EMEA

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Deloitte.

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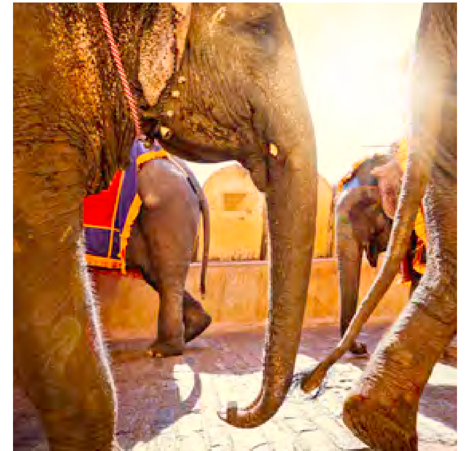
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Foreword

For many people, January is not just a month for reflection, to take stock of events from the previous year, but also a time for realization that the new year brings with it not only new opportunities, but also added challenges to face. As ever, 2019 will be no different to last year in terms of buzzwords – in this edition of Performance we only have ESTER and PEPP, but that is sure to change throughout the year. Both of these and more will surely become as perennial and entrenched in our daily jargon as Brexit, PRIIPS and MiFID.

Continuing our "round-the-world" trip, this time we visit two continents and two contrasting countries - India and Switzerland. Given that there are thousands of companies listed on the Indian stock exchanges, have you ever wondered why only a few of them find a place in investment portfolios? The answer lies within these pages, as does our guide to the myriad of inbound investment routes that allow global investors to invest in India – FDI, FVCI, FPI and ECB to name just a few. In Switzerland, 2019 will prove a tumultuous year with the practical preparations for the expected introduction of two landmark Swiss Financial Acts (FinSA and FinIA). The aim of these acts is to establish equivalence with MiFID II, PRIIPs and the EU Prospectus Directive. Independent asset managers will be most impacted by the requirement for substantial reorganization to meet new licensing requirements. Our Swiss colleagues explore the impacts whilst comparing the old regime with the new.

As ever, we provide insights on the asset management industry, this time from the new Luxembourg Country Manager of Société Générale Securities Services. After 30 years, the UCITS brand is still unassailable, yet is beginning to face competition from rival passporting schemes emerging from the Asia-Pacific region. Until now, environmental, social and governance criteria (ESG) have been considered more from a theoretical standpoint but they are now becoming reality. Find out how CPR Asset Management is approaching ESG investing, whilst being driven by financial materiality yet at the same time retaining a flexible approach to meet client expectations and future challenges.

Talking of buzzwords, ESTER (Euro Short-Term Rate) is sure to be on everyone's lips this year as arguably this constitutes one of the biggest challenges currently facing the financial industry. It involves the shift from EURIBOR and other prevailing benchmark indices to more sustainable benchmarks and will start daily publications in October 2019.

Have you ever thought about the parallels between sport and our financial environment? Deloitte has been in discussions with Adrian Vodislav, a former professional tennis player, to discover the parallels and how the two disciplines are inter-connected? Just think about the financial contribution required to transition from performing the sport as a hobby through the junior ranks to becoming a professional. Even something as simple as swimming, which does not necessarily require particularly technical equipment, can cost in the region of US$100,000 on an annual basis.

With that in mind, we conclude by wishing all our readers all the best for 2019. If you make just one New Year's resolution, it should be to continue reading Performance magazine. Perhaps a second resolution could be to contribute a thought-provoking article.

Vincent Gouverneur
EMEA Investment
Management Co-Leader

Tony Gaughan
EMEA Investment
Management Co-Leader

Editorial

Dear Readers,

After experiencing a bitter economic crisis in 1991, India significantly liberalized its economy in 1992. The reform saw considerable easing of government control over foreign trade and investment and the abolition of the License Raj across many sectors. The economic reform also resulted in the increased access of foreign investment in several sectors, with the list expanding ever since. Foreign investors were formally allowed to access Indian capital markets in late 1992. In 2014, the former FII regime was replaced with the Foreign Portfolio Investor (FPI) regime, which allowed all types of investors to invest in Indian capital markets subject to anti-money laundering and KYC checks. A FPI license is now issued by the local sub-custodian unlike in the past where the FII license was issued by the regulator. SEBI remains committed to FPI reforms and I have personally witnessed the efforts as a member of the H R Khan Committee.

During the last 26 years, the market capitalization of Bombay Stock Exchange (BSE), Asia's oldest stock exchange has grown from US$123 billion to US$2 trillion. The current market capitalization of the other leading stock exchange i.e. the National Stock Exchange (NSE) is more than US$2.27 trillion making it the world's eleventh largest stock exchange.

The Indian economy is currently the sixth largest in the world in terms of nominal GDP at US$2.6 trillion. Since liberalization, India's GDP has grown at an average rate of 6 percent to 7 percent year on year and since 2014 (excluding 2017) Indian economy has been the fastest growing major economy worldwide. India remains an attractive destination for long-term growth, relying on the positive factors such as the population dynamics, the growing middle class and the continued push towards economic reform.

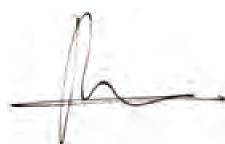
In the medium-term, IMF projects India's growth rate prospects to remain strong at 7.75 percent, benefiting from the ongoing structural reforms introduced by the government such as GST, inflation targeting monetary policy framework, the Insolvency and Bankruptcy Code (IBC), liberalization of foreign investment norms and steps taken to promote the ease of business exchange.

Despite the staggering economic growth, the corporate sector accounts for less than 20 percent of India's GDP and the rest of the economic activity is carried out in the unorganized sector and by households. Recent initiatives such as GST and demonetization are expected to encourage the migration of businesses to the organized sector.

Since 2002, on average FPIs have made a net investment of around US$9 billion in Indian equities year on year. In an encouraging trend, domestic mutual funds in India are attracting significant subscriptions (more than US$17 billion in 2018) from domestic investors who historically have been deploying their savings in bank deposits, gold, real estate and endowment policies. Another development relates to Alternative Investment Funds (AIFs), which primarily cater to institutional investors (foreign as well as local) and high-net-worth individuals. AIFs are a domestically pooled investment vehicle managed from India and include venture capital funds, private equity funds and hedge funds.

The next few months will be interesting as the largest democracy in the world will go through the mammoth process of general elections later this year. Certain reforms may be postponed until the elections and some priorities could change depending on which political party comes to power; but the overall framework of the economic and investment policy and the macroeconomic trajectory is expected to remain steady.

Rajesh H. Gandhi
Partner - Tax
Deloitte Haskins & Sells LLP



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Mr. Ashwini Agarwal
Portfolio Manager and Designated Partner of Ashmore India

Ashmore Group is a UK based investment management firm dedicated to Emerging Markets. Globally, the Ashmore Group manages about US$76.4 billion in assets (as of 30-Sep-2018), spread across various investment themes.

Ashwini Agarwal, Designated Partner and Portfolio Manager, is responsible for the firm's investments in the Indian subcontinent. He has been with the Ashmore Group since 2006. Ashwini holds a bachelor's degree from Shriram College of Commerce, Delhi University and an MBA from IIM Bangalore.

What lies ahead for the Indian investment market?

Rajesh H. Gandhi, Tax Partner in Deloitte India, had an interesting conversation with **Ashwini Agarwal***, Portfolio Manager and Designated Partner of Ashmore India.*

Deloitte: The Indian stock markets have corrected significantly recently. Do you think difficult times still lie ahead or would you say that the markets have bottomed out and we can expect steady growth from here?

Mr. Ashwini Agarwal: India has seen a moderate correction in frontline indices such as the NIFTY 50 and BSE SENSEX, but there has been a much deeper correction in broader markets, especially small cap stocks. We see strong valuation support in several smaller stocks with price-earnings or price-book ratios down to multi-year lows. This indicates that the large swathe of the market that has already witnessed a significant correction may not see much more of a downside. We also see the earnings environment improving for a whole host of industries including pharmaceuticals, industrials, and banks. In these areas, and especially when it comes to specific stocks, we feel quite optimistic about the upside from current levels. Having said this, there are two event-specific risks that may cause Indian markets to fall below the levels seen in October 2018: one, if the crude oil price were to rally significantly and two, if there is a large default event in India within the NBFC or the real estate space. We see both of these events as unlikely, but we cannot rule them out.

We see strong valuation support in several smaller stocks with price-earnings or price-book ratios down to multi-year lows.

From a practical standpoint, pooled vehicles or funds may find it easier to invest via AIFs after acquiring a Foreign Portfolio Investor (FPI) license in India.

Deloitte: Over the last year or two, the Indian mutual fund industry has been attracting very high levels of retail investment, i.e., over US$ 1 billion every month, through Systematic Investment Plans (SIPs). Do you expect this number to fall given that the markets are choppy right now, or do you think instead that this number will rise because investors feel the time is right to increase their equity investments? Also, are you seeing significant growth in the numbers of new domestic investors in the capital markets? One last question related to this: what do you think will be the share of equity investments in an individual Indian investor's portfolio, five years from now?

Mr. Ashwini Agarwal: Mutual fund (including SIP) monthly inflows into equities in late 2017 and early 2018 were in the region of INR 200 billion (US$ 3 billion) per month. From September/October 2018, this has dwindled to INR 70-80 billion (US$ 1.1 billion) per month because of the market sell-off. SIP inflows have remained largely unaffected by this. My conclusion is that a large number of retail investors have successfully negotiated market cycles and profited from long-term equity investments. Despite a big fall in the Indian markets approximately every five years or so (1994, 1998, 2001, 2008, 2013, 2018), equities have provided the best returns among financial assets over long periods of time. My sense is that investors are not

very happy right now, but I am not seeing the level of distress that would cause them to roll back their SIP commitments. I do not expect that we will see a significant outflow from mutual funds led by retail investors unless, of course, the market falls even further because of some of the risks outlined above. At the same time, it is too optimistic to expect new investors to enter an asset class that has not yielded any returns for the last year or so. Hence, my view is that mutual fund inflows will remain stable at the current rate for a few months and improve gradually, provided that there are no unforeseen circumstances within or outside India.

In terms of exposure to equity assets, if we assume that the total market cap is US$2.4 trillion, for example, and exclude the 75 percent owned by promoters (including the government) and foreign portfolio investors, the total equity exposure of local investors (direct, or indirect via mutual funds, insurance plans, provident funds, etc.) is about US$600 billion or INR 43 trillion. Compared to this, aggregate bank deposits made by individuals are valued at approximately INR 60 trillion, LIC unit-holder funds at INR 30 trillion, and government-managed provident funds including those of the Employees Provident Fund Organization (EPFO) at approximately INR 20 trillion. This does not include several other financial asset categories such as savings with private insurers, corporate provident funds, fixed income mutual funds, fixed deposits with companies, chit funds, and other informal savings instruments. My guess is that, as a starting point, equity exposure for local investors is somewhere in the region of 25 percent of their financial savings (direct + indirect). My sense is that equity exposure within the financial savings mix for an individual investor five years from now will be in the region of 30 percent or so, if direct allocation stays at 10 percent of financial savings but there is a rise in allocation from provident funds and an increase in the market value of the existing pool. However, averages hide as much as they reveal. The reality will be that some individuals will be 70 to 100 percent invested in equities while others will hold 0 to 30 percent of their assets in equities.

Deloitte: There are thousands of companies listed on Indian stock exchanges, but a few large Indian companies tend to find a place in the portfolios of most of the best-performing funds in the country. Why do you think this is?

Mr. Ashwini Agarwal: There are several reasons why most mutual funds have exposure to the same large stocks. The first, and perhaps the most important, reason for this is that the large market cap of a company is usually an outcome of the company having fared well in its business sector over a long period of time. Such companies are led by very smart managers and possess competitive strengths that are not easy for others to replicate. Staying invested in such stocks has proved to be a very successful long-term investment strategy. The second reason is that larger stocks tend to be more liquid, which allows mutual funds to deploy large sums of money with lower levels of liquidity risk. As mutual funds become larger in size, they have no option but to seek larger and more liquid stocks for much of their portfolio. When you combine both reasons, you end up with a small set of large cap stocks that every portfolio manager wants to own!

Deloitte: Alternative Investment Funds (AIFs) seem to be picking up pace in India owing to the advantages the AIF structure provides over PMS both for investment managers and investors. Do you think AIFs can channel fresh money into the capital markets and if so, what can or should be done to boost this platform?

