much faster transformation.

The key question for the industry at this time is how to adapt to those changes or even proactively pave the way for them. In this fluid environment, decision-makers need to categorize what is anecdotal versus what is critical, and make trade-offs in terms of managerial focus between what will have an immediate effect and what will have greater lasting impact.

The articles in this current issue of Performance magazine unpack and analyze specific areas of change in the industry, painting an impressionist picture of the acceleration of adaption that has been driven by multiple externalities. The bigger picture, which emerges beyond the specific examples highlighted in this edition, is the image of an industry under economic and regulatory pressure, but one that is still growing and able to reinvent itself.



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Three roads to MiFID III

WHAT LIES AHEAD FOR THE UPCOMING REGULATORY REVIEW?



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INTRODUCTION

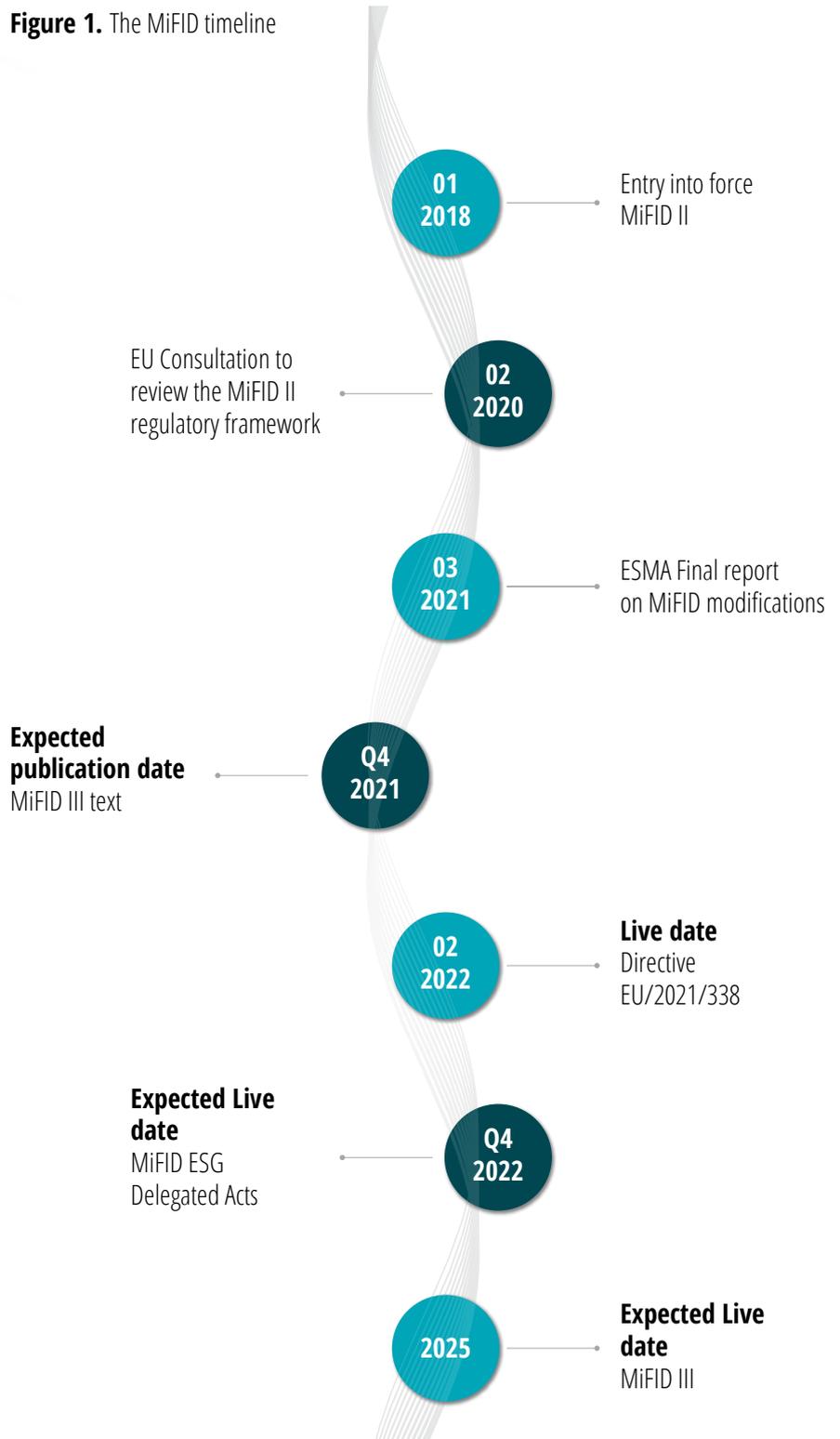
Three years on from the enforcement of the Markets in Financial Instruments Directive (MiFID II) and the financial services supervisory authorities are preparing a road to regulatory evolution. This modification is currently set on three main paths:

01. Through the consultation made in 2020, there is a plan to move from MiFID II to MiFID III;
02. As a consequence of the capital markets union recovery package to help EU economies exit the COVID-19 crisis, there is a proposed intermediary change that we will term 'MiFID 2.5';
03. The need to include client's ESG preferences into the scope of MiFID II.

As is so often the case, a picture is worth a thousand words, so too does **Figure 1**, The MiFID timeline, which clearly depicts the assumed MiFID changes and when they should take effect.

In this article, we will address these three subjects, examine their contents and potential impacts, and identify which entities may be most critically effected by such proposed changes.

Figure 1. The MiFID timeline



To be as practical as possible, it may be worthwhile not to follow the order of likely application, but instead to focus on the live date of the proposed changes. In this instance, MiFID 2.5 is the most pressing issue to address, as its changes will be live from the end of February 2022. The text proposed under the reference EU/2021/338 should mark an intermediary step between the current MiFID II regime and the future MiFID III. It addresses “low hanging fruits”; issues which many from within the regulatory community have wanted to approach since the end of negotiation back in 2014.



MiFID EU/2021/338

The EU/2021/338 directive contains a few changes that are essentially aligning with market practices and should, overall, make the life of investment firms (IFs) slightly easier.

The core element is that from next year, MiFID will be allowed to opt for an approach that could be called “digital first, paper second”. Currently, the legal reference under MiFID is still a “wet signature” on paper; practically speaking most IFs already have recourse to digital communication as a core reference, but it is by derogation to the paper regime where clients have to explicitly accept digital communication. However, from next year, the process will be the reverse. By default, firms will be able to communicate with clients electronically and by derogation rely on paper. For some recalcitrant clients willing to stick to paper, IFs may need to provide additional tools to invite such clients to move to digital. Indeed, for existing clients, a simple information via usual means (e.g. account statement) is sufficient to confirm by tacit consent the

agreement to use electronic communication. For new clients, obviously the change is that digital will be the norm, unless they explicitly derogate.

This MiFID review of 2021 also brings in a few practical changes applicable to the category of professional clients to bring it closer to the ECP (eligible counterparty) regime. This includes simplifying the communication on costs and charges, as well as easing communication through the use of digital technologies.

Another less commented change in this amendment, is the necessity in case of product switching to explain why the change proposal is superior to staying in the current product. This change comes from an old demand raised during the ESMA preparation of MiFID II and is now a reality. This may require technical changes to the delivery process from advisory to client by preparing a new document.

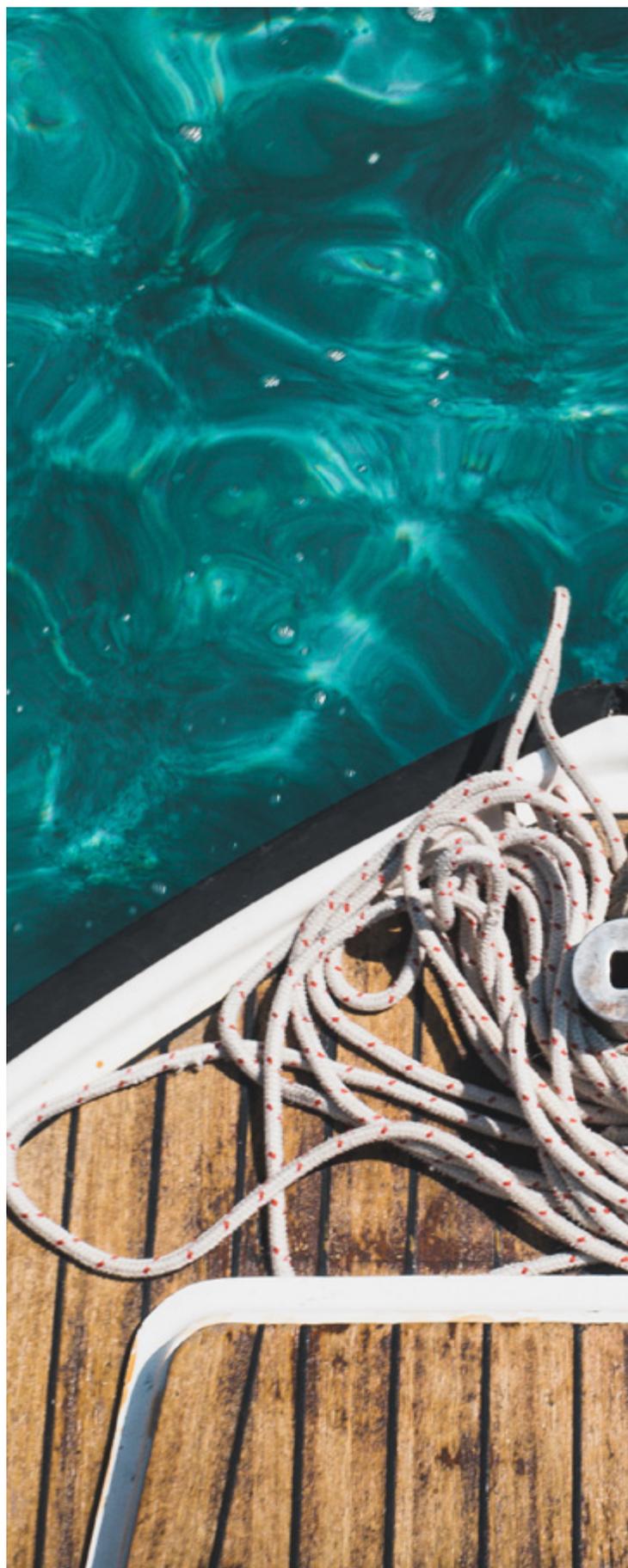
This amendment to MiFID also brings additional changes in the areas of commodity trading. However, these, although important, are generally of a lesser concern in Luxembourg. The deadline for application of this directive is 28 February 2022.



MiFID ESG: Sustainability delegated acts

Contrary to previous amendments, these bring changes via updates to MiFID II delegated acts 2017/565 and 2017/593, which means that the generic obligations of MiFID do not change, but the way they are performed does.

In this case, it is by the inclusion of clients' sustainability preferences into their profile.





This translates into the capture of information, the determination of the level of preference, and then adapting the service and products to these new ESG requirements. There is also the additional requirement to demonstrate via the suitability report how demands are met on an ongoing basis by presenting how the client portfolio converges with the ESG preference level. At present, although the texts are final, they still must be released in the EU Official Journal to become applicable. Therefore, in terms of timeline, three periods must be factored into:

01. Firstly, the text, a delegate act, is under a veto procedure for three months from publication;
02. Secondly, the time to release in the EU Official Journal takes between three to five months to which an additional delay of 20 days for texts being legally in force;
03. Thirdly, the texts include a transition period of 12 months before being live.

So taking these times into consideration—and without any issues—the directives would be applicable around Q4 2022. As the next stages are technical, the likelihood of changes is pretty slim, hence the need to start planning as soon as possible. Since the changes will affect the profile of clients, training of staff, updates in the product governance, and suitability reporting to clients, plus ensuring the access to products and the needs of their providers, IFs need to act now.

We note that besides this impacting change on the client profile, the entire product governance will also have

to be revised to take into consideration the nature of products and their compliance to the EU Commission objectives of carbon neutrality by 2050. This means that the European PRIIPs Template (EPT) and European MiFID Template (EMT) will change, and with it, the way the information is shared and captured by IFs.

Finally, the MiFID delegated act on article 16 (governance) will also be amended in a direction anticipated by the Commission de Surveillance du Secteur Financier in its 20/759 Circular on central administration so that new products or services are designed in a way that take sustainability into consideration.

For Luxembourg based entities at least, these double-delegated acts are likely to be the most critical ones.



MiFID III review, full scope

There are many changes to anticipate regarding the evolution of MiFID. Some are regulatory in nature by change to the MiFID directive or regulations, others are changes brought in gradually by adaptations of Q&A, ESMA, and local guidelines (i.e. complaints handling paper from ESMA).

The biggest evolution will be the changes seen between MiFID II and the anticipated MiFID III. There are three areas which should demand our focus: creation of a new investor category, the lost cases under



MiFID II negotiations regarding the inclusion of FX spot, and custody within the scope of MiFID. These would translate into some big changes for a few institutions whom, until now, have been able to elude the scope of this regulation. Finally, there will be some changes in the market structure notably with the forced introduction of consolidated tape providers.

The most likely and major change in term of organization, will be the creation of new investor categories. In previous articles, we have mentioned this eventuality, but with the rapprochement of the regime of the professional and the eligible counterparties from next year (EU/2021/338), this opens the possibility to

introduce a new category of “super retail”. This category will probably have less protection than the current retail, but will gain more opportunities to invest in products so that these investors will support the EU economy by using alternative investment funds (AIFs) or the European long-term investment funds (ELTIFs) which are, up to now, closed to retail investors. Conceptually, a regime as we know it in Luxembourg of the “qualified investor” could be a potential template. The issue is that clients who have been categorized as retail for years, will now need to be reclassified.

The second set of changes may be complex as well to introduce from an operational perspective. Indeed, if FX spot

(currently out) and custody become full MiFID services, this will translate into the need to include a full set of new clients under the scope of MiFID. The clients doing only FX or only custody, will need to receive profiles, reports, and, potentially, be included in product governance. Part of this will be static information, hence once done it is cleared for future changes. However, if by including custody and FX spot this applies to all clients (including retail) there will be a need to include transaction reporting in FX and application of best execution, price transparency, and reporting to authorities in the MiFID reporting. This would present a true technical and operational challenge.