Mr. Ashwini Agarwal: The Indian market has evolved to a point where large, wealthy investors are looking for differentiated strategies in addition to mutual funds, which tend to be reasonably straightforward plain-vanilla products. The Alternative Investment Fund platform was conceived by SEBI to address the needs of this market, and as more people become aware of these products, and more people become wealthy, the size of the AIF industry will grow at a rapid clip. Notwithstanding this growth potential, Category III AIFs specifically continue to be treated ambiguously under current tax law. It would be a great help if the tax authorities would allow income from these funds to be taxed on a pass-through basis, as is the case for Category I and Category II AIFs.

Deloitte: Do you think AIFs can be successfully used as a platform by foreign investors?

Mr. Ashwini Agarwal: Insofar as Indian regulations go, any foreign investor can invest in an AIF so long as they have a tax ID, or a Permanent Account Number (PAN) in India. From a practical standpoint, pooled vehicles or funds may find it easier to invest via AIFs after acquiring a Foreign Portfolio Investor (FPI) license in India. There are other issues surrounding tax and capital market regulations that apply to different jurisdictions across the world that investors need to consider. All in all, I believe that AIFs will become a powerful platform to attract foreign investors as solutions to some of these issues emerge.

Foreign portfolio investment in India

Rajesh H. Gandhi
Partner
Tax
Deloitte

Karamjeet Singh
Director
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Deloitte

India continues to be the fastest-growing major economy in the world with a GDP growth rate well above 7 percent. In its latest publication, "World Economic Outlook" (October 2018), the IMF[1] states that it expects India's growth rate to be 7.3 percent in 2018 and 7.4 percent in 2019. In the medium term, the IMF predicts that India's growth rate will remain strong at 7.75 percent as the country benefits from ongoing structural reforms by the government such as the GST, the inflation-targeting monetary policy framework, the Insolvency and Bankruptcy Code (IBC), the liberalization of foreign investment norms and the steps taken to improve the business environment. It is noteworthy that India's position in the World Bank's "Ease of Doing Business" ranking has improved dramatically from 130 in 2016 to 77 in 2018.

1. International Monetary Fund

Though the country has experienced a significant outflow of funds in recent times (in line with other emerging markets) coupled with falling stock market indices and a weakening currency, these adversities appear to have been triggered primarily by external factors such as rising US yields and soaring crude oil prices. Given its strong fundamentals and growth forecasts, India is expected to remain an attractive destination for foreign investors in the medium to long term.

Inbound investment routes

Indian regulations currently allow global investors to invest in India via a number of different routes depending on the nature and purpose of the investment. These include FDI, FVCI, FPI, ECB, NRI-PIS and the AIF route, which may be summarized as follows:

- Foreign Direct Investment (FDI)—primarily used for private equity and strategic investments
- Foreign Venture Capital Investment (FVCI)—venture capital investments in ten specified sectors
- Foreign Portfolio Investment (FPI)—portfolio investments in listed equities and other securities
- External Commercial Borrowing (ECB)—offshore foreign currency and rupee lending to Indian corporates
- Non-Resident Indians—Portfolio Investment Scheme (NRI-PIS)—portfolio investments by non-resident Indians
- Alternative Investment Fund (AIF)—domestic pooling vehicle with a liberalized investment and tax regime

In addition to the above, foreign investors can also acquire exposure to Indian securities by using indirect access products such as participatory notes, swaps, offshore foreign currency notes, and ADRs/GDRs.

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FPI framework

As briefly discussed above, foreign investors can make onshore investments in listed equities and other securities via the FPI route. For this purpose, they need to obtain an FPI registration (i.e., license) in India in accordance with the SEBI[2] (FPI) Regulations, 2014. The FPI license is granted by a local custodian in its capacity as a DDP[3] on behalf of the SEBI. To obtain an FPI license, the investor needs to make an application in a prescribed format and complete the necessary documentation. Based on the investor's risk profile, it can obtain one of the following three categories of registration:

FPI Category	Type of entity
Category I (Sovereign & international entities)	Government and government agencies, sovereign wealth funds, central banks, international or multilateral organizations/ agencies
Category II (Regulated entities)	Broad-based[4] investment funds, asset managers, broker dealers, swap dealers, portfolio managers, pension funds, banks, insurance companies, university funds
Category III (Unregulated entities)	Non-broad-based funds, hedge funds, corporates, family offices, individuals, and all other investors not covered in Categories I & II

To obtain an FPI license, the investor needs to make an application in a prescribed format and complete the necessary documentation.

2. Securities and Exchange Board of India
3. Designated Depository Participant
4. Having at least 20 investors investing in the fund directly or on a look-through basis

India is a segregated market and the FPI regulations do not permit omnibus structures. As a result, the investing entity (e.g., fund, sub-account) needs to obtain an FPI license as well as open accounts (depository and bank) in its own name. This requires the investing entity to submit an FPI application form and various other documents. Importantly, every Category II and III FPI needs to identify natural person(s) as the beneficial owner(s) (BO) of the FPI and provide personal information of such BO to the local custodian in India. FPIs are permitted to invest in most transferable securities (including equities, bonds, derivatives, units of mutual funds & AIFs, and securitized debt instruments) on the Indian capital markets, subject to certain restrictions. In respect of equity investments, FPIs can only invest in listed equities or equities that are to be listed. Also, investments made by a single FPI or all related FPIs[5] taken together should account for less than 10 percent of the paid-up capital of the Indian company; if the Indian company is a private sector bank, the 10 percent limit is reduced to 5 percent. FPI investments in debt securities are primarily regulated by the RBI. In April 2018, the RBI introduced additional restrictions on FPI investments in debt securities, which have adversely affected debt investments in the last six months.

FPIs need to open an INR account with an authorized bank (typically the custodian bank) through which all the investments and disinvestments are to be routed. Any remittance of sale/income proceeds out of India can be made only after the necessary taxes have been discharged. FPIs are not permitted to borrow funds in India. Also, they are not permitted to earn interest on the balance in the bank account maintained in India.

Upcoming regulatory changes

Simplification of FPI norms: the SEBI has set up a high powered working group (of which Deloitte is a member) under the chairmanship of Mr. H.R. Khan (ex-Deputy Governor of the RBI) to further simplify the FPI regulations and rationalize the entry process. Based on interim recommendations submitted by the working group, the SEBI has already amended the KYC framework that applies to FPIs. The working group is expected to submit its final recommendations in the next few months, after which the SEBI board will take them up for implementation.

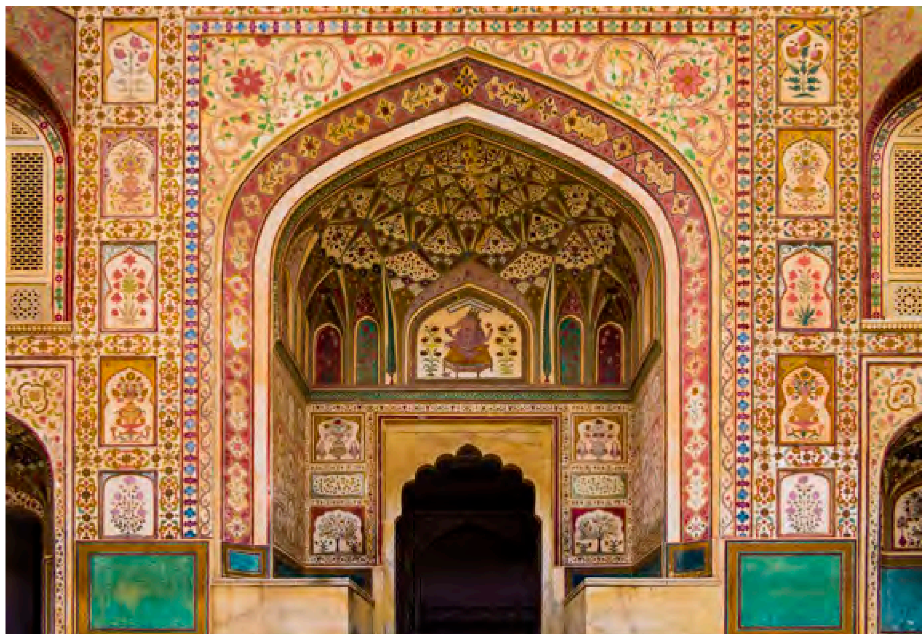
Voluntary Retention Route (VRR): the RBI recently issued a white paper for public comments in which it proposed a new route for FPIs to invest in government securities and corporate bonds. Under this framework, an FPI would commit to investing a specified amount in Indian bonds for a minimum retention period of three years or more, as specified by the RBI. Also, the FPI would need to ensure that at least 67 percent of the committed amount remained invested at all times during the retention period.

5. Related FPIs are defined as two or more FPIs that share more than 50 percent of their beneficial ownership

Taxation framework

As a first step in the taxation process, FPIs are required to obtain a Permanent Account Number or PAN (tax ID) from the Indian tax authorities. A PAN card is also a mandatory KYC document and the PAN must be quoted in the FPI's depository account opened with the custodian. Also, the PAN is quoted in all tax filings as well as tax payments.

Income characterization: gains made by FPIs from the transfer of shares and other securities are characterized as capital gains under Indian tax law, which provides certainty as to the classification of income received by FPIs (this is not the case for other investors). Other than capital gains, FPIs earn income from securities in the form of dividends and interest.



Tax rates

Domestic tax rates

Type of income		Tax rate[6]
Capital gains on sales of listed shares/ redemption of equity-oriented mutual funds (where securities transaction tax is paid)	Long-term	10 percent
	Short-term	15 percent
Capital gains on transfers of other securities (e.g., bonds, derivatives)	Long-term	10 percent
	Short-term	30 percent
Interest on securities[7]		5 percent / 20 percent
Dividend[8]		Exempt

India has signed comprehensive tax treaties with over 90 countries, some of which (e.g., those with Cyprus, Ireland, Japan, Mauritius, Singapore, and Switzerland) allow for an exemption from capital gains tax on sales of securities other than shares, whereas others (e.g., those with Denmark, France, Netherlands, and Korea) also allow for an exemption from capital gains tax arising on sales of shares. Where a treaty applies, the FPI automatically enjoys the benefits arising therefrom if these are more favorable than domestic law.

6. The tax rate is exclusive of surcharges and cesses, which vary depending upon the investor's legal form
7. Five percent (plus surcharges and cesses) is applicable on interest payable up to 30 June 2020 on government bonds and those corporate bonds whose coupon rate does not exceed 500 bps of the base rate of the State bank of India on the date of issuance of bonds. Interest from other corporate bonds is taxable at 20 percent
8. The Indian company is required to pay dividend distribution tax of 20.56 percent on the dividend

Key tax updates

Long-term capital gains tax

On 1 April 2018, India introduced a 10 percent tax on long-term capital gains on transfers of shares and equity-oriented mutual fund units. Before this change took effect, such gains were exempt from tax provided that the transaction was subject to securities transaction tax. To avoid retrospective levying of this tax, gains already accrued on 31 January 2018 have been grandfathered. The grandfathering provision is enabled by providing a step-up in the actual cost of acquisition on the basis of the fair market value of the shares on 31 January 2018, capped at the sale price.

Amendment of India's tax treaties with Mauritius and Singapore

In a historic development, India amended its tax treaty with Mauritius (effective 1 April 2017) and introduced source-based taxation on sales of shares. This essentially means that gains on sales of shares of Indian companies by a Mauritius tax resident are now taxable in India at Indian domestic tax rates. Investments made prior to 1 April 2017 were grandfathered and a Mauritian investor can also enjoy a 50 percent reduction in the tax rate for purchases and sales made during the period from 1 April 2017 to 31 March 2019 provided that the investor satisfies the Limitation of Benefit (LOB) clause in the treaty. In line with the change in the treaty with Mauritius, India also amended its tax treaty with Singapore effective 1 April 2017 with similar effect except for a modified LOB clause. It is important to note that the revised Mauritius and Singapore treaties continue to provide exemption from capital gains tax on securities other than shares. Furthermore, the revised Mauritius treaty provides for a 7.5 percent tax on interest income, which is the lowest tax rate on interest income agreed by India with any country.

Ongoing tax compliance procedures

FPIs appoint a tax consultant in India to compute capital gains and other taxes payable and the tax consultant is required to issue letters/certificates to the custodian banks for the remittance of any income outside India. The tax agent also helps the FPI to file its PAN application, file annual income tax returns, respond to notices from tax authorities, and attend tax audit hearings.

While the tax framework for FPIs is fairly straightforward, the selection of jurisdiction for registering the investment entity has become more complex since the introduction of the GAAR. Also, frequent changes to the regulatory provisions including KYC and debt investment conditions have irked investors, although the government and the SEBI have made some efforts to simplify the regulations.

On 1 April 2018, India introduced a 10 percent tax on long-term capital gains on transfers of shares and equity-oriented mutual fund units. Before this change took effect, such gains were exempt from tax provided that the transaction was subject to securities transaction tax.

To the point:

- Any foreign investor can access Indian capital markets by obtaining a FPI license. The license is issued by the local sub-custodian on behalf of the regulator.
- FPIs are permitted to invest in almost all types of listed securities including equities, bonds, derivatives, domestic mutual funds, alternative investment funds etc. The investments are subject to certain restrictions and caps.
- Gains from sale of securities attracts Indian capital gains tax which is required to be paid before remitting funds out of India.
- Each FPI needs to obtain a tax ID and file an annual income tax return.
- Recent tax changes include introduction of long term capital gains tax and partial removal of capital gains tax exemption under India's tax treaties with Singapore and Mauritius.

Doors opening for FPIs in India

Rajesh H. Gandhi, Tax Partner in Deloitte India, had an insightful discussion with ***Aditya Sharma****, Director at Citi South Asia, on the state Indian Stock market today.*

Aditya Sharma
Director, Head of Prime, Futures & Securities Services, Citi South Asia

- Appointed role in Sept 2018
- Prior Roles/ Experience: Joined Citi in 2003. Worked in multiple roles across the Institutional Client Group, most recently heading the India Listed Derivatives business, Chief of Staff to CEO - Citigroup India, Product & Sales Management (Direct Custody & Clearing/ Treasury & Trade Services) and various Operations roles
- Prior to joining Citi, has worked with Ernst & Young for a year in the Audit division. Chartered Accountant (ACA) by qualification, and holds a Bachelor's Degree in Commerce

Deloitte: What is your view of the potential of the Indian stock market and the opportunities for Foreign Portfolio Investors (FPIs)?

Aditya Sharma: In the near term, the biggest event to look forward to is the Indian general election, due in the first half of 2019. I expect heightened volatility as we approach the event and that will present a lot of opportunities for investors, including FPIs. While we see a lot of domestic money being invested in equities after demonetization, FPIs still own over 20 percent of India's public equities versus approximately 7 percent of domestic mutual funds. While we have faced a lot of macro headwinds like the crude price spike, INR depreciation, and fiscal pressures, to name a few, the good news is that they seem to be easing off. Indian equity as an asset class will continue to remain an attractive bet for global investors.

Deloitte: India is a heavily regulated market and investors have to keep up with frequent regulatory changes. In your view, what are the biggest challenges for FPIs (on-boarding, capital gains tax, transaction cost, lack of quality stocks, pricing and depth of market, etc.) and what are a few top items on your wish list that would help to simplify the regime in a meaningful way?

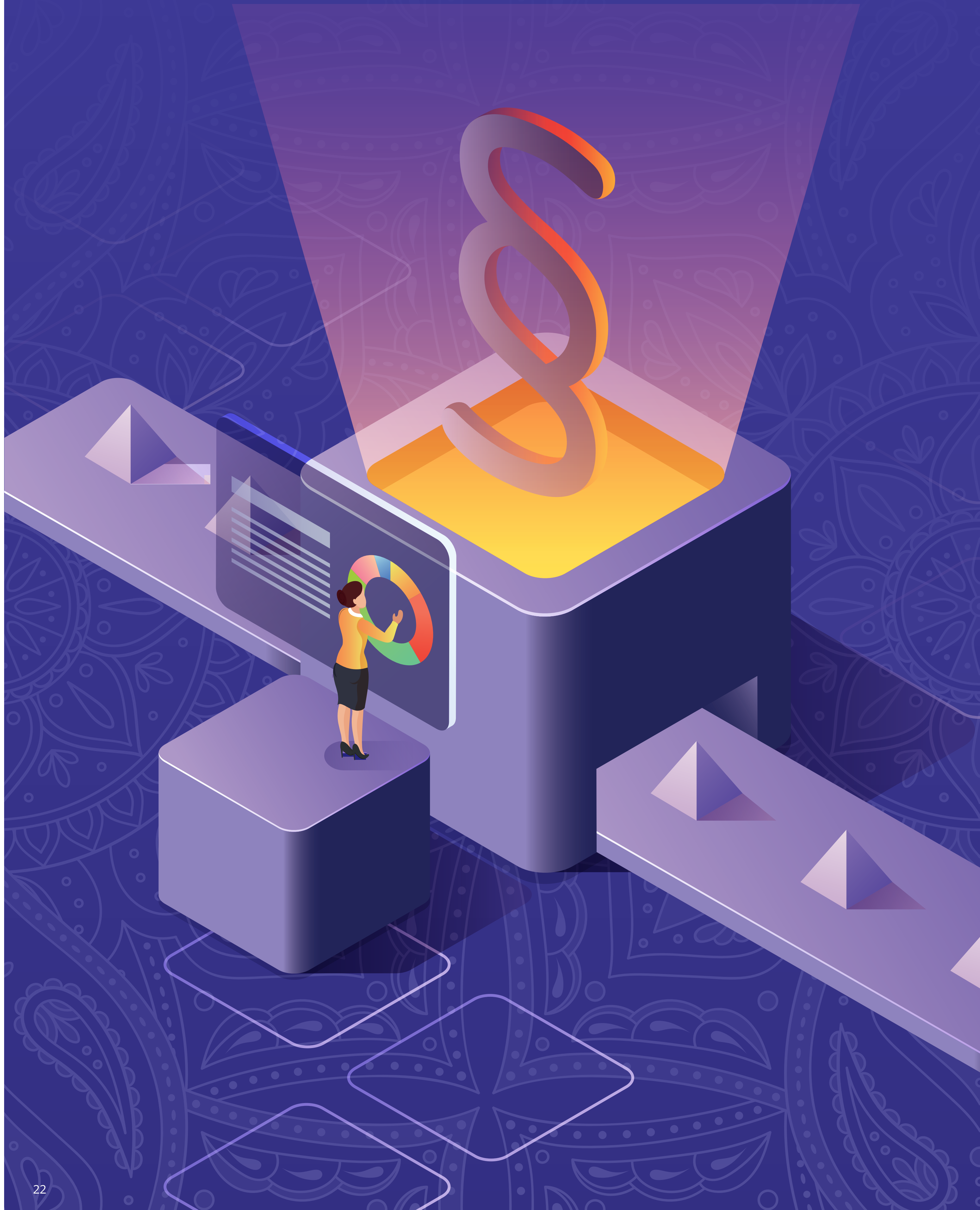
Aditya Sharma: The FPI regime has evolved over the years and is much simpler now than in previous iterations (FII/QFI). Moreover, SEBI, the Indian Securities Regulator, has been receptive to new ideas and is addressing the issues raised by investors and intermediaries alike on an ongoing basis. I do believe that certain additional measures would help to simplify matters still further, including in particular the removal of the broad basing (minimum number of investors/concentration of holding norms) requirement for CAT II FPIs (appropriately regulated funds). This would help a vast swathe of FPIs (around 80 percent) bring their cost of compliance down significantly. Specific restrictions, such as prohibiting non-broad-based Cat II FPIs from issuing/dealing in ODIs, would satisfy any regulatory concerns in this regard. While most global markets have foreign ownership limits, "clubbing requirements" (aggregation of direct/indirect holdings) are unique to India, and could be simplified to allow each FPI to hold up to 10 percent of a company's equity. If some FPIs are persons acting in concert (PAC), they should monitor themselves to ensure compliance with SAST regulations/open offer etc.

Deloitte: Last year SEBI banned FPIs from issuing swaps and other offshore derivative instruments backed by onshore derivatives. This move was expected to compel a significant number of hedge funds and other investors to obtain FPI registration and start trading in onshore Indian derivative markets. Have you seen this expectation materialize for most investors? If not, what do you think could be the reasons for this?

Aditya Sharma: We did see a spurt in FPI registrations during the August-November 2017 period after the ODI regulations changed in July 2017. A Citi internal study estimates that over 100 hedge funds sought FPI registration in this period. They needed to do so to ensure minimum interruptions to the availability of their hedging options for their underlying long portfolio and other trading requirements. This, however, does not necessarily account for all affected investors as we observed some spikes in activity in the offshore markets where Indian listed products trade (for using proxy hedging through index products) and there was also some closing out of Indian positions.

Deloitte: To promote the GIFT-IFSC, the Indian government has introduced a number of concessions including capital gains exemption, segregated nominee account structure, waiving of the FPI license requirement, etc. Given that there is hardly any liquidity in stock exchanges in GIFT-IFSC, there is not much interest among FPIs in trading derivatives there. However, if and when liquidity increases, is there a possibility that the onshore derivatives markets on NSE/BSE would move to GIFT-IFSC?

Aditya Sharma: The current regulations do not permit domestic players to participate on the GIFT-IFSC exchanges unless they set up an entity in GIFT, which is quite challenging to achieve at scale. Also, the composition of foreign participation of investors in the equity derivative space hovers around 25-30 percent (F&O Segment on National Stock Exchange) only. Given the availability of index products on Indian underlyings e.g., CNX NIFTY, etc. on offshore exchanges, liquidity will remain a challenge.



Implementation of General Anti-Avoidance Rule in Indian tax law

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India introduced General Anti-Avoidance Rules (GAAR) provisions in its tax law in 2012, although they were deferred a couple of times and finally implemented from April 2017. The objective of GAAR is to prevent tax benefits being derived from arrangements that have been entered into with the main purpose of obtaining tax benefits and that lack commercial substance or create rights and obligations not compliant with the arm's length principle, that result in the misuse of tax law provisions, or are carried out in a manner not ordinarily employed for lawful purposes. The over-arching principal of GAAR provisions is "substance" over "form".

Around the world, many countries have incorporated anti-avoidance or anti-abuse rules into their tax laws. These include Australia, Brazil, Canada, China, France, Germany, Italy, South Africa, South Korea, Sweden, and the UK. In this context, it is helpful to refer to the BEPS initiative introduced by the OECD and G20 countries. Under the BEPS framework, over 100 countries (including non-OECD countries like India) and jurisdictions are collaborating to implement 15 specific action plans to tackle various tax avoidance strategies adopted by taxpayers to avoid or evade tax. Action 6 of the BEPS project seeks to address treaty abuse and over 70 countries have already made a start on the implementation process by signing the Multilateral Instrument, which sets out minimum standards as regards the prevention of treaty abuse.

How does GAAR impact FPIs or investors in FPIs?

GAAR affects FPIs who benefit from the tax treaty between India and their country of residence. That said, GAAR only applies if the "main purpose" test is satisfied (i.e., the main purpose of the FPI in setting up in a country is to obtain treaty benefits) and one of the "tainted" tests is also satisfied (e.g., the FPI does not conduct commercial activities in the country). To illustrate this, if the main purpose of setting up a structure in a jurisdiction is not to obtain treaty benefits, GAAR will not apply even if the FPI does not have sufficient commercial activities in the relevant country. Likewise, even if the main purpose of an FPI in setting up in a particular country was to obtain treaty benefits, if it has sufficient commercial activities in the relevant country, GAAR should arguably not apply.

The law specifically exempts the following investments/arrangements from GAAR:

- Investments made prior to 1 April 2017 regardless of when the securities are sold/disposed of
- An arrangement where the total tax benefit for all concerned parties in a particular financial year does not exceed INR 30 million (approx. US$0.5 million)
- An FPI who does not claim tax treaty benefits
- A non-resident in relation to investments made in an FPI by way of offshore derivative instruments (e.g., participatory notes/swaps) or otherwise

The over-arching principal of GAAR provisions is "substance" over "form".