The third pillar to address concerns changes in the market structure with adaptations to trading and commodity trading, notably the “merger” of EMIR and MiFID obligation with compulsory trading of cleared derivatives. At the stage, the EU Commission is willing to push for a consolidated tape, a central and unique place, by asset class at least, where trading prices will converge, in real-time. This may bring some interesting views on the concept of an EU single market if all prices converge to one single place. Additionally, a consolidated tape may also serve as a huge improvement for compliance and reconciliation of prices for trades, but it needs to be entirely developed. In this latter market part, we could on top



of this trend, at market price level, anticipate the arrival of a broader consolidation of information at ESMA level about products, service providers to give investors, and, more generally, provide MiFID stakeholders with a consolidated view of the market across member states.

This latter MiFID stream is definitely more the anticipation of changes to be introduced than material ones. Change does not happen quickly. After all, the time line (a first draft release by the EU Commission), now looks set for Q4 or later. Add to this the inter-EU institutions' discussions will most likely continue for 18 months, and the changes themselves must be followed

by a transition period of 18 to 24 months all of which leads to changes actually going live around 2025.

However, anticipation is key – especially when changes to core infrastructures are envisaged.

CONCLUSION

To conclude and put things in perspective, we have seen MiFID changes impact the industry every seven to eight years, from the prehistory of the investment services directive (ISD) (prior to 2000, to MiFID I in 2007 and MiFID II in 2014 (2018 for application), it is thus not unreasonable that the text and its profound changes will come into effect around 2025. In the meantime, and contrary to what was experienced in the

past, there are more continuous evolutions on the horizon, which will serve as intermediary steps (ESG, Quick fix) but will make the challenge of complying to MiFID even more complex setting different starting dates, with overlapping demands or requirements. Therefore, anticipation is key.

TO THE POINT

01. MiFID II will experience on going adaptations in the future
02. Priority should be given to the inclusion of ESG client preferences, as this will liaise ESG regulations and MiFID
03. Data and data management systems will be a key to success
04. First review of MiFID will apply from February 2022



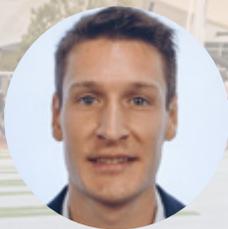
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CSRD: Corporate sustainability reporting

CORNERSTONE OF EU'S SUSTAINABLE FINANCE STRATEGY FOR QUALITY INVESTOR ESG DATA

INTRODUCTION

The European Union (EU) affirms its leadership ambitions with the proposed Corporate Sustainability Reporting Directive (CSRD), part of the European Commission's (EC) formidable initiative to direct capital flows towards sustainable activities. The largest bottleneck in achieving this aim is the lack of reliable and comparable data, which this proposed Directive tackles.

On 21 April 2021, the EC adopted a sustainable finance package including the proposed CSRD, the EU Taxonomy Delegated Acts, and amendments to other MiFID- and UCITS-related Directives. The proposed CSRD revises and strengthens the Non-Financial Reporting Directive's (NFRD) disclosure requirements, increasing the scope of concerned companies from 11,600 to almost 50,000 companies in the EU.

In Europe, companies' non-financial reporting requirements have considerably evolved in recent years, whether through formal regulations like the NFRD or through adopting voluntary international frameworks. Many large companies have adopted reporting standards, including:

01. The Global Reporting Initiative (GRI);
02. The International Integrated Reporting Council (IIRC);
03. The Task Force on Climate-Related Financial Disclosures (TCFD);
04. The Sustainability Accounting Standards Board (SASB);
05. The Climate Disclosure Standards Board (CDSB);
06. The Carbon Disclosure Project (CDP); and
07. Various international pledges, such as the United Nations Global Compact and OECD Guidelines for multinational enterprises.

However, the absence of binding European guidelines on the content of extra-financial reports has left Member States with a significant margin of maneuver when transposing laws. This creates reporting disparities between European countries, particularly regarding the definition and consistency of published environmental, social and governance (ESG) indicators and external assurance.

The conclusion is inescapable: the information published by companies does not meet investors' needs, mainly due to a lack of consistency, reliability or comparability.

This article will describe how ESG reporting is set to evolve, especially in light of the upcoming CSRD. Firstly, we will introduce the CSRD's key requirements, the scope of concerned companies, and its major milestones. Then, we will analyze how CSRD addresses the current shortcomings of the EU's sustainable finance strategy. Finally, we will reflect on how companies can manage these new ESG reporting requirements and what they will mean, especially in terms of benefits, for firms as a whole.



CSRD key requirements, scope of companies and timeline

With the CSRD, the EU proposes to:

01. Extend the scope of companies under the NFRD;
02. Standardize the disclosure requirements and make them mandatory;
03. Impose an external assurance on non-financial information; and
04. Digitalize the reported information.

In a nutshell, the CSRD is the EC's effort to strengthen and standardize European companies' communication on sustainability-related disclosures, putting financial and non-financial information on a level playing field.

A major feature of the CSRD is that concerned companies must integrate non-financial disclosure into the management report. This new reporting structure allows ESG data to be integrated into investors' decision-making frameworks. And, the shift from voluntary to mandatory disclosure, which was previously left up to each Member State under the NFRD, will significantly boost the coverage of sustainability indicators across Europe.

The EC mandated the European Financial Reporting Advisory Group (EFRAG) to develop draft EU reporting standards in close collaboration with international initiatives such as GRI, TCFD, SASB, IIRC, CDSB and CDP.

Central to the new reporting framework will be the concept of double materiality. This concept encourages entities to consider both the impact of sustainability topics on the company's value, and the entity's impact on the economy, the environment and people. Therefore, companies will need to identify and manage material sustainability topics accordingly.

To further bridge the ESG-data-availability gap, the CSRD also reinforces the scope of companies concerned. Companies that will need to follow the EU's sustainability reporting standards include those with more than 250 employees, listed companies (except listed micro-companies), and companies meeting the CSRD's turnover or balance sheet thresholds. For listed small- to medium-sized enterprises (SMEs) the application of standards will be delayed and proportionate, while unlisted SMEs can use them voluntarily.

The CSRD aims to effect another fundamental change: making it mandatory that non-financial information is verified by an external auditor. A progressive approach is proposed, starting by requiring a "limited" assurance, **with the possibility that a "reasonable" assurance is made mandatory once the EU reporting standards are introduced.**

Finally, companies will need to publish management reports in XHTML format and "tag" reported sustainability information following a digital classification. This is to support the EU's ambition to create an open-access European ESG database with the European

Single Access Point (ESAP) model.

Following the EC's proposed CSRD, the ball is now in the European Parliament and Council's court. Negotiations on the final legislative text are expected to come to fruition in mid-2022. In parallel, the European Financial Reporting Advisory Group (EFRAG) is expected to deliver on the sustainability reporting standards shortly after the final legislative text is agreed upon.

If this timeline is respected, the EC will be able to adopt the first set of EU reporting standards by the end of 2022. Consequently, the CSRD disclosure requirements would apply by January 2023. This means that companies would have to publish their first integrated management reports by January 2024, covering the financial year 2023.

CSRD aims to bridge the ESG data gap

Data availability, quality and comparability are essential to ESG investment success. In 2020, an HSBC global study concluded that available data is not yet comparable enough¹. While third-party ESG data providers help gather information about companies' ESG practices, their diverging methodologies limit the relevance of ESG scores. This lack of standardization is compounded by proprietary methodologies, and a lack of transparency around data acquisition, materiality, aggregation and metric weighting.

Despite this, the OECD insists—rightly—on the responsibility of financial market actors to ensure

"consistency, comparability and quality of core metrics in reporting frameworks for ESG disclosure"².

These obstacles in investors' and fund managers' journeys towards data accuracy are exacerbated by the lack of ESG data. As financial market stakeholders struggle to find actionable ESG data for their portfolios, companies are still busy wrestling with climate risk analysis to accurately integrate sustainability factors into their climate transition plans and disclosures.

At Deloitte, we believe that uniform standards, like those of the CSRD, can provide a consistent and comparable baseline that enables comparability of corporate disclosures across jurisdictions.

Unsurprisingly, public consultations have shown strong support for aligning non-financial reporting requirements with relevant European legislation, in particular, the Sustainable Finance Disclosure Regulation (SFDR) and the EU Taxonomy Regulation. By giving Member States room to move when transposing the current NFRD into local laws, the EU did not go far enough to tackle the issue of data comparability, reliability and relevance. On the other hand, the CSRD proposal would allow companies to better align their reporting strategies with these new reporting requirements.

¹ HSBC, "Sustainable Financing and Investment Survey 2020," 13 October 2020.

² Boffo, R., and R. Patalano (2020), "ESG Investing: Practices, Progress and Challenges", *OECD Paris*, 2020.

For example, the CSRD will integrate the EU Taxonomy Regulations' disclosure requirements, requiring companies to disclose alignments with its screening criteria, do-no-significant-harm thresholds and the six objectives³.

On the corporate side, the CSRD's sustainability reporting standards will complete the data puzzle to "create a consistent and coherent flow of sustainability information throughout the financial value chain"⁴. It should enable companies to effectively report their climate transition plans towards a net-zero economy and set key metrics for risk, impact and performance assessments; or, simply put, to create or improve the tools required for their climate change transition.

Characteristics, sustainability indicators, and main developments compared with NFRD

Characteristics

- 01. Mandatory standards developed by EFRAG
- 02. Dual materiality
- 03. Generic and sectoral reporting
- 04. Connectivity with financial reporting

Themes and indicators

- 01. Environment: alignment with the six EU Taxonomy Regulation objectives.
- 02. Social:
 - A. Equal opportunities including gender equality, equal pay/work, training, employability and inclusion of people with disabilities;
 - B. Working environment, wages, social dialogue, collective agreements, employee engagement, life balance, health,

- 03. Governance: composition and role of governance bodies (including sustainability issues), business ethics, corporate culture, anti-corruption policies, political engagement including lobbying, business relations including payment deadlines, internal control and risk management systems including reporting processes.
- 04. Safety and adaptation of the working environment; and
- 05. Respect for human rights, fundamental freedoms, democratic principles and international standards.

Main developments compared with NFRD:

- 01. Extended scope
- 02. Standards for SMEs
- 03. Digitalization

- 04. Publication in the annual report
- 05. Mandatory external audit for all Member States

How companies will need to manage CSRD compliance

With the CSRD likely applying as from January 2023, this leaves firms only 18 months to prepare. The Directive will place ESG reporting under the same quality, control and audit obligations of financial reports, so we encourage business leaders to start preparing for the CSRD now.

Beyond reporting requirements, the CSRD will bring up fundamental questions that firms may have already started asking themselves, such as:



Is the organization's governance enabling oversight, assessment and management of ESG risks and opportunities?



³ Climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources, transition to a circular economy, pollution prevention and control, protection and restoration of biodiversity and ecosystems.

⁴ Proposal for a Directive of the European Parliament and the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting. EUR-Lex - 52021PC0189 - EN - EUR-Lex (europa.eu).



Is the organization aligning its business, strategy and financial planning to ESG risks and opportunities?



What is the organization's exposure to climate risk?

The sustainability reporting journey of companies starts by identifying material ESG topics at the country, industry and company level, so that organizations can select the appropriate reporting standard to comply with the upcoming CSRD. However, this is not enough—business leaders must also engage in integrated thinking and put sustainability at the heart of their business model. Not only because it is ethical to do so, but because it is sound business practice.

Since the SFDR and the EU Taxonomy Regulation will apply before the CSRD, financial players will already be putting pressure on their investees to collect non-financial information. Retail investors and customers are demonstrating a deep and sustained interest in ESG products, showing that sustainability is more than just a fad⁵. Overall, sustainability-related information will increasingly be embedded in investment decision-making. So, we urge companies to start their sustainability transformation journeys now.

Our experience shows that integrating ESG into organizations requires collaboration across the firm. Alongside the Chief

Sustainability Officer (CSO), the Chief Financial Officer's (CFO) unique skill set can also play a key role in facilitating and managing this transition. CFOs' experience in measuring and tracking financial information, engaging in risk management, internal controls, and third-party assurance makes them coveted members of sustainability transformation teams. Close collaboration between CSOs and CFOs will enable companies to better manage the risks and opportunities of ESG topics and drive a successful sustainability transformation.

CONCLUSION

As per the EC's aim, the proposed CSRD will play an essential role in transforming the corporate reporting ecosystem to enhance the quality and consistency of sustainability information. It will provide the information required for financial players to meet their own transparency obligations under the EU Taxonomy Regulation and the SFDR.

While the CSRD's transposition into national law could happen by the end of 2022 and apply in 2023, the CSRD is introducing several revolutionary elements regarding ESG and sustainability. Therefore, companies should start preparing to report on sustainability topics today, or risk falling behind.

TO THE POINT

01. The proposed CSRD, adopted in April 2021, is the cornerstone of the EU's sustainable finance strategy towards global leadership.
02. The CSRD aims to extend the scope of companies concerned, standardize the disclosure requirements and make them mandatory, impose an external assurance on non-financial information, and digitalize the information reported.
03. Next steps: Member States are expected to transpose the CSRD by the end of 2022, for an application date in early 2023.

⁵ Cornell, Bradford, "ESG Preferences, Risk and Return," European Financial Management, 2020.



IM changes on the horizon

A QUICK TOUR OF UPCOMING REGULATORY CHANGES



TO THE POINT

01. The investment management industry (IM) needs to ready itself for some important changes on the horizon.
02. New ESMA guidelines, ESG demands and cross-border marketing measures are looming large, with the reviews of AIFMD and likely UCITS to arrive further down the line.
03. In the meantime, value for money and AML-CFT will dominate the IM agenda.
04. The replacement of UCITS KIIDs with PRIIPs KIDs could shake up communication with investors.



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INTRODUCTION

Now and then, the regulatory environment undergoes a major shift or evolution, rocking the market to its core. We think that 2021 will be such a year – at least in terms of new regulations being proposed and published, with most expected to go live post-2021.

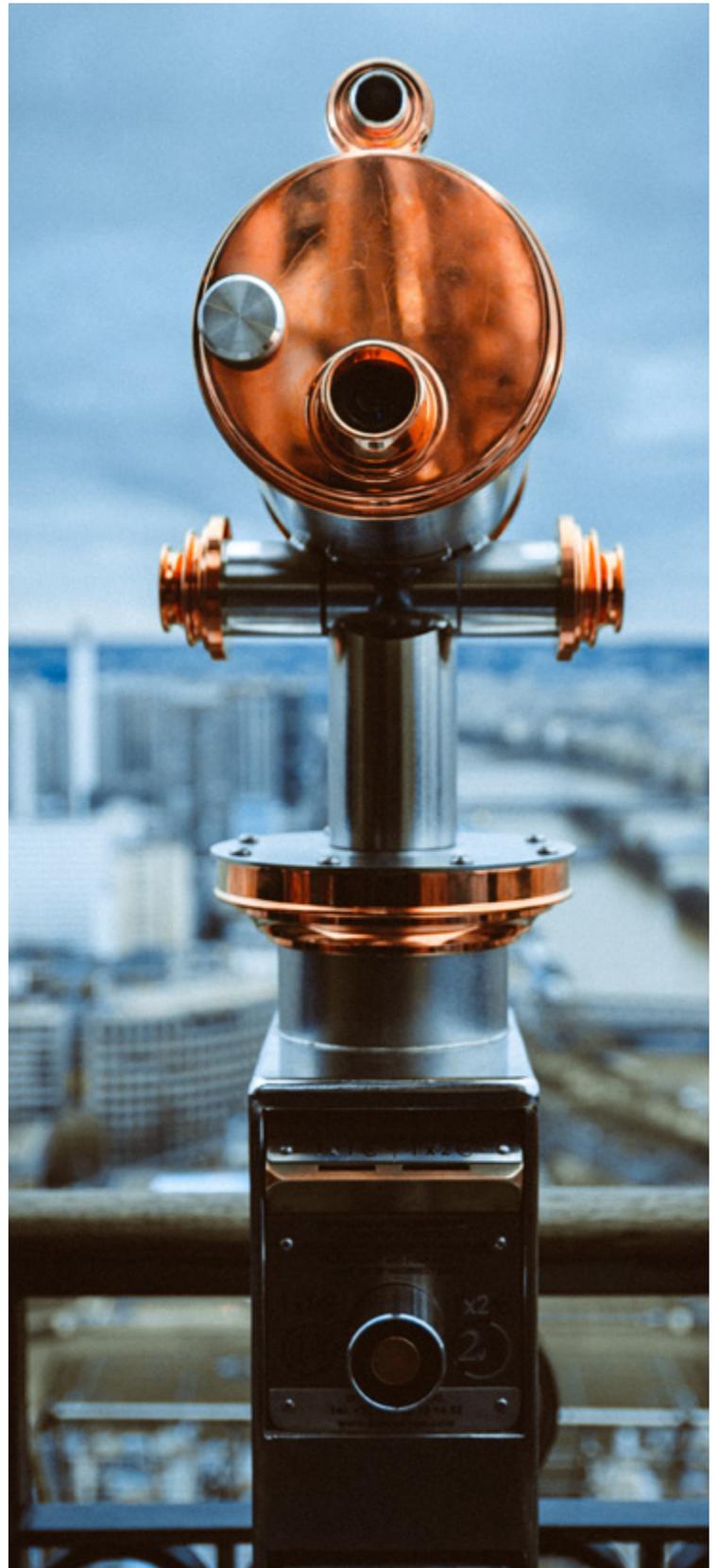
But when regulations are produced, they need to be adopted by all stakeholders. The AIFMD review and the evolution of the EU's anti-money laundering and counter-terrorist financing (AML-CFT) approaches could affect financial entities across the board, including investment managers and their funds.

With level 1 requirements of the Sustainable Finance Disclosure Regulation (SFDR) applying from March 2021, the road towards environmental, social, and governance (ESG) adaptation has begun. The next ESG stops are the level 2 SFDR requirements and the EU Taxonomy Regulation.

Other big changes will be brought by the amendments to the UCITS and AIFMD delegated acts, as well as the Markets in Financial Instruments Directive (MiFID) and the Insurance Distribution Directive (IDD) on the distribution level.

To better visualize the road ahead, a picture is worth more than a thousand words.

In this article, we will focus on the most important changes ahead, examine their potential impact, and identify which entities could be the most critically affected by these proposed changes.



While there are many changes on the horizon, some are more critical to the IM market than others. Therefore, we will address the following:

01. The AIFMD review
02. The ESG evolution
03. Cross-border marketing changes
04. UCITS KIID and PRIIPs KID merger

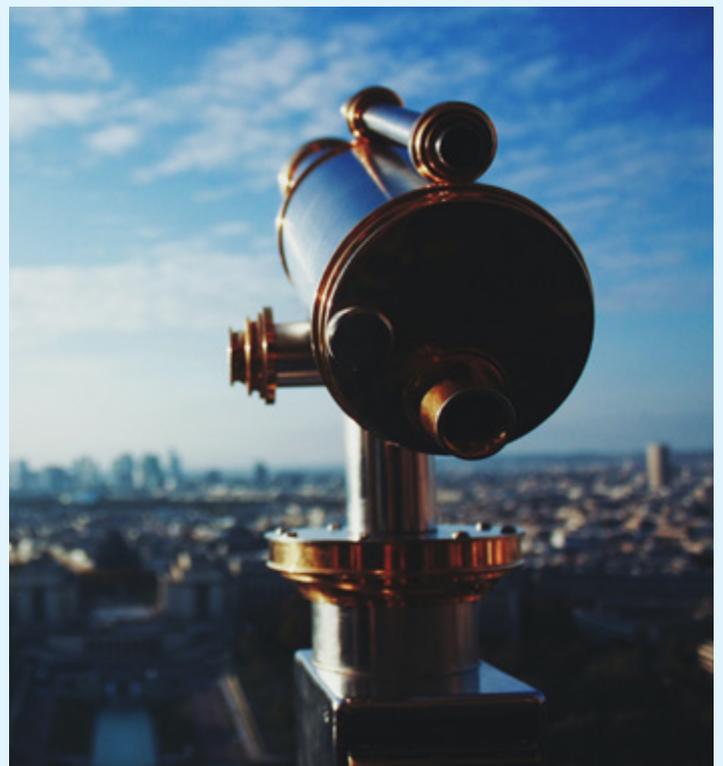
AIFMD review

The AIFMD review already kicked off in 2019, with the first consultation on the topic. The major motivation of this review is the directive's age – nearly 10 years have elapsed since it was first introduced. Brexit has also had an impact, with AIFs and AIFMs in the UK now having third-country status like US products and managers.

Last year, the European Commission launched a stakeholder consultation to explore the market's opinion of what areas require attention, and even presented the parts it thought were ripe for review.

Before addressing ESMA's proposals, it is worth revisiting the industry's overarching opinion on the European Commission's first proposal: "If it ain't broke, don't fix it". This attitude was shared by many industry participants and local authorities during a European Commission workshop in November 2020.

The overall consensus was that, generally, the AIFMD did not require major changes but instead minor adjustments.



These comments are backed up by the sector's strong growth in new funds and assets under management (AuM), showing the market has adapted to this new type of fund and that the products are gaining momentum across all markets.

While the regulators' views were similar, they highlighted a few areas that the European Commission should consider. In total, in its letter to the European Commission, ESMA identified 19 areas of the AIFMD to amend or enhance. There are two main areas that we expect will be reviewed.

First, some supervisors consider certain reporting requirements to be inadequate, notably regarding leverage information and liquidity management. These are certain to receive attention during this review.

Second, the rules governing delegation are also likely to be looked at, as several non-EU AIFs are being sold in the EU and many AIFs lack a fund manager located in the EU. We expect there will be additional demands to better frame delegation arrangements and ensure proportionality between the different entities. There may also be proposed changes to further harmonize the individual country practices on delegation requirements and local substance needs. This will certainly not make third-country delegation (or any delegation for that matter) impossible; instead, it would require a minimum level of substance and sufficient controls over the delegation chains. In this regard, we can also take inspiration from the ESMA guidelines on outsourcing that were revised at the end of 2020.

The chart lays out the topics raised in the European Commission's consultation, including the number of questions and points brought up for each. Regarding the AIFMD review timeline, the European Commission has stated that a first draft should come in Q3-Q4 of this year.

One big, pending question is how the AIFMD review will affect the UCITS product world. For a few years, we have seen certain areas of these two sets of products converge, i.e., depositary rules, ESG, and responsibility for assets. Will this proposal be strictly for AIFs and their managers, or will some changes spill over to the world of UCITS funds?

ESG evolution

With ESG, the timeline is a

little simpler. The SFDR, which applied in March 2021, did cause some confusion among market players, as only its level 1 requirements were ready. The SFDR's technical aspects, which are required for it to function coherently across all industry participants, will be completed by delegated acts before the year-end.

The EU Taxonomy and the SFDR level 2 requirements, which apply to the entities themselves, will come into force from next year. So will the obligation to incorporate sustainability risks into the management of funds, if the delegated acts released by the European Commission in April are endorsed.

Speaking of ESG evolution, it is worth mentioning the changes on the horizon regarding MiFID and IDD. Likely to apply from the end of 2022, these distribution regulations will require market participants like banks, insurance companies and independent financial advisors (IFAs) to gather investor preferences for ESG in their profiles and adapt product governance for funds. While these are not direct regulations, these changes could still force distributors to adapt their priorities.

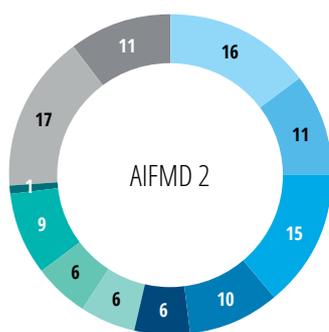
Cross-border marketing changes

From the beginning of August 2021, the UCITS and AIFM directives will be adapted by a package of reforms that will change the way AIFMs distribute their funds across borders:

- 01. Directive (EU) 2019/1160 regarding the cross-border distribution of collective investment undertakings (CBD); and
- 02. Regulation (EU) 2019/1156

on facilitating cross-border distribution of collective investment undertakings (CBR).

Figure 1: Topic overview



- AIFM framework
- Investor access
- Reporting
- Depository
- Sustainability/ESG
- Delegation/substance and outsourcing
- Private credit
- Leverage
- Remuneration
- Distribution - marketing and passports
- Disclosure, conflicts and valuation



The CBD will address certain points regarding the marketing of activities and delisting from distribution in EU member states under the passport regime.

The CBR will address changes to the passport regime and remove the need to have a physical presence in a distribution (host) member state. Therefore, it aims to have all marketing arrangements established on a remote basis.

One of the main aims of this new cross-border distribution framework is to remove hurdles

in the way AIFMs can market AIFs across borders. While this new framework achieves this purpose on paper – removing the physical presence requirement will allow for more efficient distribution and a reduction in costs – it appears that the rules are not as clear as they could be. Notably, while the arrangements for cross-border marketing are not regulated per se, some regulators, including the CSSF, require that only authorized entities can render these services to guarantee both investor and member state protection.

There are still some open questions around the automatic notification process across all member states, the use of language, and the possibilities of premarketing or “de-notified funds”.

UCITS KIID and PRIIPs KID merger

Another high-stakes question is regarding the future merger of the UCITS KIID with the PRIIPs KID. This topic is heavily debated by all stakeholders. First, talk centered around the merger deadline, which was initially scheduled for 1 January 2022; fortunately, this is now



postponed to at least July 2022, if the plans develop as expected.

While this postponement was welcomed by market participants, the replacement of UCITS KIIDs is less popular. PRIIPs KIDs are very costly to create and maintain, and there is much disagreement on the content. The aim of the PRIIPs Regulation to allow investors to compare different products will lead, in practice, to information being constructed in a way that renders it less usable by investors. This will reshape previous UCITS content and,

accordingly, make it difficult to compare products across time. Regarding the PRIIPs KID switch, the time is now to take action, in order to be ready for this change to communications with intermediaries and clients in mid-2022.

CONCLUSION

There are some important changes on the IM industry horizon. Fortunately, the largest shift ahead for the IM industry, the review of AIFMD/UCITS, will only start in 2021; its changes are unlikely to fully apply for the next two years.

However, this does not mean that industry players should rest on their laurels—the changes discussed in this article must be seriously considered in a timely manner. IM industry players must reinforce their capacities at both the fund and ManCo level, to be able to comply with these changes when they arise.



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New PRIIPs RTS

WHAT YOU NEED TO KNOW FOR A
SUCCESSFUL MIGRATION

INTRODUCTION

Since it entered into force in January 2018, the EU Regulation on Key Information Documents for Packaged Retail and Insurance-based Products (“PRIIPs regulation”) has been subject to much criticism from the financial industry. Its main regulatory aim is to help investors compare investment products more easily, by making their costs, potential performance and associated risks more transparent.

However, since the PRIIPs regulation’s infancy, industry and consumer representatives have raised concerns about its methods for compiling performance scenarios and calculating transaction costs, which retail investors can find complicated and difficult to understand.

In October 2019, the European statutory authorities (ESAs) issued a consultation paper that included proposals relating to performance, costs, and multi-option products. This paper aimed to respond to these criticisms in a way that was consistent with the PRIIPs regulation’s overall regulatory objectives. It also covered how the PRIIPs regulation will apply to UCITS funds when their exemption from the regulation’s scope expires on 31 December 2021.

In July 2020, the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA) adopted proposals to amend the PRIIPs regulation based on feedback from the consultation. And, in February 2021, the European Insurance and Occupational Pensions Authority (EIOPA) finally agreed to support the draft regulatory technical standards (RTS), as long as the PRIIPs Level 1 regulation is reviewed.

These new draft RTS are expected to be validated without changes by the European Commission, Parliament and Council. Given the delay in the regulatory acceptance process, the application date for these new RTS, as well as the end of the UCITS exemption period, has been pushed back to 1 July 2022.

TO THE POINT

In July 2022, the new PRIIPs RTS will apply to all products, including UCITS funds that were previously exempted.

The new RTS will deliver several changes to the way costs, charges and performance scenarios are calculated and displayed, as well as introducing template amendments.

In parallel, for all UCITS funds that are distributed in the UK, the UK HM Treasury has extended the PRIIPs KIDs exemption until the end of 2026.