The government has also issued a circular to provide clarifications on the applicability of GAAR. A synopsis of the key clarifications for FPIs is provided below:

- GAAR will not be invoked merely on the grounds that the taxpayer is located in a tax-efficient jurisdiction. If the jurisdiction of an FPI is finalized based on non-tax commercial considerations and the main purpose of the engagement is not to obtain tax benefits, GAAR will not apply.
- Even if an arrangement satisfies a specific anti-avoidance rule (SAAR) provided for in the law, it may still be subject to GAAR because the SAAR may not address all situations of abuse of the law by taxpayers. GAAR are generic and therefore can coexist with SAAR.
- If there is a LOB clause in a tax treaty that sufficiently addresses tax avoidance, GAAR will not be invoked. However, if certain tax avoidance strategies are not addressed by a LOB clause, these can be tackled by GAAR.
- If the law allows taxpayers to select between two alternatives when conducting a transaction, GAAR cannot be invoked by the tax authorities to challenge the option selected by the taxpayer.
- If an FPI claims treaty benefits in one year and opts to be governed by domestic law in another year, this does not fall within the scope of GAAR.
- Grandfathering provisions are available for shares acquired in a share split or consolidation or through a bonus issue, provided the original shares were acquired before 1 April 2017.
- Grandfathering benefits are available to investors in shares acquired after 31 March 2017 if the shares are acquired by the investor through conversion of compulsorily convertible instruments (e.g., compulsorily convertible preference shares or debentures) issued before 1 April 2017, provided the terms of conversion were finalized when these instruments were originally acquired.
- GAAR does apply to any arrangements covered by an advance ruling issued by the Authority of Advance Ruling.
- GAAR will not be applied to any arrangements sanctioned by the court where the court has explicitly and adequately considered the tax implications of the arrangement.
- If the approving authorities (Commissioner/Approving Panel) have rejected the tax officer's request to invoke GAAR provisions in relation to an arrangement in a given year, GAAR will not be invoked in respect of the arrangement in subsequent years provided the facts and circumstances remain the same.

The government has reiterated that GAAR will only be invoked in clear-cut cases involving an intention to evade/avoid tax, and not where there is a difference in interpretation. Also, there is a two-step approval process in place before GAAR can be invoked.

Considering the above, even if an FPI is located in a tax-efficient jurisdiction (e.g., Mauritius or Singapore), it may not be adversely affected by GAAR if its main purpose in establishing a presence in the relevant jurisdiction is not to obtain treaty benefits. Also, GAAR will not apply if the FPI has commercial activities in the jurisdiction in question.

While GAAR has been on the statute books since April 2017, the tax authorities have not yet had the opportunity to start tax audits and examine the applicability of GAAR for the first financial year (2017-18). This is expected to happen in 2020 as the deadline to complete tax audits is 30 September 2020. In the meantime, it is imperative that taxpayers have sound arguments around claiming tax benefits and that they maintain meticulous documentation.

To the point:

- GAAR was introduced in the Indian tax law from April 1, 2017.
- Tax authorities can deny tax benefits to any arrangement whose main purpose is to obtain tax benefit and the arrangement does not have sufficient commercial substance or it is not bonafide etc. An example of such arrangement could be treaty abuse.
- GAAR will apply only where obtaining tax benefit is the "main" purpose of the arrangement. Even in such cases, GAAR cannot be applied unless one of the other tainted tests are also satisfied.
- GAAR will be invoked only in deserving cases which are highly aggressive and artificial and not where there is a difference in interpretation. Also, there is a two-step approval process in place before GAAR can be invoked.

The investment fund industry
The latest trends in a dynamic market

Mathieu Maurier
Country Manager
Societe Generale Securities Services (SGSS)

Mathieu Maurier, Country Manager for Societe Generale Securities Services (SGSS) in Luxembourg since 1 September, looks at a number of issues currently facing the asset management industry.

UCITS is still unassailable
Few fund structures are held in such high esteem as the UCITS—a product that helped augment Luxembourg's position as a leading European fund domicile and is widely purchased by retail and institutional investors worldwide. Harmonization has allowed the UCITS to flourish within the EU while its strong reputation for transparency and investor protection has seen it succeed on the global stage, acquiring a loyal following in Asia-Pacific and Latin America and turning the structure into a €10 trillion plus industry[1].

Unlike other products, which have struggled to stay competitive, the UCITS has effortlessly evolved in line with market and consumer trends and expectations over the last 30 years. Following growing investor demand for greater portfolio diversification, regulators responded with UCITS III, which expanded the list of eligible assets managers could trade by allowing firms to use derivatives, leverage, and synthetic short positions.

Meanwhile, post-crisis versions of UCITS addressed investor concerns about the asset management industry by imposing new protective and transparency measures: namely, reporting requirements in the form of the KIID (Key Investor Information Document) and a requirement for fund houses to appoint a depositary subject to strict liability for any loss of assets or financial instruments, bringing the rules into line with the AIFMD (Alternative Investment Fund Managers Directive).

Retaining the top spot
The UCITS is not indefatigable, however; it currently faces a number of challenges including the threat of rival passporting schemes emerging in Asia-Pacific and increased competition from low-cost index tracking funds. The framers of UCITS (and AIFMD) have also been criticized—despite repeated standardization efforts—for failing to prevent member state regulators from imposing additional requirements and surcharges on managers seeking authorization.

1. Efama (March 12, 2018) 2017 was an exceptional year for the European investment fund industry, with net assets of UCITS and AIF surpassing the EUR 15 trillion mark

Asset managers at the ALFI Global Distribution Conference in Luxembourg on 25 and 26 September said that gold-plating in individual markets was an impediment to cross-border distribution as it led to higher costs and heightened workloads, as evidenced by data showing that only one third of UCITS are registered for marketing in more than three EU countries.[2] Regulators have listened to the complaints and are making meaningful changes through the Capital Markets Union (CMU).

A proposal from the European Commission in the context of the CMU should homogenize member state marketing requirements, introduce consistency as regards how national competent authorities' fees are calculated, and scrap the requirement for managers to appoint local agents.[3] By streamlining the UCITS registration process, EU regulators hope to make it easier for managers to attract more capital from the cash-heavy retail market in Europe, where savings are suffering because of low interest rates.

Leading the way with new products

EU product innovation is not limited to UCITS and AIFs alone. Luxembourg has enjoyed spectacular success with the launch of its RAIF (Reserved Alternative Investment Funds) and this product is now a key focal point for Societe Generale. RAIFs are a blend of SIFs and SICARs but qualify as AIFs, which means that nearly any asset management strategy may be followed within the bounds of this structure.[4]

RAIFs do not require CSSF (Commission de Surveillance du Secteur Financier) authorization although this lack of supervision is offset by indirect oversight by the AIFM, depositary, and auditor—an arrangement that provides comfort to clients.[5] The flexible structure has facilitated growth, with EY calculating that 200 RAIFs have been launched since 2016,[6] while ALFI estimates that the new product accounts for approximately 5 percent of all AIFs by regulatory regime.[7]

The emergence of the PEPP

Another interesting product development—being instigated as part of the CMU—is the proposed PEPP (Pan-European Pension Product). This initiative seeks to enlarge the EU personal pension market following EC findings showing that just 27 percent of Europeans aged between 29 and 59 have subscribed to a pension product.[8] The PEPP program will promote competition among pension providers, thereby creating more choice for consumers and remedying the current regulatory disjointedness around personal pensions across the EU.[9]

The scheme has strong industry and consumer backing, with savers receptive to the idea that PEPPs will transcend national borders, while providers (banks, insurers, investment firms, asset managers, occupational pension funds) will reap commercial benefits if they become more active in the personal pension market.[10] Given that only 11 percent of EU households invest in funds—versus 43 percent in the US[11]—the PEPP could help consumers accumulate savings rather than remaining wedded to low-interest deposits.

ESG takes center stage

Investors—especially millennials—are increasingly choosing to invest with asset managers with proven ESG strategies and track records. ESG is integral to asset management and we have seen a shift towards sustainable investing at institutions, beginning firstly in the Nordic countries, and subsequently spreading to France, the UK, Switzerland, and Japan. ESG strategies are a key tool when it comes to attracting millennial investors, who will receive a large transfer of global wealth in the next few years.
As ESG is interpreted and applied differently across institutions, asset managers need to provide very bespoke solutions on a client-by-client basis. ESG investing has noticeably matured, moving beyond excluding unethical companies from portfolios to encompass active engagement whereby asset managers use their voting rights to reform shortcomings in corporate behavior and enhance sustainability standards.

The EU—through its Sustainable Finance Reforms—is also nudging asset managers towards ESG. While attitudes to ESG are famously diverse, the EC is looking to create a standardized definition. Creating fixed terminology for ESG would provide transparency to investors and simultaneously spare managers from having to fill out multiple ESG questionnaires from clients in different markets, all with conflicting views on sustainability.

Asset servicers can help managers with ESG. Depositary banks, for example, are increasingly developing services to ensure managers running ESG strategies are sticking to the terms of their investment mandates. Depositaries and trustees will also be able to support managers by providing investors with ESG reporting, which is another requirement contained in the EC's proposals. By embracing ESG, asset managers can broaden their market appeal to underserved younger investors looking to deploy capital.

Bringing distribution into the digital sphere

Attracting younger, more digitally savvy investors will also require major changes to distribution practices. Distribution has, until recently, remained somewhat resistant to digitalization, and this weakness means that the process of buying and selling fund units continues to be highly manual. However, disruptive technologies such as artificial intelligence (AI) and blockchain are being increasingly used in customer onboarding and KYC/AML checking, which has the potential to make distribution far more seamless.
In addition, the industry is giving serious consideration to robo-advisors, or automated investment platforms. This technology allows investors to select funds for their portfolios using smart devices, shaving off transaction costs and effectively disintermediating the traditional IFAs and wealth advisors. Robo-advisory is a fast-growing

market, having accumulated more than US$200 billion in assets,[12] chiefly because it provides a much easier path for tech-smart younger investors to buy funds.

Despite this, robo-advisors have a checkered performance record, with studies showing that the recommended products have failed to beat industry benchmarks.[13] Nonetheless, experts at ALFI say that more data is needed before people can reach a firm conclusion on the intrinsic worth of robo-advisors. Others also believe robo-advisors will pivot away from simply following an index towards more active management, in what would be a major development, and a potential challenge to existing fund managers.

Asset management in 2019

The UCITS—along with the fund domiciles that support it—is growing, buoyed by steady product innovation and solid regulation. ALFI, for example, estimates that the UCITS could enjoy a compound growth rate of 5 percent over the next three decades, potentially quadrupling its AUM to €42 trillion by 2048.[14] However, the asset management industry faces a number of challenges from technological disruption and Brexit over the next 12 months. The fund industry has no choice but to respond and evolve.

To the point :

- UCITS has effortlessly evolved in line with market and consumer trends and expectations over the last 30 years
- Leading the way with new products: Luxembourg has enjoyed spectacular success with the launch of its RAIF
- PEPP: A product in the making: Another interesting product development is the proposed Pan-European Pension Product, an initiative designed to enlarge the EU personal pension market
- ESG becomes real: Capturing millennial investors can be done through ESG strategies
- Disruptive technology such as artificial intelligence, Blockchain, robo-advisors and automated investment platforms are being increasingly used in the industry

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3. Maples and Calder (15 March 2018), UCITS and AIFMD update: Cross-border fund distribution proposals
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7. ALFI/Deloitte (November 2017), Luxembourg Private Equity & Venture Capital Investment Fund Survey
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10. Eurofi (September 2017), Regulatory update
11. ESMA (16 November 2016), How can we improve outcomes for investors in investment funds?
12. Barrons (3 February 2018), As robo-advisors cross $200 billion in assets, Schwab leads in performance
13. Financial Times (24 August 2018), Robo-advisors fail to beat market benchmark
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ESG: shaping the new normal for active managers

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CPR Asset Management's new approach to ESG investing is all about ensuring a level playing field to facilitate the implementation of successful active management strategies.

Investment based on environmental, social and governance (ESG) criteria is moving into the mainstream. In 2016, over US$22 trillion of assets were managed via responsible investment strategies. This represented a quarter of all professionally managed assets around the world, up 25 percent from two years earlier.

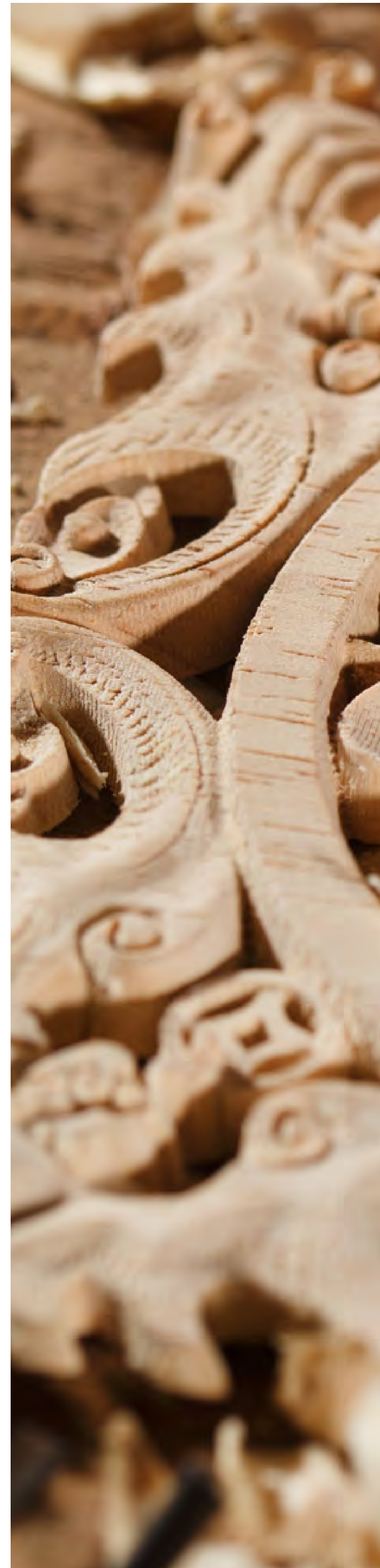
But what exactly is ESG investing? Unlike approaches based on ethical considerations such as prohibiting investment in certain companies or industries (e.g., alcohol, tobacco or firearms), ESG investing is built on the premise that investment research should incorporate an analysis of long-term sustainability factors to help identify companies with high investment potential.