Financial market participants must start to prepare for these new requirements, where data management and architecture flexibility will be key aspects for a successful implementation.



Q. What are the main changes brought by the new PRIIPs RTS?

A. The new RTS were designed to solve some of the PRIIPs regulation's flaws, by introducing changes to the methodology for calculating performance scenarios and costs.

First, the new methodology will modify the data requirement for the calculation of performance scenarios. Instead of the current 5-year performance data requirement, the maximum of 10 years or 5 years more than the product's recommended holding period (RHP) will be used.

Then, the RTS will modify how unfavorable, moderate and favorable scenarios are computed. Breaking away from simulations based on daily returns, this new methodology will take the worst, median and best evolution of the product's real performance in a sub-interval of time corresponding to the RHP. No changes are expected for the stressed scenario methodology, but it will not be more optimistic than the unfavorable scenario.

Regarding costs, one key requirement is that the simplified transaction costs methodology known as "New PRIIPs" will be extended by 3 years until 31 December 2024 for UCITS funds. Another requirement is that total transaction costs might not be lower than explicit transaction costs, making it impossible to observe negative transaction costs. This issue often occurs within the current regulatory framework, due to either the

arrival price methodology for implicit costs, or high anti-dilution proceeds.

Even if a more prescriptive method is added to the implicit transaction cost compilation of over-the-top (OTC) derivatives with the arrival price, the new regulation provides flexibility through different options based on bid-ask data availability.

Finally, the reduction in yield has been simplified to take a 1-year period without one-off costs amortization and performance.

The new RTS prescribe that financial market participants should publish the fund's past performance, analytics that were part of the UCITS KIID document. However, authorizing the publishing of this information in the PRIIPs KID would require a change to the PRIIPs Level 1 regulation; therefore, this is unlikely to occur before July 2022. This means that the fund industry must choose between displaying this past performance on a dedicated page of their website, or producing a separate document to the PRIIPs KID.

A new rule also requires the manufacturer to compile and publish all past performance scenarios on their website monthly. This will likely cause confusion, as the performance scenarios displayed on the KID may vary from the performance scenarios on the website. This is because KIDs do not need to be published monthly; instead, only if the (moderate) performance scenario fluctuates by more than 5%.

On a positive note, the new RTS foresee the possibility of reusing some information that is already included in the UCITS KIID's "Objective and Investment Policy" section, as well as some changes in the costs and performance scenario tables. The new RTS will also simplify the performance scenarios. If a product's RHP is less than 10 years, the manufacturer will only need to provide the product's performance and costs information after 1 year and at the end of the RHP. The intermediary period data will no longer be required.

A major change is also coming for multi-option products. These include insurance-based investment products, for which the cost tables must show a clear distinction between costs induced by the insurance product against those induced by the underlying investment options.

The changes that the RTS impose on the PRIIPs KID will also affect the European PRIIPs Template (EPT) data files. As a reminder, these data files are not a regulatory requirement. Instead, they are imposed by market participants, such as insurers or distributors, who require PRIIPs data from asset managers to complete their own PRIIPs reporting obligations. Considering the same deadline applies to all financial participants, it is worth considering that insurers may require asset managers to send their revised EPT files for testing and preparation purposes before the new RTS July go-live date.



Other factors that complicate the game

Along with the new PRIIPs requirements imposed at the European level, there are several national obligations that manufacturers must consider when distributing across borders, specifically with the UK and Switzerland. In the UK, the HM Treasury announced on 1 June 2021 that the current UCITS exemption from the PRIIPs regulation would be extended until the end of 2026.

This means that, as of 1 July 2022, UCITS marketed in the UK will need to produce both PRIIPs KIDs in the EU and UCITS KIID in the UK until 31 December 2026. Maintaining both templates could have a significant impact on the costs of producing these reports.

In addition, the review of the UK retail disclosure regime may introduce amendments to the UK PRIIPs regulation or even bring in a new regime. This could lead to the introduction of UK-specific KIDs.

Switzerland's regulator FINMA requires a KID for each financial instrument registered in Switzerland, the so-called Swiss KID. While the EU PRIIPs KID is considered an acceptable alternative to the Swiss KID, the UCITS KIID is not viewed as such. However, they are accepted for use with products registered in Switzerland until 31 December 2021 to match the end of the exemption of UCITS in the EU originally planned for that date.

Currently, the relevant law does not foresee the possibility of using the UCITS KIID after 31 December 2021, regardless of any extension to the UCITS exemption period. Even though fund associations are expecting FINMA to align these document requirements with the EU exemption period, there is no guarantee this will happen.

Finally, in addition to the European PRIIPs regulation and related national regulations, it is worth mentioning that ESMA issued a set of guidelines on the consistency of marketing and fund documentation in May 2021¹. As regulatory requirements increase around fund documentation, such as the PRIIPs regulation, the Sustainable Finance Disclosure Regulation (SFDR), and the EU Taxonomy, manufacturers must put adequate oversight in place to guarantee their fund documentation is fully compliant, including their prospectuses, KIDs, factsheets and annual reports.



Q. What does the migration entail?

A. The new RTS changes data requirements and such data is reviewed. Compared with the previous 5 years historical data requirement, financial market participants will need to source longer-term pricing data to reach the maximum of 10 years and 5 years plus recommended holding period and complete it with proxies when the time series is insufficient. They will also need to review the choice of proxies with the prescriptive new guidelines on benchmark selection.

For transaction costs, additional internal bid-ask data of the manufacturer can be sourced to optimize the arrival price transaction costs of OTC derivatives.

The RTS also introduce the possibility for UCITS fund manufacturers to reuse several narratives from their UCITS KIIDs in their PRIIPs KIDs. To benefit from this, manufacturers should conduct a gap analysis of the information that can be reused to identify any data gaps.

Financial market participants must also consider the ability of their data management system and KID system to allow UCITS and PRIIPs data to coexist, if they need to produce PRIIPs KIDs for EU jurisdictions and UCITS KIIDs for the UK. The ability to store both documents and maintain an ongoing review of their content to comply with both regulations will be a major operational challenge.

Interestingly, several asset managers have started considering streamlining the technology and/or providers they use for different report types (KIDs, KIIDs, EPT, the European MiFID Template [EMT], factsheets, and on their website), not only to improve their cost efficiency but also to ensure the consistency of

data and statements across the board and comply with regulations.

Manufacturers should also start tackling the requirement to publish past performance scenarios and data. Regarding the past performance data, they need to decide whether to use a separate document annexed to the KID or a digital publication on their website. No clear market trend has yet emerged regarding this publication.

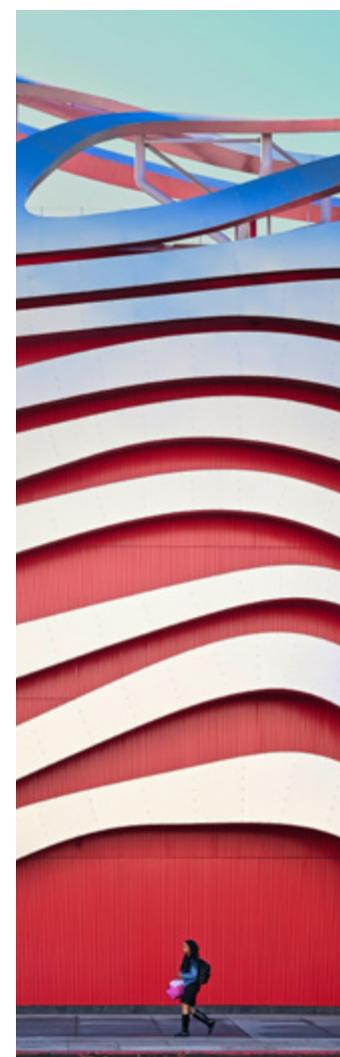
Last but not least, the application delay of the new RTS to 1 July 2022 will force UCITS manufacturers to perform a final UCITS KIID annual update in February 2022, while also working on the migration to PRIIPs KIDs. These two major events are sure to put pressure on organizations. Organizations must put a well-structured data management framework in place during this period to ensure all changes introduced in the UCITS KIID annual update are properly reflected in the PRIIPs KID under preparation.

CONCLUSION

Even though the application date of the new PRIIPs RTS has been pushed back to July 2022, organizations will still find it challenging to be ready on time, as well as potentially maintaining multiple versions of the documents after this deadline.

Key to this migration's success is good project governance and a dedicated team of specialists on data compilation and management.

Finally, we recommend that organizations keep a close eye on all publications on this topic until the end of the year, including the Level 1 modifications and the final PRIIPs RTS. Industry groups are also expected to publish additional Q&As on this topic.



¹ SMA, Final Report - Guidelines on marketing communications under the Regulation on cross-border distribution of funds, 27 May 2021.

Demystifying your ManCoTech journey

A VARIETY OF ACCELERATING FACTORS HAS PUT THE SPOTLIGHT ON DIGITALIZATION AS A KEY ENABLER TO SUPPORT THE STRATEGIC AGENDAS OF MANCOS



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INTRODUCTION

The need for fund management companies (ManCos) to implement a robust and scalable operational framework through new dedicated technologies referred to as ManCoTech has been a topic of much discussion in recent months. For an industry under increasing pressure from complex regulatory constraints and growing competition, the digitalization of core activities is a crucial step in the ManCos' transformation journey to migrate from traditional operating models relying on labor-intensive operations, towards a future-proof and efficient model exploiting the benefits of technology.

Recently, an overall rise in market awareness has occurred towards the business opportunities ManCoTech can offer. However, we are seeing little sign of major ManCoTech adoption within the industry. Here, we consider the reasons behind following the status quo but also propose ways to encourage and kick-start your ManCo's digital journey.

Strategic agendas are calling for technology enablers

From survey feedback and exchanges with a representative array of management companies in the Luxembourg marketplace, we can see a clear interest in ManCoTech solutions. A variety of accelerating factors has put the spotlight on digitalization.

Reporting and data management solutions—often combined—are commonly adopted by ManCos to handle the mass production of regulatory reports, while cost pressures are accelerating the need for solutions to automate operational routines. The multiplication of interactions with external stakeholders has also increased demands for funds and third-party lifecycle management tools (i.e. oversight and onboarding solutions). Finally, the COVID-19 pandemic has been an accelerator for digital trends and has ignited the wide-spread adoption of web-based solutions to conduct virtual meetings, and share and sign-off confidential documentation.

Expectations vs reality, what are the hurdles?

Overall, there is a consensus that technology is a key enabler to support cost-effective organic growth and offers an alternative to systematic staff hiring or outsourcing to handle new regulations and/or new products or service launches. Yet, we haven't observed massive launches of ManCoTech or digital projects within the market, leading us to question ManCos about their constraints and concerns in onboarding the available technologies.

A common hindrance is the limited capacity to identify relevant opportunities for transformation and to obtain the internal buy-in to ultimately introduce a formal initiative. For instance, screening the ManCoTech landscape can seem intimidating because of the sheer number and diversity of the solutions on the market and because of the lack of clear and established market leaders. As an example, 400+ RegTech firms already populate our Deloitte RegTech Universe, thus, it is easy to get lost when looking for the solution(s) that meet(s) your expectations.

Finance can also be an issue. In many cases, the minimum required budget of ManCoTech offerings is a no-go for small firms, whereas larger firms find it difficult to accept volume-based fees that may drive total cost way above historical ones (especially for technology-only solutions where a cap at some stage is generally expected). It is therefore crucial that ManCoTech providers carefully adapt their pricing model to the financial reality of their different target client segments.

At the end of the day, we must also answer the fundamental question: "Is there proof that ManCoTech adds value to ManCos?"

This needs to be looked at by breaking down ManCoTech into the various elements that it covers. You will actually realize that there are many concrete use cases which demonstrate the benefits brought by new ManCoTech solutions. At Deloitte, just on the particular area of regulatory technology, we have witnessed those solutions in action, utilizing them both within the organization and in collaboration with our clients. Internally, we have developed our own solutions to massively increase workflows made of 'mechanical' mandatory activities such as regulatory reporting, as well as integrating third party solutions to enable a rapid launch of new services (i.e. in the domain of oversight, regulatory watch, and governance management).

In parallel, we have observed very impressive innovative implementations for our clients. Some have adopted innovative digital KYC solutions to reach new client segments and thus create new revenue channels, while others chose to digitalize their compliance monitoring processes to maximize effectiveness and minimize the risk of regulatory fines. Other practical achievements include the reduction in governance, risk, and compliance (GRC) personnel through the use of digital solutions, as well as reduced client case handling time or compliance check efforts.

TO THE POINT

A variety of accelerating factors has put the spotlight on digitalization as a key enabler to support the strategic agendas of ManCos.

Despite the trend for digital transformation, we have not witnessed a large wave of such initiatives in the marketplace just yet.

A lack of dedicated resources and access to knowledge remains a challenge for ManCo organizations, meaning it is difficult to compile a comprehensive business case and kick off a digital transformation project.

At Deloitte, we believe that the benefits of ManCoTech massively outweigh the transformation efforts that it requires. The challenges relating to the latest regulations and new customer expectations are real and can only be overcome with the right resources.

We therefore recommend an agile approach to launch your ManCoTech journey. Initiated over three phases, our approach helps define a 'light' business case which outlines the expected benefits, tests the outcome of ManCoTech solutions, and gathers stakeholders to embark on a more comprehensive digital transformation.

What's next? "Think big, start small, scale fast"

At Deloitte, we believe in designing an approach to unite your teams in order to accelerate decision-making and deliver a better outcome through the disruption of ordinary thinking. We encourage you to challenge the status quo of your current organization—start small with a given use case having a realistic potential of improvement, and define and track the expected benefits as you gradually integrate ManCoTech solutions.

We imagine three pragmatic phases to launch your digital journey:



Phase 1

Define a 'light' business case

Your journey starts with an initial workshop where you assess the current state of chosen processes in terms of key challenges, pain points, and constraints, including legacy tools but also the high-level efforts and costs spent. You may request external support to explore suitable solutions and best market practices. This phase ends with the definition of a 'light' business case setting the overall objectives to reach your target digital ManCoTech model and presenting the main integration options (i.e. rent, build, buy, or re-use) and their projected ROI.



Phase 2

Assess the suitability of the target solution

By developing a Proof of Concept (POC) to test the solution's capabilities, you help your organization to pinpoint risks and obstacles when implementing the proposed target operating model, but

also to verify its outcome and scalability. The POC will be showcased to your teams who will then share feedback about their user experience and other valuable details. The latter highlights any required improvement and gives significant insight for other relevant actions moving forward. With a refined cost-benefit analysis, you can decide whether to transition to a formal initiative and invest in a Minimal Viable Product (MVP).



Phase 3

Deliver a meaningful product

The MVP is the last phase of your digital journey initiation. It is based on developing only the main functionalities that will provide core added value to your business. This small-scale delivery in your production environment helps your organization to spend less effort on technical integration, make a quick launch, and then set the foundations for your change management. Closing the journey initiation will echo your first success story, making it easier to roll out ManCoTech over time to an increasing number of service lines and functions.

CONCLUSION

Despite all the obstacles discussed and all the headwinds to be expected, we remain convinced that the benefits of ManCoTech greatly outweigh the transformation efforts that it requires. The challenges relating to new regulations and new customer expectations are real and can only be overcome with the right resources. Human capital will certainly remain as a crucial asset, but technology will soon reveal itself as the factor that

distinguishes the best from the rest. This has been the case in many other industries and made very clear throughout the COVID-19 pandemic. So, it's time to walk the talk, to implement the digital agenda explicitly put forward in all surveys. Start small, test well, and thereafter, achieve great ambitions.

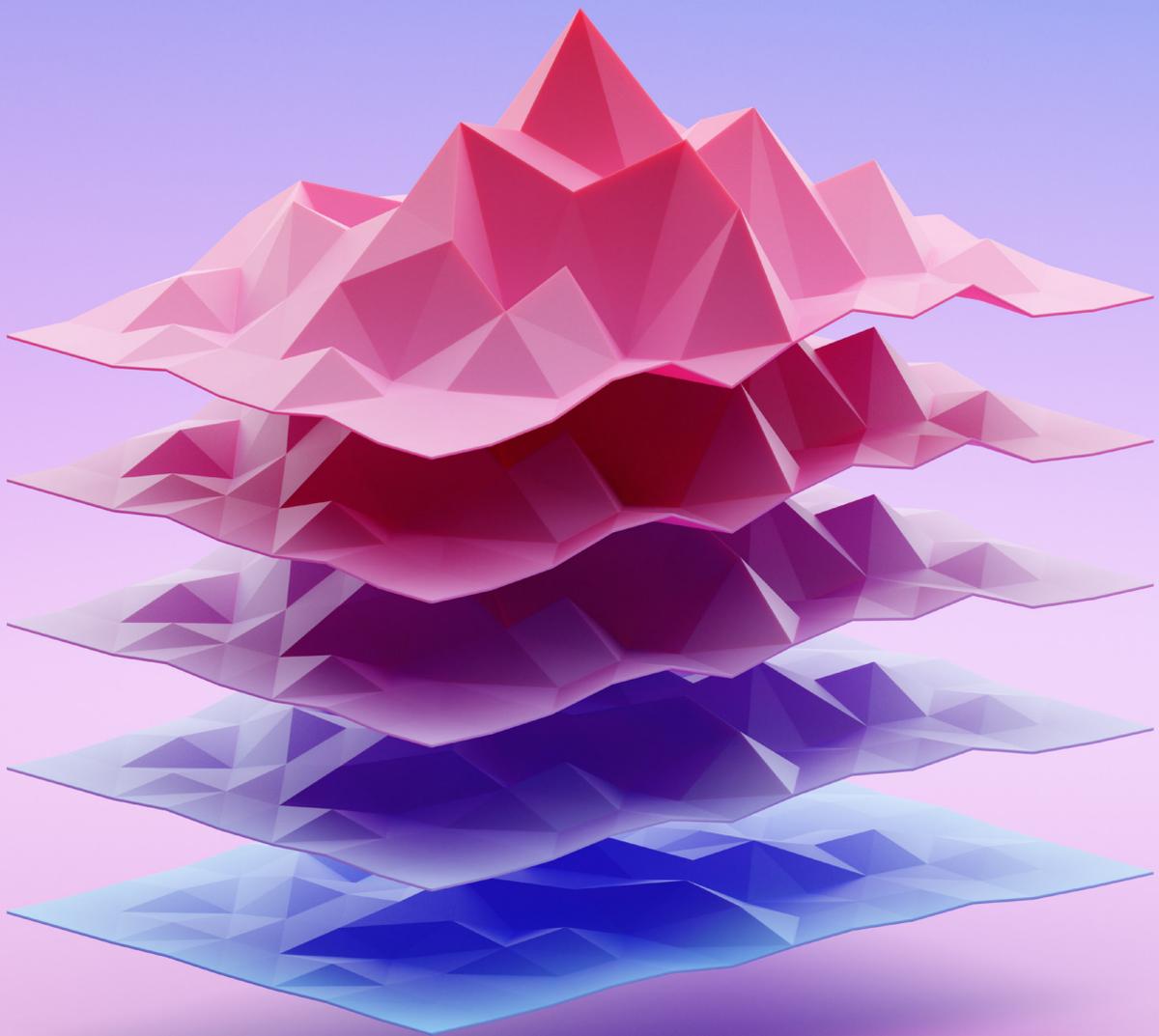


Will smart beta ETFs revolutionize the asset management industry?



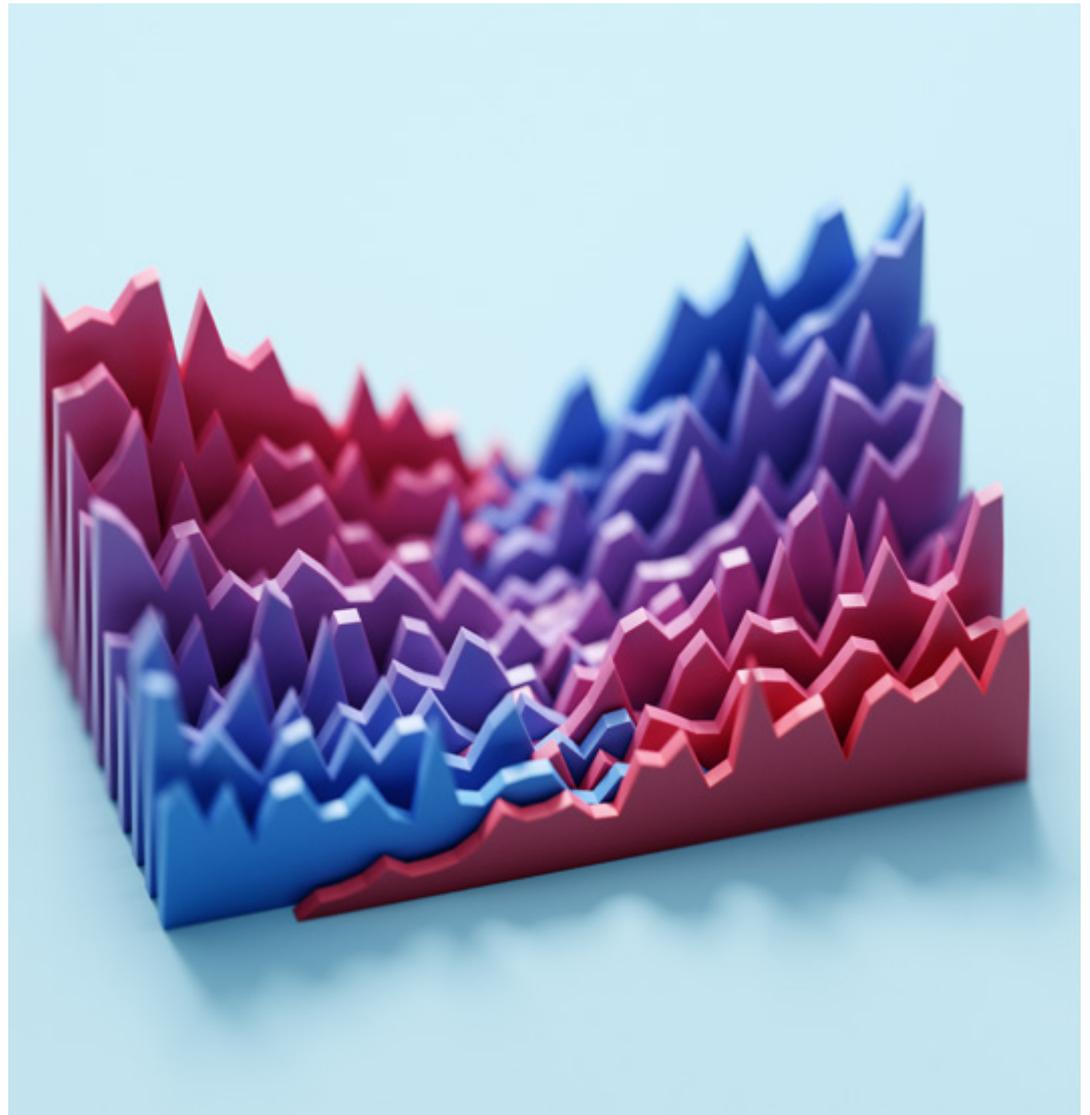
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UNDERSTANDING SMART BETA ETFS AND THEIR IMPACT
ON ACTIVE AND PASSIVE FUND MANAGERS



TO THE POINT

01. Smart beta is a rules-based portfolio-building process that harnesses indexing and ETF efficiencies while beating the risk return of traditional market-cap-weighted indices.
02. Smart beta ETFs are thriving—their market share of the European ETF market has risen from 1 to 6% over the last 15 years.
03. By expanding into smart beta ETFs, passive managers can enrich their value proposition to institutional investors and generate additional revenue.
04. Active managers can either leverage smart beta processes, or consider certain practices to provide investors with a richer understanding of returns and risk level, particularly institutional ones.



Active management is increasingly challenged by passive management due to performance, fees and volume growth gaps.

INTRODUCTION

Worth approximately EUR€25 trillion in Europe in 2020, the asset management industry is mainly split between active and passive management. While active management still dominates the industry's landscape, passive management's share gained 4 points between 2008 and 2019 to reach 15% of total assets under management (AuM)¹. This market shift is even more pronounced in the United States, where the passive management market share exceeded 40% in 2019².

Over the past decade, a new category has emerged and started gaining market share. Smart beta exchange-traded funds (ETFs) are the industry's fastest-growing ETF product, attracting new inflows. Various players are moving into this market by designing and launching new products.

In this article, we compare the value proposition of smart beta ETFs with more traditional investments and explore their implications for the industry.

¹European Asset Management Association, Nov. 2020

²Federal Reserve Bank of Boston, "The Shift from Active to Passive Investing: Risks to Financial Stability?", May 2020.

Active and passive management rationale for investing

Investment companies employ professionals to actively manage their clients' funds because they believe this approach will outperform the market. Active managers execute their trade decisions to generate alpha (and performance), rather than following an index. They leverage analyses, research and their own judgment and experience. They can control the scope and timing of the securities they own.

To generate alpha, active managers can leverage or combine multiple techniques, such as:

Stock picking: selecting securities according to the analysis of various criteria, such as growth rate, intrinsic value and favorable trends.

Market timing: increasing the fund's exposure when the market is on an uptrend and reducing exposure when the trend is reversing.

The potential benefits of active management include:

Exploitation of market inefficiencies: active managers can exploit pricing anomalies created by emotional biases and information failures. This can be one of the reasons why European small-cap equity active funds had the highest success rates³ compared with other European funds across all 1-year to 10-year timeframes.

Risk management: excluding companies or industries driven by negative trends, using various hedging strategies such as short selling, derivatives, and market timing strategies.

Niche market advantages: leveraging unexploited corners of the market where flexibility and knowledge are more important than size, such as thematic funds, e.g., water funds composed of mid-cap values.

Better resource allocation: passive investing can encourage inefficient allocation of resources by deploying capital towards the largest firms, rather than those generating the best returns – e.g., active large-cap funds that have different allocations than index.

Active managers claim to be especially successful during periods of market stress, by adapting their exposure accordingly. Average returns for European equity outperformed their benchmark S&P 350⁴ (1.44% versus -2.79% 1-year returns⁵) during the 2020 COVID-19 stock market crash.

On the other side of the spectrum, passive management seeks to track the returns of a specific index (e.g., CAC40, DAX30) and generally follows a capitalization-weighted index. Passive managers believe in the efficiency of markets: the highest returns are achieved by buying securities that follow market valuations.

Limitations of active and passive management

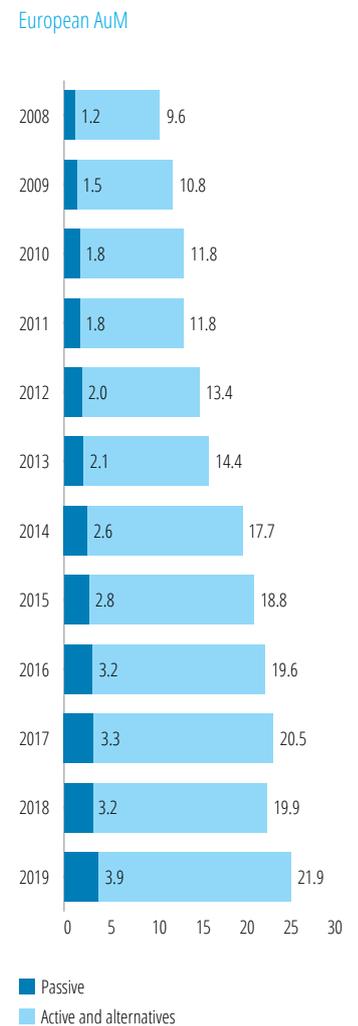
Actively managed funds typically charge higher fees than passively managed ones¹ (approximately 0.9% versus approximately 0.15%, respectively). This fee gap has tended to hinder the development of passive management, as distributors prefer to benefit from active management's higher fees. The fee difference is becoming increasingly difficult to justify, as active funds have shown disparate results when compared to passive ones (cf. figure 1b). The overall increase of passive funds' market shares in both the United States and the European Union is piling further pressure on the fees of active managers.