ESG strategies do not prohibit specific investments, but rather assign rankings to ESG factors for a specific company in a given industry. The emphasis is on finding companies with certain attributes—i.e., criteria linked to a firm's environmental, social or governance practices or procedures—with the potential to have a positive impact on future shareholder value.

Investors' growing interest in this approach comes at a time when ESG investing is undergoing considerable change. The trend is currently shifting away from simple exclusion towards risk management, and asset managers are being asked to offer ESG strategies that mimic or improve upon the risk-return profile of a standard portfolio. This is resulting in more quantitative, data-driven approaches as the availability and quality of ESG metrics increase.

An ESG approach driven by financial materiality

CPR Asset Management's research team has worked on a new approach to ESG at the request of the fiduciary manager for several French public sector pension schemes: the Caisse des Dépôts. This client had for some time felt that ESG ratings, which are often based on weighted averages and blunt risk management, conceal many of the subtleties that ESG information can provide to asset managers. This became apparent in the wake of the 2016 "Dieselgate" scandal, in which it became apparent that Volkswagen employees had manipulated the results of emissions tests. Overall, Volkswagen scored well when it came to ESG, but there were some specific governance indicators that should have served as a warning for investors.



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CPR AM has conducted in-depth research into the criteria used to calculate a firm's overall ESG rating. The aim was to exploit extra-financial information to the fullest extent possible and determine which criteria have a clear impact on a security's risk-return profile. Identifiable weaknesses that may not show up in an issuer's overall ESG rating may provide early warning of the potential for controversies with significant financial consequences.

Looking for individual ESG criteria in which a company scores poorly despite a good overall ESG score is comparable to one of the most difficult aspects of stock selection in traditional value investing: when the manager must differentiate between true value firms and "value trap" stocks that are trading at low levels because of long-term problems. "I like buying quality when it is marked down," Warren Buffet used to say to illustrate the need to understand why a particular stock is trading at low levels before investing.

Similarly, CPR AM's methodology looks beyond the overall ESG rating to offer a 360-degree view to help asset managers avoid the most damaging stocks while maintaining a risk-return profile similar to the relevant investment universe.

Integration methodology

CPR AM's risk-based approach helps to minimize the asymmetric risk that investors face in anticipating strong drawdowns. The company's ESG integration methodology is mainly about minimizing risk rather than acting as a major source of outperformance, which is generated by CPR AM's subsequent active management process.

CPR AM's ESG integration process relies on primary research conducted by parent company Amundi. Since 2010, Amundi has assigned over 5,500 issuers with an ESG score. This score is based on 15 generic extra-financial criteria including energy consumption, board structure, and employment practices. The score also incorporates some sector-specific factors, such as involvement in green car production for the automotive sector. These criteria are aggregated within the environmental (E), social (S) and governance (G) pillars by integrating sector-based issues. All three levels of rating range from A to G (where A is the highest score) and the overall score reflects the issuer's entire range of ESG procedures and practices.

The first step in CPR AM's ESG integration methodology is to exclude companies with an overall score of F or G in order to screen out firms with poor ESG profiles. The second, more stringent, step is to filter out companies rated F or G for certain individual criteria that have been shown to have significant financial materiality, even if the firm has a higher overall ESG score. This helps users avoid investing in companies with weak practices or procedures in important areas that could lead to problems down the line.

Leaving room for geographical specificities

This process aims to spot weaknesses through a series of tests on each of the 15 generic ESG criteria. The tests performed on each security from the investment universe sort each criterion by the best information ratio (e.g., risk-adjusted performance). The analysis is then supplemented by additional screening procedures such as market coverage (criteria representativeness), exclusion rate (assessing whether the investment universe is large enough), turnover (implementation cost), and correlation between the selected criteria (for diversification purposes).

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Individual analysis of each of the 15 common ESG criteria per region

	Information ratio	Criteria coverage	Exclusion ratio	Turnover	Correlation
WHAT?	Only select positive ratios within maximum of five criteria	Criteria coverage ratio by providers (60 percent min.)	Proportion of values excluded for these criteria	Average turnover for this criteria	Interconnectedness of the criteria
WHY?	Risk-adjusted performance	Criteria representativeness	Maintain an investment universe large enough for financial management	Management implementation cost	Ensure the diversification potential of the selected criteria

Source: CPR AM

OBJECTIVES

- Select the performance criteria...
- ...to define an ESG universe with an equivalent risk-return profile...
- ...and enable implementation of financial management.

Source: CPR AM

This exclusion filter helps CPR AM to limit its exposure to credit events and the losses that follow by identifying where there is cause for concern. For example, in June 2015, a few months before the "Dieselgate" scandal. This methodology would have prompted CPR AM to exclude Volkswagen's portfolio bonds due to concerns about its audit and control practices.

The top five ESG measures across all these tests are then combined to define an ESG investment universe with an equivalent risk-return profile. Since ESG criteria are not all relevant in the same way across the various regions, regions, the selection differs according to regions, in order to assess ESG risk effectively.

For instance, within the eurozone/Europe, we CPR AM shuns companies with weak procedures or practices in the following areas: energy consumption and GHG emissions; structure of the board of directors; audit and control; shareholder rights; and health and safety. However, there are no environmental measures for Japanese companies, while there are no social measures applied to North American companies (although the methodology relied on the full set of 15 criteria initially to screen out the companies with the worst overall ESG practices in each region).

Equity investment universeSelected criteria by region

	Euro/Europe	North America	Japan	Asia ex-Japan	Emerging
E	Energy & GHG	Energy & GHG Water Biodiversity & waste	-	Biodiversity & waste	Biodiversity & waste
S	Health & safety	-	Health & safety Labor-management relations	Human resources Clients/suppliers Local communities	Health & safety Local communities
G	Executive Board Audit & control Shareholder rights	Executive Board Audit & control	Executive Board Shareholder rights Ethics	Shareholder rights	Shareholder rights Ethics

Source: CPR AM

Deriving outperformance from active management rather than ESG integration

Applying quantitative modelling to the equity universe reveals sector deviations specific to each geographical region, but no structural bias over the period 2010–18. CPR AM's ESG integration methodology preserves the structure of the standard investment universe, allowing for the implementation of supplementary active management strategies to deliver alpha.

CPR AM also preserves the structure of the credit universe its portfolios. The distribution of ratings in the company`s ESG-screened credit universe is almost identical to that of the Barclays Euro IG Senior 7+ index. The two universes' average spread by rating and the distribution of the portfolio by maturity do not vary significantly, and their returns are also similar.

This exclusion filter helps CPR AM to limit its exposure to credit events and the losses that follow by identifying where there is cause for concern. For example, in June 2015, a few months before the "Dieselgate" scandal. This methodology would have prompted CPR AM to exclude Volkswagen's portfolio bonds due to concerns about its audit and control practices. Furthermore, analysis shows that this filter helps CPR AM avoid investing in a significant proportion of the bonds that substantially underperform the broad universe over a monthly timeframe. While the methodology helps to limit drawdowns, it does not allow the manager to take advantage of any rallies for as long as the exclusion remains in place.

Dynamic multi-factor investing

CPR AM have tested the impact of its ESG methodology in the context of its multi-factor portfolios. CPR AM's dynamic multi-factor investment strategies combine bottom-up stock selection with dynamic factor allocation based on the prevailing market regimes and/or investment zones. This quantitative process to select factors involves no structural style or sector biases. The portfolio is optimized every month.

Based on the market regime, the investment strategy combines exposure to defensive-type factors (such as low-volatility, high-dividend and financial-soundness styles), offensive-type factors (momentum, haircut, growth) and deep-value factors (discount, high discount). Applying the ESG filter keeps the portfolio's exposure to the various factors almost identical. CPR AM analysis reveals that the purity of the factors is maintained according to the market regime from 94 percent to 100 percent in the ESG universe.

A flexible approach to meet client expectations and future ESG challenges

The best path to innovation is the co-design of solutions by asset owners and asset managers. The teams at CPR AM are convinced that the ESG methodology developed for its clients is worthy of being integrated into its core offer. This is why the company is transforming "standard" open-ended funds into their ESG equivalents. CPR AM has already incorporated its new ESG methodology into its historical range of core quantitative equity funds and also some of its credit and convertible funds. At a time when investors expect managers to take better account of social, environmental and governance aspects, CPR AM now intend to broaden the scope of this ESG integration process.

Factors by CPR AM

Defensive		Blend		Deep value	
▼	Purity of factors maintained from 92% to 99%	▼	Purity of factors maintained from 85% to 97%	▼	Purity of factors maintained from 96% to 100%
Low volatility	ESG: 0.76 Initial: 0.77	Price momentum	ESG: 0.26 Initial: 0.27	Value	ESG: 0.42 Initial: 0.43
Dividend yield	ESG: 0.43 Initial: 0.43	Earnings revision momentum	ESG: 0.09 Initial: 0.10	Deep value	ESG: 0.37 Initial: 0.37
Piotroski	ESG: 0.36 Initial: 0.37	Quality	ESG: 0.39 Initial: 0.41		
Earnings revision momentum	ESG: 0.10 Initial: 0.11	Value	ESG: 0.50 Initial: 0.53		
		Growth	ESG: 0.12 Initial: 0.13		

Each factor strategy is a monthly optimized bottom-up portfolio

Source: CPR AM

CPR AM's approach is flexible enough to meet client expectations and future ESG challenges. The five exclusion criteria the company has chosen have demonstrated good results because the modelling has found what has worked in the recent past—from 2010 in developed markets and from 2014 in emerging markets. But this combination of criteria certainly will not always be the best, which is why CPR AM retests the selection every year, aided by the fact that the quality and quantity of ESG data are increasing on a monthly basis.

The list of criteria the company analyzes also evolves in and of itself. It is possible to add new criteria to the list of 15 that are currently used by using abundant complementary sources of information and performing extensive back testing to ensure that they deliver results over the long term. Finally, CPR AM's ESG methodology is flexible, enabling the company to concentrate on specific issues at the request of each institutional client and to adapt to changes in the ESG landscape.

The teams at CPR AM are convinced that the ESG methodology developed for its clients is worthy of being integrated into its core offer. This is why the company is transforming "standard" open-ended funds into their ESG equivalents. CPR AM has already incorporated its new ESG methodology into its historical range of core quantitative equity funds and also some of its credit and convertible funds.

To the point:

1. Asset managers are being asked to offer ESG strategies that mimic or improve upon the risk-return profile of a standard portfolio. This is resulting in more quantitative, data-driven approaches as the availability and quality of ESG metrics increase.
2. ESG ratings, which are often based on weighted averages and blunt risk management, conceal many of the subtleties that ESG information can provide to asset managers.
3. Clear weaknesses that may not show up in an issuer's overall ESG rating may provide early warning of the potential for controversies with significant financial consequences.
4. CPR AM's ESG integration methodology spots weaknesses through a series of tests on 15 general ESG criteria. The tests performed on each security from the investment universe sort each criterion by the best information ratio (e.g., risk-adjusted performance).
5. The methodology has produced good results when applied to equity multi-factor investing strategies.
6. The methodology can also be applied to credit and convertible funds.
7. The approach is flexible enough to meet client expectations and future ESG challenges.
8. The best path to innovation is the co-design of solutions by asset owners and asset managers.

Here comes “ESTER”
The new benchmark rate for euro transactions

Guillaume Ledure
Senior Manager
Advisory & Consulting
Deloitte

On 13 September 2018, the working group on euro risk-free rates recommended the Euro Short-Term Rate, a.k.a. “ESTER”, as the new euro “risk-free rate” benchmark. This recommendation marks an important milestone in the process of organizing the shift from EURIBOR and other prevailing benchmark indices to more sustainable benchmarks. This arguably constitutes one of the biggest challenges facing the financial industry.