As active management funds are dynamic, with portfolio and market correlation constantly evolving, it is difficult to measure their beta (i.e., the coefficient of correlation to the market). This means it is challenging to assess their risk-adjusted performance versus their benchmarks, as investors are unsure whether performance is due to managers' judgments or risk variations. The risk dimension can be an issue, particularly for institutional investors who want to understand and monitor their asset allocations versus risk.

Both active and passive management have demonstrated limitations when addressing investors' needs. Active management funds do not always have clear indicators, generally come with high fees, and often fail to outperform their benchmarks.

While passive funds that are weighted according to each security's market capitalization increase their exposure to the most expensive stocks versus those with the highest returns. These limitations have paved the way for the development of smart beta funds.

Figure 1a: European AuM⁷ (EUR trillions)



³ Success is measured by the capacity of an active fund to provide a higher performance versus its benchmark index.

⁴ Europe S&P 350.

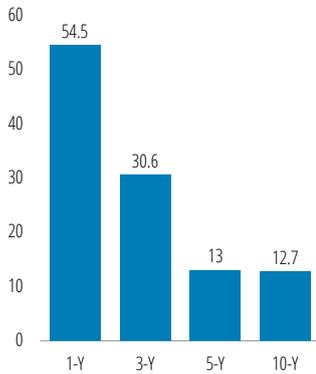
⁵ SPIVA Europe Scorecard, 2020.

⁶ Factset.

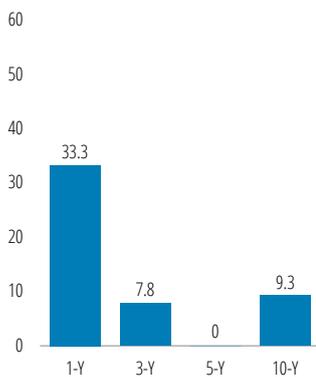
⁷ European Asset Management Association, Nov. 2020.

Figure 1b: Active funds success rates⁸
(% of funds beating their index over X years)

Europe large-cap value



Europe large-cap growth



Smart beta leverages a systematic portfolio building process to benefit from indexing while beating the risk/return of traditional market-cap-weighted indices

What is smart beta?

Smart beta strategies are designed to add value by systematically selecting, weighting, and rebalancing portfolio securities based on market factors, without being bound by market capitalization of underlying securities.

Compared with passive ETFs, smart beta ETFs take a unique approach to index construction. Managers actively collaborate with index providers to build the indices against which their ETFs will be tracked.

By focusing on index construction, smart beta aims to overcome some of the weaknesses of traditional beta. These portfolios can leverage multiple alternative weighting factors to replicate the exposure of a traditional price or cap-weighted index while maximizing its return, or vice versa.

Many of these weighting factors are not new; asset managers are already using them to actively manage their portfolios to identify elements of intrinsic value and stock that may, rightly or wrongly, be over or underpriced. They can include:



Value: inexpensive stocks relative to fundamentals such as price-to-earnings tend to outperform.



Quality: financially healthy companies typically perform better over time.



Dividend: companies that pay dividends tend to be well-established, financially healthy companies.



Momentum: stocks with a strong recent performance tend to maintain higher returns.



Growth: small, high-growth companies tend to outperform their larger counterparts.



Minimal volatility: stable securities can outperform more volatile securities on a risk-adjusted basis.

But beyond the use of these factors to try to identify over or underpricing, at an aggregate level, a portfolio's exposure to these factors is a relevant way to capture risk premia. The clarity of factor exposure and the benefit of indexing can mean smart beta combines the best of both worlds.

The popularity of smart beta ETFs or ETPs more broadly (including non und products like SPVs) has grown significantly in the past years.

01. In Europe, smart beta's share of the total ETP market has increased from less than 1% in 2005 to approximately 6% in 2020. By the end of 2020, the number of ETPs reached 160 and the total AuM amounted to EUR63 billion.
02. iShares, managed by BlackRock, is leading the smart beta ETP market in Europe by far, with more than 49% market share.
03. Most major asset managers, including Lyxor, Amundi, UBS and Vanguard, are offering smart beta ETPs today. They are uniquely

04. positioned as they have the broadest access to institutional investors, who are typically the most interested in smart beta.
05. Other medium-size or smaller players have also positioned themselves in the landscape, including CoreShares, Desjardins GAM and JPMorgan, and smaller actors are increasingly considering offering smart beta ETFs.

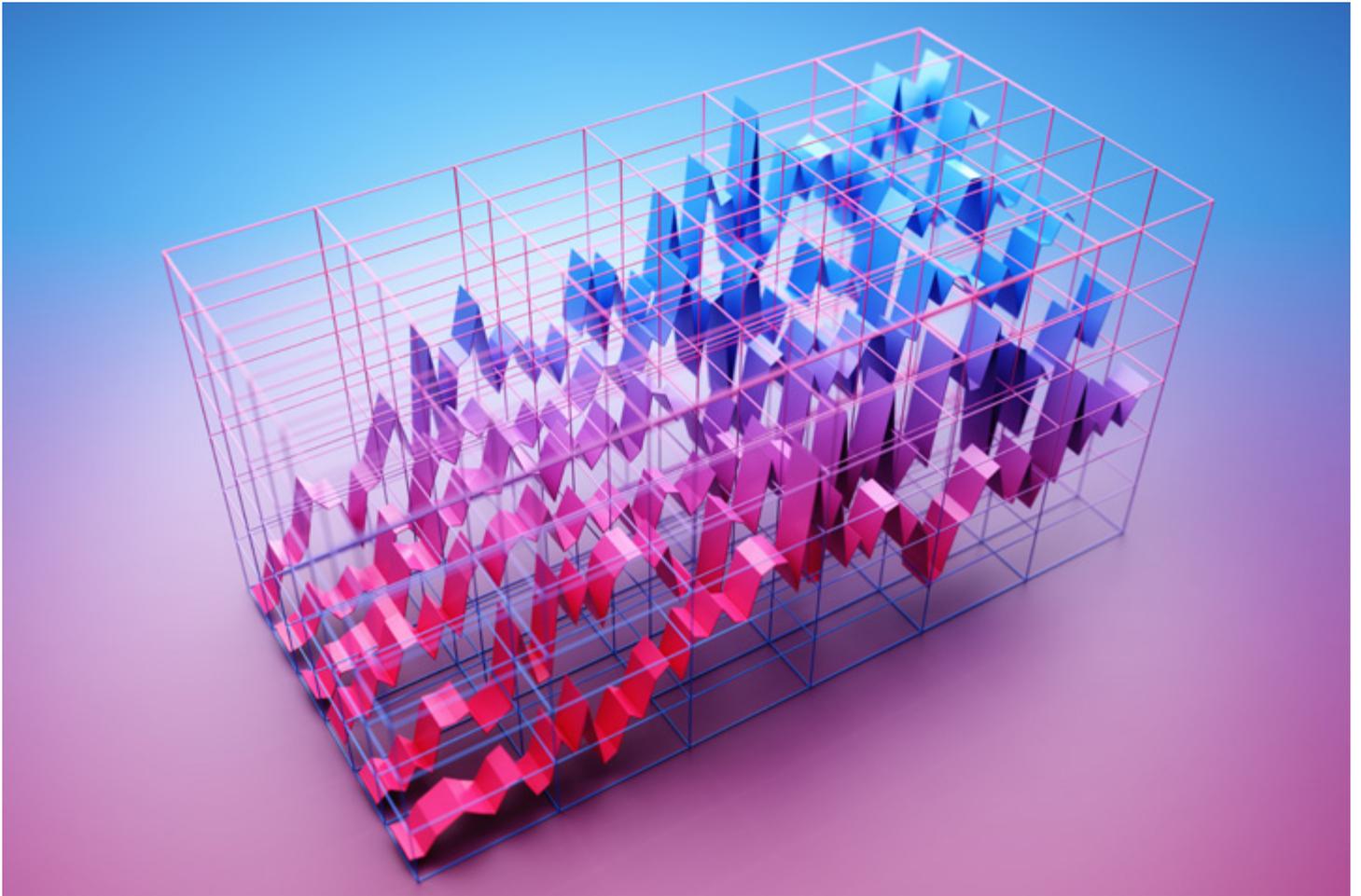
As for fees, smart beta ETPs position themselves between active and passive management, with average fees ranging from 0.2 to 0.5%. Fees are declining for active, passive and smart beta funds, while fee pressure continues to rise as the competitive landscape becomes more crowded. New smart beta entrants offering lower fees could have an edge on dominant players, challenging their current umbrella pricing setups.

Added value of smart beta funds

Smart beta ETFs aim to improve returns or minimize risk compared to their benchmarks. The way they measure risk is more explicit when compared to traditional active funds. This feature is particularly interesting for institutional investors, who need to measure their risk exposure and betas and grasp their resource allocation with greater accuracy.

Smart beta ETFs' success rates compared with their benchmarks are positive as illustrated by academic research over the years, but they are also complex to evaluate, especially in the current environment.

⁸ Morningstar, 2020.



Theoretically, smart beta ETFs should also be able to capitalize on the 2020 market crash to demonstrate their added value. Due to the current landscape's broad spectrum of varying strategies, they performed heterogeneously in the first months of 2020. Five out of the 11 smart beta categories have outperformed Morningstar Category Indexes in terms of average returns (commodity, growth, momentum, quality, and risk-oriented) and six out of 11 categories boasted success rates for their ETFs greater than 50%. Also, there were significant differences even within the same category, particularly commodity, due to the diversity of ETPs available

and the category's high volatility during that period.

Smart beta strategies could significantly impact the asset management industry. Particularly active management, as many traditional active managers deliver part of their returns via static exposures to smart beta factors while charging active fees. Additionally, smart beta strategies suit institutional clients that require specific risk measurements. With these investor types owning more than two-thirds of the AuM in Europe, this could further boost their adoption rates in the coming years.

What does smart beta mean for different asset managers?

Passive managers: expand into smart beta

Well-constructed smart beta ETFs will progressively gain market share with institutional investors, as they provide a superior performance-to-risk ratio when benchmarked with passive funds (i.e., a similar performance with reduced risk, or enhanced performance with similar risk). They can also clearly display their indicators (alpha, beta, or R-squared). Passive managers that diversify their offering with smart beta ETFs could be onto a winning strategy.

Leading asset managers with the necessary infrastructure and access to institutional clients could leverage smart beta ETFs to generate additional revenues, as their fees are higher than passive ETFs (*cf. figure 2*).

Small-to-medium-sized asset managers can leverage smart beta to provide a differentiated value proposition with the multiplicity of risk factors. They can also position themselves on niche segments where they would not be penalized by the scale effect versus leading asset managers.

Asset managers will have to tackle various challenges, such as production (e.g., human resources, research and development capabilities, IT systems) and distribution. The latter is particularly important, as many investors lack knowledge of smart beta products. Marketing campaigns by asset managers can help increase awareness of smart beta products and their added value to both distributors and investors.

Active managers: act quickly and leverage certain smart beta practices
Smart Beta ETFs could substantially impact the value proposition and fee model of traditional active managers.

- 01. Many active funds are already struggling to outperform their passive benchmarks. This will become more challenging with the rise of smart beta ETFs, with their enhanced performance-to-risk ratio and competitive fees (cf. figure 2)
- 02. Smart beta ETFs have elevated the standard of communication between asset managers and investors. Active managers could leverage these practices to improve communication around performance, and provide a richer understanding and granularity of the level of risk.

Managers will need to investigate the relevance and implications regarding fees and product offerings before expanding into smart beta ETFs. They should pay a lot of attention on index construction when selecting index providers and could even move into the business of constructing indices.

Not only asset managers but also broader financial services players can get involved in the smart beta evolution, as illustrated by the sale of Scientific Beta by EDHEC Business School to the Singapore Exchange.

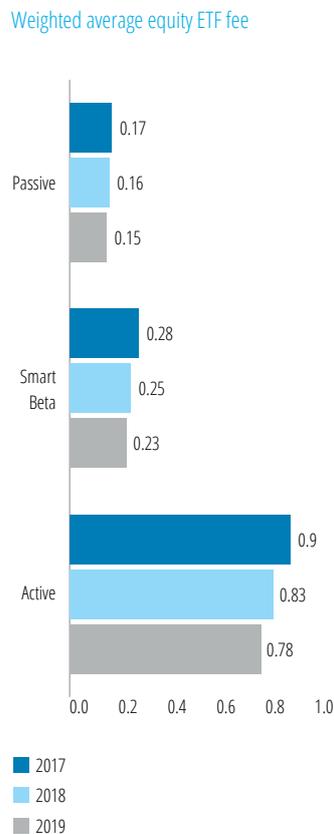
CONCLUSION

Smart beta ETFs are disrupting the activities of active fund managers – while they share some of the features of active fund management, they charge lower fees and are more explicit in the indicators they share with their clients.

Just as Vanguard revolutionized asset management by introducing low-cost investment solutions, smart beta ETFs could pave the way to a durable investment style that boasts both active and passive management features.

While their market share is still relatively small, they are growing fast and have reached more than a 20% share of the US ETF market, a hint towards their possible trajectory in Europe.

Figure 2: Weighted average equity ETF fee⁹ (%)



The latter is particularly important, as many investors lack knowledge of smart products.

⁹ Factset.

Artificial intelligence: to the rescue of tedious compliance tasks

UCITS ELIGIBILITY VALIDATION WITH AI



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INTRODUCTION

Undertakings for collective investment in transferable securities (UCITS) are collective investment schemes established and authorized under a harmonized EU legal framework. These schemes allow fund managers to operate freely throughout the European Union through a single authorization from one member state.

The Commission de Surveillance du Secteur Financier (CSSF) requires UCITS to ensure their eligibility. This requires fund managers to check each fund's prospectus to identify phrases that confirms its accordance with UCITS eligibility requirements. As fund managers have many prospectuses to review, and each averaging around 150 pages, this task is time-consuming and can be error-prone. Generally, fund managers are performing this task manually, generating high operational costs and deviating resources from more added-value activities.

To tackle this challenge, Deloitte explored the field of artificial intelligence (AI), with a particular focus on natural language processing (NLP), an AI subfield combining linguistics and computer science that allows machines to understand, process and perform human-language tasks.



Manual approach

Fund managers review UCITS eligibility by checking if these two necessary but not sufficient conditions are covered in its prospectus:

- 01. Compliance with the Luxembourg law of 17 December 2010 implementing the EU Directive 2009/65/EC; and
- 02. That the fund shall not invest more than 10% of its assets in transferable securities or money market instruments.

Without a dedicated tool, this is mainly a manual task. It consists of reading through the prospectus page by page, documenting the location of sentences that justify one of the UCITS eligibility criteria in a review sheet, and finally checking if both eligibility criteria have been met.

Identifying these relevant sentences from a 150-page prospectus is tantamount to looking for a needle in a haystack. And, if the prospectus is only available in

hard copy, keywords cannot be automatically searched. Furthermore, prospectuses from different sources have different layouts, increasing the difficulty of a human review and potentially leading to classification errors.

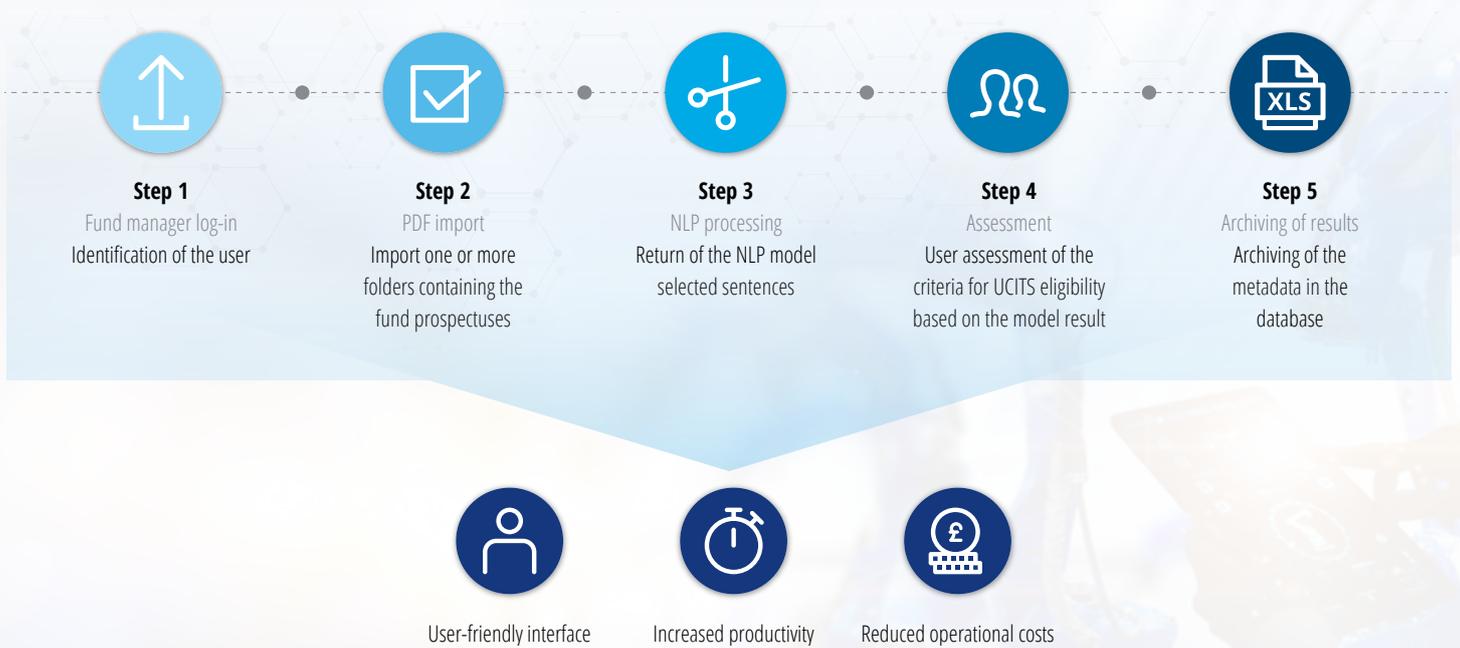


AI automation

Figure 1 shows how an AI automated solution can reduce fund managers' current burden. It inputs the PDF prospectus, preprocesses and parses the text, and then separates and organizes the

content into a standard format ready to be analyzed by the algorithm. Through NLP and rule enhancement techniques that recognize patterns, the algorithm can identify relevant UCITS compliance sentences. Based on the sentence extraction, the model can identify the prospectuses that comply with the stated criteria. The model's classification proposal is evidenced through the algorithm returning relevant sentences, page numbers and paragraphs to provide the fund manager with the full context.

Figure 1. AI-based solution



An example of the model output:

01. **Criteria 1:** compliance with the Luxembourg law of 17 December 2010

Sentence extracted:

The investment fund is an investment company incorporated in the Grand Duchy of Luxembourg and qualifies as an Undertaking for Collective Investment in Transferable Securities (UCITS) complying with the provisions of Part I of the 2010 Law.

Model output: Compliant

02. **Criteria 2:** less than 10% investment in transferable securities or money market instrument

Sentence extracted:

The sub-fund may invest a maximum of 10% of its assets in MMFs.

Model output: Compliant

The involvement of field specialists in the model's training and output validation is the foundation of the product and optimized its accuracy. More specifically, the algorithm is trained on a dataset of prospectus labeled by fund managers. Fund managers remain the final decision-makers on a prospectus' eligibility by assessing the batch of relevant sentences returned by the algorithm. Furthermore, feedback logged during the validation process is used to enhance its accuracy.

By virtue of the AI algorithm, the UCITS eligibility check can be performed in five minutes as the analyst just has to review and validate the outputs, which is statistically six times faster than the traditional manual approach.



Added value

Automating UCITS compliance tasks with AI techniques like NLP overcomes the limitations of traditional approaches and offers a multitude of benefits.

Not only does it significantly trim operational costs but it also optimizes resource allocation. As the manual processing of financial documents takes up professionals' time, outsourcing this process to AI frees up talent to focus on the core business.

It can also help reduce operational risks and bias compared with manual processing. In particular, a dedicated platform allows for

comprehensive documentation and better traceability regarding potential errors.

Last but not least, the solution provides sustainable data capacity. In stark contrast to conventional methodologies, AI works better with scale—the more data it is fed, the smarter and more agile it gets. This enables organizations to keep up with explosive data growth.

CONCLUSION

01. Investment funds and management companies are responsible for checking that investments in hybrid instruments embedding derivatives comply with UCITS requirements.

01. The traditional manual approach generates high operational costs, especially regarding the large amount of prospectuses that require assessing.

01. NLP and AI techniques can significantly accelerate this task, while also mitigating operational risks, reducing bias and increasing traceability.

TO THE POINT

The Commission de Surveillance du Secteur Financier (CSSF) requires fund managers to ensure the eligibility of funds relating to undertakings for collective investment. To meet this requirement, fund managers must review these funds' prospectus documents to ensure they explicitly report certain criteria. As this tedious task is currently done manually, it is both time-consuming and error-prone.

Automating this task with artificial intelligence (AI) and natural language processing (NLP) shrinks this workload, provides significant time gains, and mitigates operational risk. And, it allows fund managers to stay in the driving seat by validating the algorithm's results. This AI-driven product also enables traceability through an integrated database and metadata tracking process, supporting compliance and audit-check communication.

Accelerating digital transformation, responsibly

ACHIEVING A HIGHER BOTTOM LINE IN FINANCIAL SERVICES



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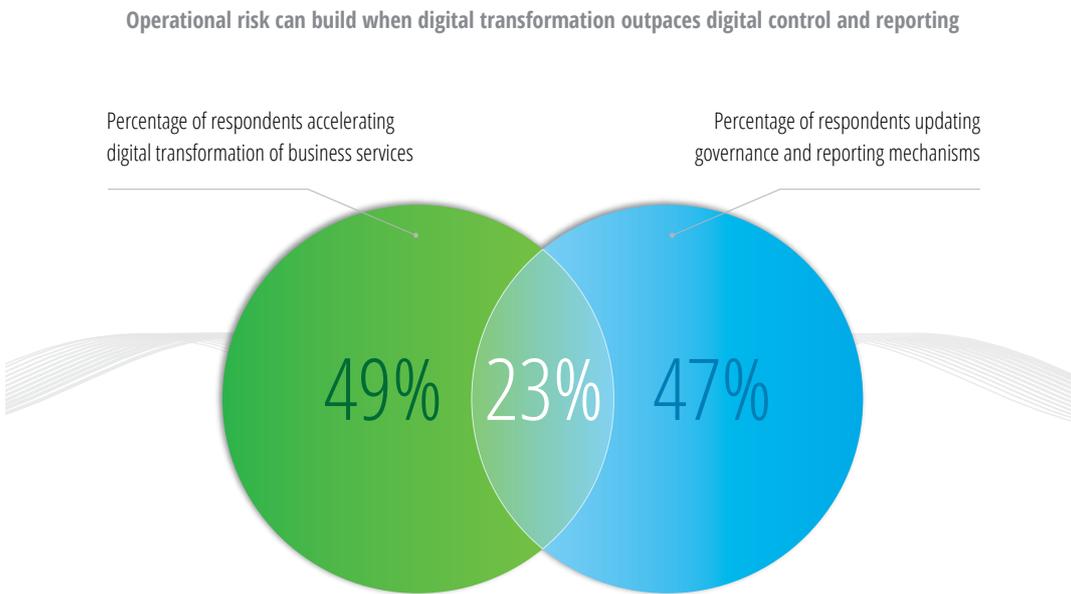
INTRODUCTION

Necessity truly is the mother of invention. During the response phase to COVID-19, financial services firms changed processes across the full scope of operating model components in the industry. They had to.

Many firms accelerated digital transformation as part of this effort. But now, as the stress of the crisis dissipates, firms can enter the next phase of their digital transformation journey. To position themselves to thrive, financial services firms can shift from an effort that was need-based during the height of the pandemic, to one that is *responsibility-based* – designed to benefit all stakeholders and achieve broader goals, not just financial ones.

In the summer of 2020, Deloitte’s proprietary survey of financial services firms revealed that 49% of respondents said their firms accelerated digital transformation efforts due to COVID-19. Meanwhile, 47% said their firm had updated governance and reporting mechanisms (see Figure 1). But only 23% of firms did both. That means that most of the firms that accelerated digital transformation did not update their governance and reporting mechanisms. Can digital transformation be achieved responsibly without updating the associated governance? Perhaps, but the likelihood of doing it responsibly is often diminished.

Figure 1. Responsible implementation of digital transformation calls for adequate governance mechanisms



Source: The Deloitte Center for Financial Services, 2020 survey of financial services firms.

TO THE POINT

01. Financial services firms faced and solved many operational issues throughout the pandemic out of necessity.
02. Firms can build from those necessary achievements as the emergency subsides by adding a perspective of responsibility.
03. Responsibility has many perspectives, and when they are given voice in mature organizational operations, the results can yield financial and overall positive results, leading to a higher bottom line.

In our previously published report, “A higher bottom line: The future of financial services,” we asserted that the future of financial services largely lies in firms’ ability to reach a “higher bottom line,” one that “values the future of our planet and people just as much as profits. It blurs the line between the striving and the successful until there’s less inequality and more shared wealth... [it] represents both the financial and human profit to be gained from a more educated, equitable, sustainable world.”¹ Going forward, responsible digital transformation is expected to be a key driver of achieving a higher bottom line.

Responsible digital transformation will mean different things to different stakeholder groups – customers, employees and management, regulators, society, and shareholders. Here, we review the considerations

and steps firms could deploy to help achieve this goal, stakeholder by stakeholder.



Customers

As financial services firms digitally transform their operations, focusing on ease of use, personalization, and on-demand services may help drive customer satisfaction². Meeting these needs responsibly can help firms differentiate and build their brand value. While firms can focus digital transformation efforts on delivering improved product offerings and providing better customer service, responsible digital transformation goes a step further. It offers customers more transparency and control over their data and ensures data security, all of which can help build trust and engender brand loyalty.

Providing personalized service involves merging disparate

data sets, such as credit rating, social media, geolocation, and web browsing history, to derive customer-specific insights. However, if firm communications are too personalized, customers may find it invasive and experience discomfort. In a Deloitte survey of financial services firm customers, most respondents (57%) agreed that privacy has become even more important to them over the past few months³. Companies that succeed at responsible digital transformation will likely address these concerns by offering customers more transparent and easy-to-understand privacy policies.

Another key aspect of responsibility relates to how companies use artificial intelligence (AI) models to evaluate customers, assess risks, and clarify price offerings. Customers expect that firms should be able to explain

the rationale behind their evaluation decisions. For example, if customers are denied a loan, they may want to know the reason so they can take corrective measures⁴.

If data sourced from third parties feeds into the models, customers may prefer an opportunity to check data accuracy and correct data mistakes, if any.

Adopting data governance policies that address these concerns may help improve customer engagement and data

accuracy. More broadly, these measures could help customers feel more confident about the firms' digital transformation.



Employees and management

Employees and management can work together to create a digitally advanced, responsible operating environment. They will need to make systems and processes fit for a digital future without losing sight of their organization's long-term vision and strategy.

They will also need to minimize operational risks, such as cybersecurity, fraud, reputation, and strategic risks. For example, implementing customer transparency and data modification measures may require establishing new control systems to protect against identity theft and fraud. Importantly, managers and employees will likely need to upskill on new technologies to meet other stakeholders' expectations and deliver high performance in a virtual environment. As Deloitte has written about previously, most "successful digital transformations realign the organization to a singular vision."⁵⁹ Therefore, if changes are made to the operating model, management should ensure that digital transformation aligns with these changes.

Having a unified cloud and cybersecurity approach can help digital projects succeed; comprehensive strategies tend to be more resilient than nascent ones⁶. Digital risk monitoring is an ever-increasing priority, and some firms now have a Board-level committee to manage and control digital risk. The committee can call for regular audits, changes

to management reporting, and stress testing for events to incorporate and enhance resilience⁷.

Organizations that establish a strong reputation for responsible behavior may gain an edge in recruiting the most talented job candidates. This, in turn, may create a virtuous cycle, because people are the drivers of successful digital transformation⁸.



Regulators

Firms will likely have to digitally transform their compliance function to sustainably and responsibly meet evolving regulatory requirements; existing mechanisms may not be able to handle the incremental burden. Furthermore, by taking a more proactive and forward-looking approach to transformation, firms may avoid lapses in governance, which could mitigate some financial penalties, lawsuits, and reputational damages.