The future of LIBOR

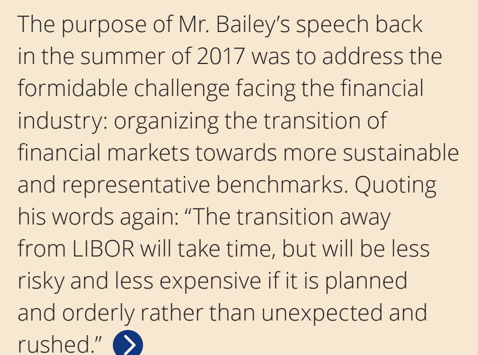
“I am going to talk this morning about LIBOR...” said Andrew Bailey, Chief Executive of the Financial Conduct Authority (FCA), on 27 July 2017.[1]

During this intervention, the head of the British financial regulator pressed his audience to consider financial markets where LIBOR would eventually cease to exist.

LIBOR, like its cousins EURIBOR, TIBOR, STIBOR, etc.,[2] seeks to measure the market for unsecured wholesale term lending[3] between banks.It is contributed to on a daily basis by a panel of banks asked for “the rate at which they could borrow in a reasonable market size (...)”. IBORs are used extensively as benchmarks for bonds, mortgage, student or commercial loans, securitization products, derivative instruments, etc. Their importance in today’s financial markets is tremendous, in that transactions with aggregated notional of hundreds of trillions of US dollars are indexed to them.

However, it is questionable whether IBORs can and should remain the main market benchmarks in the future. Two main reasons exist for this.

First, the financial crisis of the late 2000s dramatically shrank the interbank term lending market. As Mr. Bailey stated, “the underlying market that LIBOR seeks to measure (...) is no longer sufficiently active.” There are now such low volumes of unsecured interbank term lending that, quoting Mr. Bailey again,[4] “LIBOR is sustained by the use of expert judgement.” In other words, panel banks estimate the rate they believe would be applicable but have no market evidence with which to substantiate their figures.
This leads to the second reason for questioning the importance of IBORs. Heavily based on expert judgement, IBORs are vulnerable to misconduct from their contributors. The so-called “LIBOR scandal”, highlighted in 2012, demonstrated the risk of manipulation lying within its contribution process.



The purpose of Mr. Bailey’s speech back in the summer of 2017 was to address the formidable challenge facing the financial industry: organizing the transition of financial markets towards more sustainable and representative benchmarks. Quoting his words again: “The transition away from LIBOR will take time, but will be less risky and less expensive if it is planned and orderly rather than unexpected and rushed.”

1. "The Future of LIBOR", Andrew Bailey, Bloomberg London, 2017.
2. Collectively referred to as "IBORs" in the rest of this article, which stands for "Interbank Offered Rates".
3. "Term lending" refers to lending transactions with defined terms, e.g., 1 month, 3 months, 6 months and 12 months, such as for LIBOR. It differs from "overnight lending", which refers to a term of 1 day.
4. Note that Mr. Bailey represents the UK market; hence, he refers to LIBOR only. Nevertheless, all his comments and recommendations apply as well to all other IBORs.

The regulatory response

In July 2013, IOSCO[5] published a report entitled "Principles for Financial Benchmarks". This marked a first attempt to respond to the alleged manipulation of main interest rate benchmarks (referred to above as "the LIBOR scandal") and its potential impact on investors and the real economy. The objective of IOSCO's report was to provide guidance and set out principles that would secure increased transparency in benchmark administration. It covered the submission process, the transparency of methodologies, and overall governance.

IOSCO's report had the merit of addressing the potential conflicts of interest inherent to the benchmark-setting process, but its principles were not enforceable on benchmark administrators.

The Benchmark Regulation[6] (BMR) entered into force in January 2018. It establishes the IOSCO principles as a legislative and regulatory framework. The BMR applies not only to administrators but also to contributors and users of benchmarks.[7] In particular, BMR Articles 20-23 elaborate on the concept of "critical benchmarks", i.e., those benchmarks whose failure would have "significant and adverse impacts on market integrity, financial stability, consumers, the real economy, or the financing of households and businesses." As at the date of writing, the European Union recognizes four critical benchmarks[8]: EURIBOR, LIBOR, STIBOR (the Euro, London and Stockholm Interbank Offered Rates, respectively) and EONIA.
The first three belong to the family of IBORs referred to earlier. Above, we highlighted their deficiencies, and the need for replacement candidates as market benchmarks.

EONIA is a little different. It stands for "Euro Overnight Index Average". It is calculated as a weighted average of overnight unsecured interbank lending rates reported voluntarily by eurozone banks. EONIA is a critical benchmark because it serves as a base for the Overnight Indexed Swap (OIS) market in euro. The OIS market, and the OIS yield curve derived from it, represent a cornerstone for the valuation and risk management of collateralized swaps. Unlike IBORs, which refer to term lending, EONIA refers to overnight lending. Also, EONIA is exclusively based on data from real transactions. In other words, EONIA does not rely on expert judgement. However, EONIA lacks representativeness; hence, it is still not compliant with the BMR. There are two main reasons for this:

- Volumes reported (voluntarily) for overnight interbank lending are too small
- Input data used for the index is provided by too small a number of contributors

In short, despite the huge transaction volumes indexed to them (e.g., the market for swaps indexed to EONIA or EURIBOR), none of the current critical benchmarks is a viable long-term candidate as a market reference.

In his July 2017 allocution, Andrew Bailey not only warned his audience against the dangers of inertia. He also proposed a deadline for organizing the transition away from LIBOR: end-2021. He said banks in the LIBOR panel had agreed to maintain their

Working groups in various jurisdictions have been set up in the last few years to identify alternative "risk-free rates" (RFRs) to use as future benchmark indices.

contribution to the index until this date. Afterwards, "the survival of LIBOR on the current basis (...) could not and would not be guaranteed." It is the responsibility of every market participant to determine its course of action and the fallback measures it will adopt to prepare for the eventual disappearance of IBORs. In particular, market participants need to address the two following questions:

- What other benchmark should serve as a reference for new contracts and transactions?
- What is the best way to deal with legacy contracts indexed to old benchmarks?

ESTER is born

As described above, identifying and adopting alternative benchmark indices on a large scale is not only necessary, but also quite urgent. Working groups in various jurisdictions have been set up in the last few years to identify alternative "risk-free rates" (RFRs) to use as future benchmark indices.

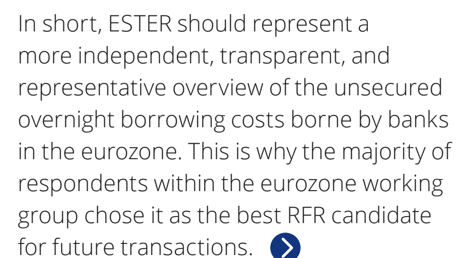
2017 saw several of these working groups deliver their verdict. One after the other, TONA[9] for JPY, reformed SONIA[10] for GBP, SOFR[11] for USD and SARON[12] for CHF were selected as the preferred RFRs.[13]

The working group for the eurozone, set up in September 2017, published its conclusions very recently (13 September 2018). It recommends the adoption of a new benchmark index: the Euro Short-Term Rate or "ESTER". ESTER is administered by the European Central Bank (ECB), which will start its daily publication in October 2019. ESTER reflects the wholesale euro unsecured overnight borrowing costs for banks in the eurozone. It will adhere to IOSCO guidelines and comply with the BMR.

So, what makes ESTER a better RFR for euro than EURIBOR or EONIA?

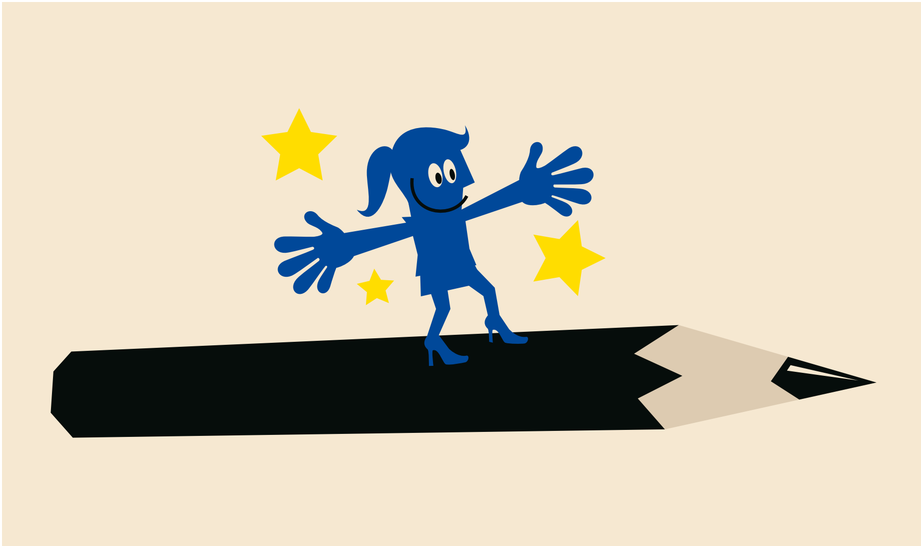
Unlike EURIBOR, ESTER will be compiled on the basis of actual lending operations. In other words, no expert judgement would be required. While not strictly risk-free, it carries much less credit risk with its overnight term than EURIBOR.

EONIA shares those two characteristics with ESTER. However, they differ in terms of their contribution processes. Firstly, ESTER is administered by the ECB, whereas EONIA is administered by a private entity (the European Money Markets Institute). Secondly, EONIA relies on data being voluntarily disclosed by a panel of 28 banks. In contrast, ESTER relies on mandatory submissions from 52 banks reporting in accordance with the Money Market Statistical Reporting Regulation. Finally, ESTER relies on the full range of wholesale overnight bank borrowing operations,[14] whereas EONIA is calculated using only interbank lending operations. In other words, ESTER is less vulnerable to a lack of data.



In short, ESTER should represent a more independent, transparent, and representative overview of the unsecured overnight borrowing costs borne by banks in the eurozone. This is why the majority of respondents within the eurozone working group chose it as the best RFR candidate for future transactions.

5. The International Organization of Securities Commissions.
6. Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016.
7. Refer to Performance Magazine Issue 27 pp 32-37 for more details on the BMR and its consequences for benchmark stakeholders.
8. Based on Commission Implementing Regulation (EU) 2018/1557 of 17 October 2018.
9. Tokyo Overnight Average Rate, sometimes referred to as "TONAR".
10. Sterling Overnight Index Average.
11. Secured Overnight Financing Rate.
12. Swiss Average Rate Overnight.
13. Note that RFR is a quite abusive denomination. All these rates of lending, whether for secured or unsecured operations, do carry some overnight credit risk.
14. "Wholesale" means that these operations may occur with any market participants, rather than only banks.



In short, ESTER should represent a more independent, transparent, and representative overview of the unsecured overnight borrowing costs borne by banks in the eurozone.

Challenges ahead

On 12 July 2018, nearly one year after delivering his speech entitled "The Future of LIBOR", Andrew Bailey was speaking again at Bloomberg's London office. His topic of the day was transitioning to a world without LIBOR.[15]

"The most effective way to avoid LIBOR-related risk is not to write LIBOR-referencing business. (...) The biggest obstacle to a smooth transition is inertia – a hope that LIBOR will continue, or that work on transition can be delayed or ignored," he said.

Even though replacement candidates for IBORs and EONIA have now been identified, major challenges remain unsolved.

Firstly, the market needs to adopt these new RFRs for new transactions. Liquidity in derivatives markets referencing these new benchmarks is crucial. As mentioned earlier, the OIS market (currently indexed to EONIA for euro transactions) plays a key role in the valuation and risk management of derivatives. If a new benchmark is introduced for overnight borrowing, a whole swap market indexed to this new benchmark needs to emerge. To this end, market participants need to be properly educated. Exchanges and clearing houses need to ensure listing and clearing of products referencing these indices. Assuming liquid markets exist for swaps indexed to the new benchmark(s), valuation and risk management methodologies would need to be completely reinvented. During the transition, inefficient hedges or model risk may result in losses for market actors. Trading and risk management infrastructure and software may also be affected by the change of interest rate benchmarks, resulting in extra costs for market participants.

Challenges exist as well on the legal and contractual sides. Significant administrative effort is necessary to ensure both the drafting of new contracts and the definition of fallback measures for existing ones.

Finally, tax or accounting consequences could also result from a change of benchmark.

All of these challenges will affect market participants throughout the entire value chain: traders, structurers, salespersons, portfolio managers, risk managers, lawyers, etc. However, most of all, final investors and consumers will have to adapt to this new reality and absorb the costs of the transition.

15. "Interest Rate Benchmark Reform: Transition to a World Without LIBOR", Andrew Bailey, Bloomberg London, 2018.

Conclusion

The Benchmark Regulation has set requirements for administrators, contributors, and users of benchmarks. One of these requirements is that users (including investment firms, credit institutions, asset managers, and insurance companies) need to ensure fallback provisions in case the benchmarks they use are discontinued.

Current critical benchmarks such as EURIBOR, LIBOR and EONIA will eventually cease to exist. We do not know exactly when this will occur, but it may be within three or four years.

Several working groups have recently expressed their preferences for replacement candidates. The working group for the eurozone has advocated the new ESTER benchmark, which will be published for the first time in 2019.

Responsibility now lies in the hands of all users of these critical benchmarks to:

- Assess the extent of their use, the impacts and risks of a discontinuation of IBORs and EONIA; and
- Start adopting the new benchmark(s) in new transactions; and
- Organize the transition to the new benchmark(s) for transactions that still reference legacy indices.

This represents a huge challenge for the financial industry, with implications throughout the entire value chain.

To the point:

- EONIA and EURIBOR are currently the most widely used benchmark indices in the eurozone. As such, they are considered “critical benchmarks” under the Benchmark Regulation (BMR). However, these indices will soon become unavailable to market participants:
  - EONIA is not BMR-compliant, so it cannot be used after the end of the BMR transition period (2020); and
  - IBORs will eventually cease to be compiled (e.g., LIBOR will continue to be published until end-2021, but no guarantee exists as to what will happen thereafter).
- Various working groups across the world have worked on defining the best candidates to replace IBORs as primary benchmark indices in the respective currencies. Following its Japanese, British, American, and Swiss counterparts, the working group for the eurozone eventually recommended ESTER as the new euro risk-free rate.
- The adoption of this new reference rate by the whole market and the shift of all existing transactions to this new benchmark are not only urgent imperatives for the financial industry, but also represent formidable challenges from a legal, operational, and risk perspective. Above all, the biggest challenge may essentially be the change in mentalities and habits.

The athlete's lifecycle
A physically, mentally, and financially demanding endeavor

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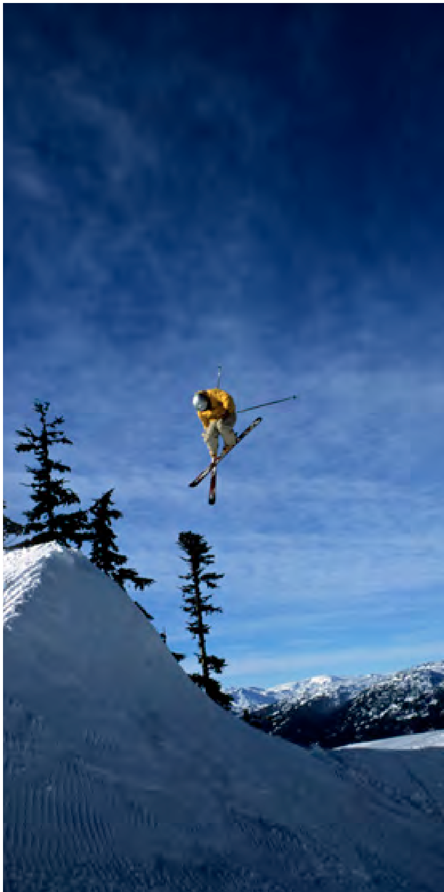
Athletes are known to have extraordinary physical and mental strength that is often admired or respected by a large proportion of the population. Regrettably, while two athletes may have the exact same skills and attitudes, the trajectory from amateur to professional often comes down to financial resources. Indeed, in addition to all of the effort an individual must put into their training, becoming a high-performance athlete is very financially demanding. At each of the different stages of an athlete's life—which we will refer to as the "athlete's lifecycle"—money can have a significant impact on the likelihood of an athlete moving to the next stage.

Acknowledging that an athlete's chosen sport can greatly affect the age at which they enter a phase, we have identified four stages in the athlete's lifecycle that are common to most athletes:

1. **Sport as a hobby**—Period during which the athlete-to-be learns and practices the sport as a hobby.
2. **Junior**—Period during which an athlete tries to transition from being an amateur to a professional athlete.
3. **Career**—Period during which the athlete reaches their highest performance level and enters professional competitions.
4. **Post-career**—Period during which the athlete's career ends and transitions to post-career life.

The athlete's needs and the money required to cover these essentials can differ significantly in each of the four phases, as can the various channels through which athletes can seek financial support.



Across all phases, the risk associated with not obtaining financial support is that the athlete will not be able to move to the next step.

Here we try to analyze, phase by phase, the general needs of athletes, the profiles of traditional investors, and why they choose to finance athletes' needs. We also present various financial gaps and new investment channels that have developed over recent years. These may, potentially, help to close the gaps that exist at present.

Sport as a hobby

As a child or teenager, the athlete-to-be innocently enjoys their favorite sport and may or may not dream of being a professional sportsperson. At this stage, parents are the main investors, financing sports lessons and purchasing some basic sports equipment. In addition, some governments provide subsidies to the various federations and clubs, which collectively invest in infrastructure and pay trainers, thereby lowering the costs borne by athletes' parents. For the government, this investment should ensure equal opportunities for everyone to develop their passion for their hobby, and also provide the adequate resources to develop potential professional athletes.
In addition to professional sport performance goals, governments are sensitive to the values sport promotes. Indeed, sport keeps children active, which lowers the chances of health problems, and brings diverse communities together to practice or play.

Junior

The transition between being a junior and being a top athlete is a very demanding phase, both physically and financially. Only a tiny percentage of those who enjoy sports can hope to turn professional and earn money from their hobby. At this stage, getting the best coaches, equipment, and training via the best infrastructure is of paramount importance if juniors wish to maximize their chances. In addition, junior athletes need to compete internationally in order to face the best opponents and raise their performance to new levels. Not doing so limits their chances of becoming a professional athlete. The costs associated with participating in and travelling to these worldwide competitions are high as juniors must pay for their own long-distance travel, as well as travel costs for any family and coaches they may take with them. In addition, the returns are minimal as these competitions are not broadcasted on media channels, have no or few sponsors, and do not attract paying spectators.

In order to meet these financial needs, athletes have a range of options. The junior athletes with the best performance will be invited by the federation to join their training camp, where they will benefit from the best public infrastructure in the country. These camps are financed by the government and sports federations, which hope to see junior athletes grow into professionals who will represent the country at international level.

Here we try to analyze, phase by phase, the general needs of athletes, the profiles of traditional investors, and why they choose to finance athletes' needs. We also present the various financial gaps and the new investment channels that have developed over recent years. These may, potentially, help to close the gaps that exist at present.

Figure 1. The athlete's lifecycle

The athlete's needs across each phase of the athlete's lifecycle, and how these are typically financed

Some juniors may also be targeted by brands who will sponsor them and therefore finance their equipment, travel, etc. These brands usually believe in the potential of the junior to turn professional. They therefore wish to secure a contract with the athlete early on to ensure that they will wear the brand's logo during competitions. As teenagers are very active on social media platforms, this is an opportunity for brands to access the athlete's community and easily reach a targeted audience.

However, these opportunities are not always available to the junior athlete. Indeed, brands and governments are more inclined to financially support junior athletes who happen to be involved in popular sports, since this maximizes media exposure. In addition, subsidies will be awarded in the first instance to the athletes that brands and governments view as "high-performing" athletes. Athletes who are involved in a less popular sport or who are not seen as high achievers relative to their peers are often forced to resort to bank lending. However, considering their low/non-existent and uncertain current source of revenue, banks are only willing to lend to athletes at a high interest rate.

Crowdfunding is becoming increasingly popular as an alternative way to raise funds for athletes. For example, young tennis players can create a crowdfunding campaign on a dedicated website, explain their professional career dreams and let investors know how much money they need in order to finance their trainings and try to make their professional dreams a reality. This method has the advantage of reaching a wide audience of people, but the returns for investors are very low. Indeed, the returns offered by most athletes are fun rewards such as a signed picture, private lesson, etc. This usually does not attract enough investors to secure the minimum funds junior athletes need to turn professional. This lack of solutions can simply put an end to their dreams of being a professional athlete and force the juniors to go back to their studies or work part-time to support themselves.

Career

Only the best juniors will have the opportunity to become professional athletes: athletes who receive payments for their performance.

While the costs a professional athlete has to bear are mostly similar to those they had as a junior athlete, the revenue athletes receive is likely to be much higher. However, the revenue discrepancies between and within sports are enormous. Indeed, according to a BBC study[1], in 2017, the winner of the US Open (tennis grand slam) won £2.71 million, 238 times more than the winner of the Biathlon World Championships (£11,349). Within sports, the tennis world number one has won 472 times more in the first 10 months of 2018 (US$8,663,347) than the world number 300 (US$18,358[2]). In addition to these prize money differences, top athletes may also earn more money thanks to sponsors, who are ready to offer attractive contracts (e.g., a US$300m 10-year contract for a top tennis player[3]) to have their brand endorsed by these athletes. In comparison, lower-performing athletes may find it harder to secure sponsorship deals because the value of their endorsement is lower from the brand's perspective.

Table 1: Yearly costs per sport

Estimations of yearly costs per sport, including training, coaching, and travel[4]

Sport	Yearly training cost estimation
Sailing	$500,000+
Shooting	$700,000 - $1.5 million
Equestrian	$100,000 + horse cost
Archery	$25,000
Swimming	$100,000
Fencing	$20,000
Gymnastics	$18,000

Table 2: Olympic Gold Medal Prize Money per country

Dollar amount of the prize money received by athletes of different countries for winning a gold medal at the 2016 Rio Olympics[5]

Country	Olympic Gold Medal Prize Money
Singapore	$1,000,000.00
France	$55,000.00
USA	$37,500.00
Germany	$22,000.00
Canada	$15,000.00
UK	$0

While some athletes will earn millions, others will face major difficulty earning enough to live on. While the yearly costs athletes face vary greatly across sports and between athletes within sports, the Fiscal Time (2012)[4] has listed the seven Olympic sports with the highest training costs as exhibited in table 1. To face these costs, athletes can hardly rely on sponsors as they are only in the spotlight once every four years, during the Olympics. In addition, while the Olympics are the biggest competition for these athletes, they are not financially rewarding. Each federation can decide on the prize money athletes will get. As illustrated in table 2, being an Olympic champion in Singapore can easily reimburse the training costs but is financially worthless in the UK.[5]

In order to face these prohibitive costs, athletes have no other choice but to get part-time jobs to finance their trainings, decreasing the amount of time and energy they can devote to their sports. This hinders their performance, thus distancing them even more from the additional funding opportunities brands like to provide to the very best athletes. Alternatively, athletes can also launch a crowdfunding campaign as explained in the section above.

In some countries, sports fans have recognized the problem and created foundations, which call for investors in order to help athletes to finance their career. For example, the Level Field Fund foundation in the US raises funds for athletes in need. It has provided critical funding to dozens of American athletes who have gone on to achieve successes that would otherwise not have been possible.[6] This method has the advantage of reaching a wide audience, including companies that can improve their brand image by providing funds.