One way to build a more responsible compliance function is to embed the requirement into frontline business units. This action may allow the compliance team to perform initial assessments and track regulatory requirements; frontline units could then focus on delivering positive business outcomes within the implementation framework⁹. This collaboration could reduce cost and help minimize damages due to noncompliance with early detection and faster mitigation of problems¹⁰. However, according to the Deloitte global risk management survey, 58% of respondents faced significant challenges in getting buy-in from businesses and functions and only 33% of respondents said that control

testing was embedded in the frontline functions of their organizations¹¹. Clearly, the industry has a long way to go to successfully integrate control mechanisms into the frontline units.

Moreover, firms that use entrepreneurial regulatory technology (RegTech) to digitally transform the compliance function may need to think holistically to avoid having a suboptimal mosaic of tactically applied solutions¹². Siloed approaches to implementing RegTech solutions may lead to low interoperability and conflicting outcomes. For a RegTech example, United Overseas Bank (UOB) successfully increased true positive detection by 5% and reduced false positives by 50% in its anti-money laundering (AML) program¹³. UOB teamed up with Tookitaki, a Singapore-based RegTech startup, to use machine learning as part of its AML program¹⁴. To make this new AI-assisted approach work responsibly, UOB updated its staffing considerations for model supervision skills, data privacy factors, and processing system interoperability¹⁵.

In addition to updating old mechanisms, responsible digital transformation explores internal and external avenues to sustainably reinvent compliance and accountability.



Society

From a societal perspective, responsible digital transformation factors in financial inclusion, fairness, sustainability, and financial system stability during the digital transformation planning process. As a result, firms are more likely to be viewed as a positive force for good.

Responsible digital transformation aims to boost financial inclusion and fairness by mitigating bias among employees, data, and AI models¹⁶. Being responsible is easier said than done. However, requiring anti-bias training for employees, qualitatively and quantitatively managing data quality, and using explainable AI models may help prevent biases from forming and spreading across the financial system¹⁷. Firms that remove bias and decouple financial decision-making from factors that have no impact on risk could raise their social reputation as well as improve environmental, social, and governance (ESG) ratings.

On the sustainability front, firms can take a number of actions, including: financing green enterprises, using clean energy sources, reducing and offsetting emissions, and adapting infrastructure to withstand more extreme weather¹⁸. Wells Fargo achieved carbon neutrality in its operations in 2019 and has committed to achieving net zero in its financing activities by 2050¹⁹.

As firms develop their digital transformation plans, it is important to provide the public the reporting metrics needed to support full transparency.

Another aspect of social responsibility is advancing diversity, equity, and inclusion (DE&I) efforts within the firm.

In this work, recognizing that people have different starting positions in today's society is paramount. An equitable enterprise "listens to, invests in, and actively works to dismantle the systemic inequities" that have influenced the world as we know it today²⁰. Firms that incorporate this approach may be able to strategically break down the underpinnings on which the inequities are built, for the betterment of society²¹.

Last, but not least, firms can evaluate the impact of their advanced digital systems on financial system stability. As AI systems more frequently communicate with one another, firms may need to add new governance processes and safeguards to detect and prevent incidents²². Black box AI-decision logic can be revealed and monitored to mitigate risk consequences across interconnected institutions. Systemwide risks may arise due to:

01. **Herding behavior:** Market movements fueled by momentum can escalate when different systems construe market signals in a similar way.
02. **Algorithmic competition:** Multiple AI systems bidding against each other may artificially inflate the price of an asset after one drops out, which may create an incentive to engage in riskier behavior or perhaps never even enter the market in the first place.
03. **Information vacuums:** AI systems may misinterpret human inaction following a shock to the market as disinterest, and instead of pausing continue selling as prices fall, exacerbating the effects of the shock due to the absence of human

demand²³.

Apart from regulatory requirements, firms can use techniques such as scenario modeling, human-in-the-loop, and sentiment analysis to identify and mitigate systemwide risks²⁴.

Financial institutions that achieve responsible digital transformation can "positively affect society without negatively affecting profits"²⁵. This is likely to boost a firm's brand value at a societal level.



Shareholders

Today's shareholders tend to care about far more than just profit and loss statements. Most positively view firms that incorporate high ethical standards and societal impact into their operations. Shareholders expect responsible firms to be adequately transparent and disclose identified material risks. Taking these steps can help firms achieve a higher bottom line, which is increasingly important in shareholders' eyes²⁶.

In addition to considering financial returns, most shareholders now expect firms to consider operational risks from an ethical and resilience perspective²⁷. For example, if digitization means offshoring, the cost savings may not be worth it if offshoring ties firms to corruption, human rights violations, or use of unfair labor practices in other countries²⁸.

The US Securities and Exchange Commission, acting as an advocate for shareholders, is stepping in with recommendations for ESG reporting frameworks. As more and more shareholders measure their investments on more than financial results

alone, the additional measures firms take are becoming more regulated and are affirmed by accountable third-party auditors or rating agencies. Overall, firms' success, in the eyes of shareholders, now depends on verified measures that demonstrate a net positive corporate impact.

LOOKING FORWARD

The scope and goals of responsible digital transformation extend beyond a typical upgrade to reporting and governance. Given all of these factors, to achieve this level of transformation, financial services firms may have even more catching up to do than our survey data indicated. Still, there is enormous opportunity for firms that are able to get this right.

Financial services firms made significant advances in their digital transformation journeys during the height of the COVID-19 pandemic. They can now take those advances to the next level and create new benefits by taking steps to ensure their transformation efforts are not just need-based, but also responsible. Then, they can succeed in achieving a higher bottom line.

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Assessing the value investment funds deliver to investors

LESSONS FROM THE UK EXPERIENCE



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INTRODUCTION

Value for money in the asset management industry is a key theme for regulators in many jurisdictions. For example, in the European Union, the European Securities and Markets Authority (ESMA) has identified retail investment products' cost and performance as a Strategic Supervisory Priority for national competent authorities. ESMA is currently conducting a common supervisory action on the supervision of costs and fees in UCITS funds, which includes compliance with the obligation of not charging investors undue costs.

In the United Kingdom, since 2019, asset managers have been required to assess annually the value that their authorized funds deliver to investors and publish a summary of their assessments. The Financial Conduct Authority (FCA) recently published feedback from its first formal review of the implementation of these rules. This article discusses the FCA's key findings, as well as our own observations based on industry reports and our work with firms in this area. It draws out lessons relevant for firms globally as they consider how to assess value for money.

The FCA's value assessment framework requires asset managers to evaluate whether a fund's charges are justified based on the overall value delivered to investors, considering the following seven assessment criteria at a minimum:

01. The range and quality of services provided to investors;
02. Investment performance over an appropriate timescale, based on the fund's investment objectives, policy and strategy;
03. The costs incurred by the asset manager in providing the services;
04. How the fund's charges compare with similar funds in the market;
05. How the fund's charges compare with other services provided by the asset manager (e.g., institutional mandates of comparable size with similar investment objectives and policies);
06. Whether the asset manager benefits from economies of scale and whether these benefits are shared with fund investors; and
07. Whether investors in some share classes pay higher fees than those in other share classes with substantially similar rights.

These criteria are similar to the criteria [set out](#) by ESMA on how firms should design a structured pricing process, although the FCA's framework includes explicit consideration of profitability, economies of scale and comparable services provided by the asset manager.

Following the United Kingdom's first round of value assessments, an Investment Association [study](#) of nearly 1,500 funds found that action was considered necessary in 21% of funds. Poor performance was the biggest contributor to poor value, with performance being a concern in 85% of funds where action was taken. How a fund's charges compare with similar funds in the market was the next largest contributor, with nearly a third of poor value funds failing this criterion. Quality of service was the least likely criterion to be deemed poor value, with only eight funds in the study reporting issues.

Findings from the FCA's review of firms' value assessments

[Key themes in the FCA's feedback from its review](#) include:

Some firms assessed value against a lower standard than investors may reasonably expect.

Many active funds only assessed value against vague fund objectives such as achieving "long-term capital growth", even though they charged fees in line with active management and rewarded fund managers based on a comparator benchmark. Firms must consider what investors would reasonably expect from the fees they pay and the fund's investment policy and strategy. Some firms justified the underperformance of funds over several years due to the investment style underperforming the market; however, they had not clearly disclosed the risks of relative

underperformance over longer time periods to investors. Some multi-asset funds and funds of funds only assessed value against other multi-asset funds or funds of funds, without considering that investors typically pay higher fees for these fund types to achieve better risk-adjusted returns than with a cheaper fund.

Many firms' analysis was insufficiently granular, leading to poorly evidenced conclusions.

Some firms assessed value only at the firm or fund level rather than at the share class level. This meant firms potentially overlooked poor value in some share classes. For example, some firms only assessed net performance for the wholesale share class with the lowest charges, rather than considering that net performance will be lower for share classes with higher charges.

Some firms over- or under-emphasized certain value indicators.

For example, some frameworks gave a very heavy weighting to a fund's performance, which meant other indicators like profitability were not escalated to the board. In other cases, little emphasis was placed on poor performance.

 **Many firms assumed current industry fee and profitability levels were acceptable, even though the FCA has found that the market is not competitive.** When assessing profitability, some

firms assumed typical existing profit margins were justified, with changes only considered for material outliers. However, in its [asset management market study](#), the FCA found that typical industry profit margins were not consistent with competitive outcomes. Also, some firms assumed that existing fund charges already reflected economies of scale being shared with investors without any justification for this. Overall, firms were typically less active in analyzing the fees paid for asset management and distribution services than those paid to outsourced service providers.

Independent non-executive directors (INEDs) often did not provide sufficient challenge.

Some of the INEDs on the board did not provide a robust challenge and appeared to lack sufficient understanding of relevant fund rules.

How can firms improve their value assessments?

[Our own analysis, in addition to the FCA's findings, has identified some key steps that firms can take to improve their value assessments:](#)

01. Ensure that a standardized process for assessing value across all funds does not prevent fund-specific issues from being considered – for example, the value assessment must consider each fund's purpose, objectives and investment strategy.
02. Articulate clearly what constitutes poor value – for example, while it

is inevitable that active funds will sometimes underperform the market, how long or by how much can a fund underperform before it is deemed poor value?

03. Ensure the data used in the analysis is fair and accurate – for example, we saw some firms using very broad categories of funds for peer group comparison, when many of the peer group's funds were not genuinely comparable.
04. Include quantitative information in the published reports where relevant.
05. Give board members plenty of opportunity to challenge the assessment methodology and document any challenge appropriately.

What are the effects of the value assessments?

Overall, the value assessment process has succeeded in bringing firms' attention to the value they deliver for investors. Firms have applied a range of remedies, including fee reductions, moving investors into cheaper share classes, closing funds, or changing investment strategies or teams. However, so far, we have not seen widespread corrective measures. An [analysis](#) of 968 funds by Boring Money found that only 3% of funds were deemed poor value, although a further 18% were being monitored or had some fee reductions implemented.

The FCA requires firms to publish a summary of their

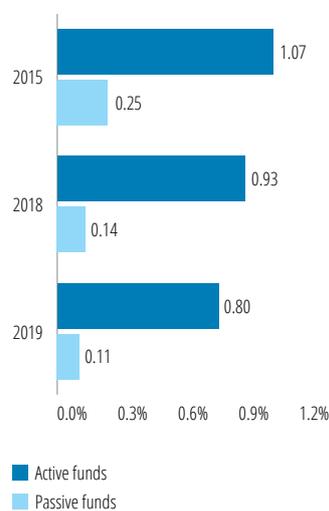
value assessments and external scrutiny can put pressure on firms to provide better value. So far, the (trade) press has picked up on several reports, giving positive coverage of fee reductions and criticizing unconvincing reports. Financial advisers could use these reports to aid fund selection. However, a [study](#) by the Lang Cat consultancy of 565 financial advisers found that only 6% used the reports in the first year. However, this may increase as the process becomes more established.

Another potential audience is retail investors. [Research](#) by Boring Money found that of over 3,000 UK retail investors, 19% had read at least one report, of which 58% said they were "somewhat useful" and 32% said they were "very useful". The number of retail investors reading the reports could grow if the reports were consistently displayed prominently on firms' websites which is currently not always the case.

In its [asset management market study](#), the FCA found evidence of weak price competition (particularly for active retail funds) and sustained high profit margins, suggesting some funds were not offering value for money. There has been a [downward trend in fees](#) in the sector since then (see Chart 1), and the FCA cites this as evidence that its measures (including value assessment requirements) may be leading to improvements

in competition. Nevertheless, the average profit margin is [still 36%](#), which raises questions about whether some funds are not delivering adequate value to investors. Given the increased pressure from the FCA and external scrutiny on firms' value assessments, we expect that the number of corrective remedies implemented by firms may increase.

Figure 1: Average ongoing fees for UK-domiciled funds



Source: FCA Investment management data – Annual Report 2019/20

CONCLUSION

Global asset managers can apply the lessons learned from the UK industry's value assessment exercise when assessing the value that their funds deliver to investors. The following actions will help firms perform a robust value assessment:

01. Have a consistent assessment framework across funds, but also consider value based on each fund's purpose and what investors can reasonably expect given the way it was marketed;
02. Give each value indicator due weight in the analysis, so that no value indicator is overlooked simply because other value indicators do not show any problems;
03. Assess value at a sufficiently granular level, including differences between share classes;
04. Articulate clearly what constitutes poor value;
05. Ensure the data used in the assessment is fair and accurate; and
06. Subject the value assessments to robust governance and independent challenge.

TO THE POINT

In the United Kingdom, asset managers are required to assess annually the value that each of their authorized funds delivers to investors, and to publish a summary of these assessments. The FCA has recently conducted its first review of firms' value assessments. Since value for money is a key focus of many jurisdictions, the lessons learned are relevant to asset managers globally.

The following actions will help firms perform a robust value assessment:

01. Consider value based on each fund's purpose and how it was marketed;
02. Consider each indicator of value individually, so that good value under one indicator does not hide poor value under another;
03. Consider value at a sufficiently granular level, including differences between share classes;
04. Articulate clearly what constitutes poor value;
05. Ensure fair and accurate data is used; and
06. Subject the value assessments to robust governance.



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