1. BBC, (2017). Prize money in sport - BBC Sport study. Retrieved from https://www.bbc.com/sport/40300519
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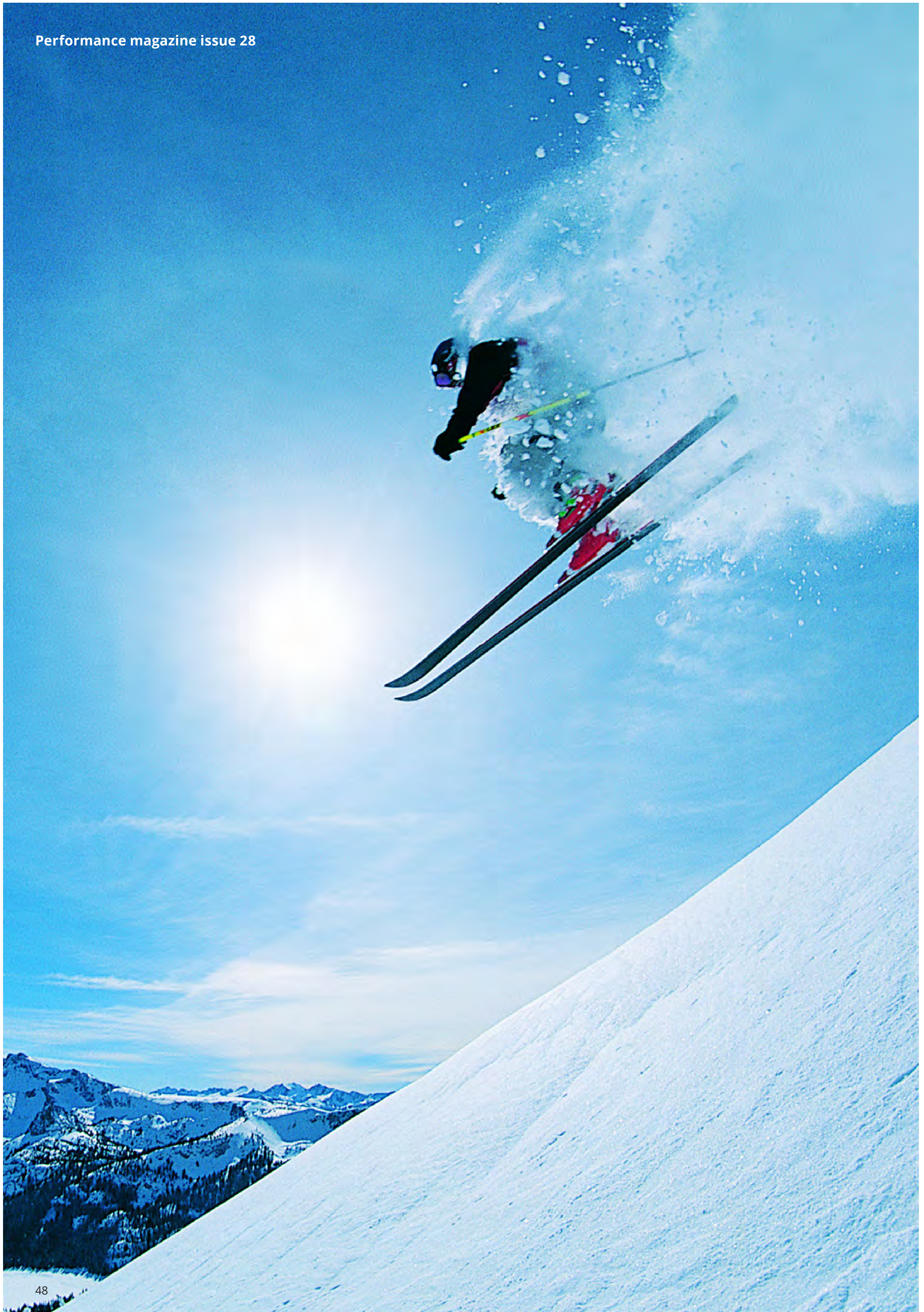


Post-career

Transitioning to post-career life can be a difficult moment for an athlete. While most athletes can envision and plan for the end of their careers a few years before, others have to stop abruptly because of injuries. From one day to another, on top of missing out on the stamina they could have while taking part in competitions, athletes stop receiving financial revenue from their sport. On the one hand, some athletes will not have financial difficutlties as they have been able to save money for their post-career life. Athletes who have wisely planned out their post-career lives can finance their needs with the revenue from the various assets they have invested in, such as real estate investments, fund investments, etc. On the other hand, some athletes will have difficulties meeting their families' day-to-day needs, either because they did not get enough revenue during their career to save money or because they have not managed their career revenue well. Indeed, over their career, the athlete usually has a hectic lifestyle, going from one competition to another, leaving little time to think about post-career life. Most athletes will then try to find a job after their career where they will be able to secure a regular source of income. Clubs and federations can benefit from this opportunity to offer contracts to ex-athletes to share their sports experience as a coach or advisor. For example, Marián Vajda was an average tennis player in the 1980s-1990s who has successfully transitioned into post-career life by coaching top tennis players, including the current world no. 1 Novak Djokovic. Others get hired by television channels or newspapers to become sports broadcasters, such as Laurent Jalabert, a former professional cyclist who is now a cyclist consultant for France 2, a public French channel.

An alternative source of revenue for ex-athletes is to benefit from their fame and the image they have built during their career. Currently, brands understand the value of engaging with ex-athletes for long-term or even life-long partnerships to reinforce the image of their brand. Indeed, some athletes have been real idols for fans, who admire the athlete not only because of their career achievements but also because of their personality. Brands have understood this phenomenon and bet that these athletes are still good brand representatives once they retire, as illustrated by the contract that Michael Jordan has with Nike, 15 years after his retirement.

Sport is a great equalizer and it is one of the main contributors to social mobility around the world. However, the question of financial stability plagues many athletes in all stages of the life cycle, from high financial barriers to entry to achieving financial independence after retirement.

Adrian Vodislav
Former professional tennis player

The virtuous and vicious circle

As analyzed in this article and depicted in Figure 2, the four phases of the athlete's lifecycle are not independent of each other. Young athletes who benefit from the best training conditions have better chances of turning into top junior athletes. Top junior athletes will access the funding and infrastructure that will maximize their chances of becoming a good professional athlete. High-performing athletes in turn get the most revenue, which they can invest in assets to secure good post-career life revenue. On the other hand, athletes who do not have the best training conditions have less chances of becoming a famous professional athlete, forcing them to get a part-time job to finance their training. This gives them less time to practice, which further deteriorates their performance and makes it unlikely that the athlete can save enough money for their post career life.

With this virtuous circle, top athletes in the most famous sports will not need further external help to boost their income. They might, however, need investment advice on how to manage their revenue. Others, including lower-performing athletes in famous sports, top athletes in less famous sports, and especially lower-performing athletes in less popular sports, have difficulties securing sufficient funding from their sport to live comfortably once their career comes to an end. Indeed, despite the many different traditional and alternative ways to secure funding mentioned here in this article, these methods do not allow these athletes to close the financial gap between their revenue and their needs.

Figure 2: The virtuous and vicious circle

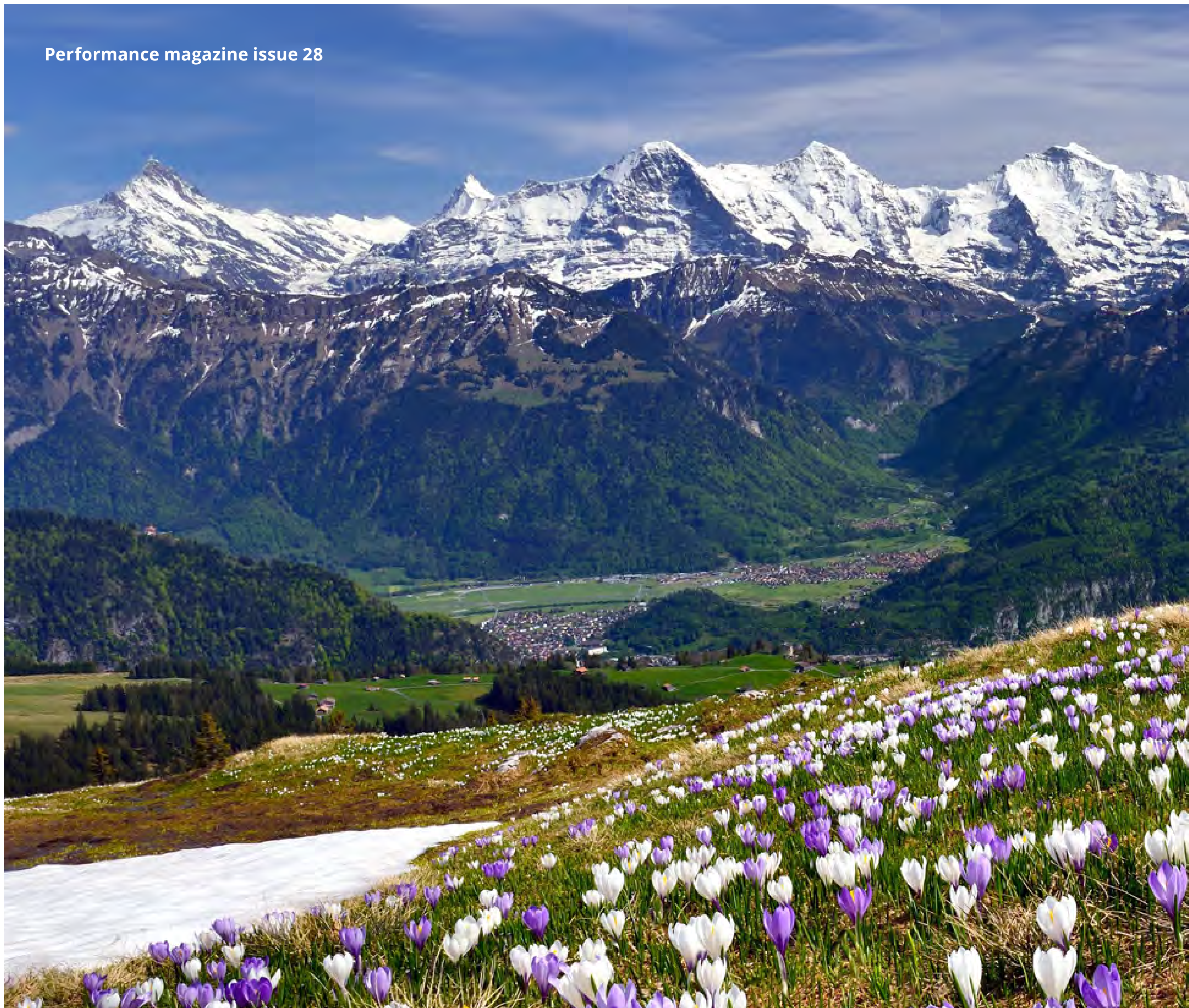
High-performing athletes in popular sports will easily transition from one phase to another; while other athletes (lower performers in popular sports, high performers in less popular sports, and lower performers in less popular sports) will face financial difficulties making the jump between phases.

	Sport as hobby	Junior	Career	Post career
High performer athlete in popular sports	Access to best infrastructures and coaches	Brands and governments subsidy	High revenues form competition and brands contracts	Financial buffer
Others	Access to basic infrastructures and coaches	High training costs, no/low revenues	High training costs, average/low revenues	Financial distress

Despite the many different traditional and alternative ways to secure funding mentioned here, these methods do not allow these athletes to close the financial gap between their revenue and their needs.

To the point:

1. Many athletes have difficulties to obtain sufficient financial resources to cover their training, material and travel costs.
2. Across the different phases of an athlete's lifecycle, the risk of not obtaining financial support is the inability to move to the next step.
3. The four phases are not independent of each other; great success in one phase increases the chance of being successful in the following one.
4. There is a need for new investment methods to financially support athletes.



The (partial) beginning of a new era

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The new Swiss Financial Services Act (FinSA) and Financial Institutions Act (FinIA) and their impact on independent asset management in Switzerland

With both FinSA and FinIA expected to enter into force on 1 January 2020, the core regulations governing the historical business of fund managers and asset managers in Switzerland face only minor changes. However, the practical impact of FinSA on the industry may be substantial depending on each asset manager's business model. What is clear across the board is that FinIA sets a new standard for the group of professionals known as independent asset managers (IAMs). A substantial reorganization will be required for them to meet the new licensing requirements. Despite the potential benefits afforded by a long transition period, existing IAMs would be well-advised to consider their transformation efforts early.

A short history of Swiss financial market regulation

Drafting of FinSA and FinIA began in 2014. In light of high-profile international cases of customer fraud, the financial crisis, and the pressure for tax normalization, the Swiss financial market had no choice but to react to a series of amended EU laws (EMIR, MiFID II, MiFIR, PRIIPs and the Prospectus Directive). The goal was two-fold: fostering investor protection and providing access to the EU financial market by establishing material equivalence in terms of regulatory framework. Accordingly, four landmark bills were introduced: one sought to improve the Financial Market Supervisory Act (FINMASA, defining the target groups for supervision by the Swiss Financial Market Supervisory Authority (FINMA)), there was the Financial Market Infrastructure Act (FMIA, defining the infrastructure for payment systems and the stock exchange), and there were the two acts covered herein.

While FMIA came into force in 2015, the drafts of FinSA and FinIA—both related to investor protection—were plagued by controversy: some people felt that they did not go far enough in terms of customer protection, whereas other market participants found that they were too prescriptive. The resulting acts reflect a compromise and their impacts subsequently differ for the various market participants.

Selected FinSA impacts for asset managers

FinSA imposes a number of rules of conduct for all providers of financial services, such as:

- Obligations to provide information
- Obligations to carry out suitability assessments and appropriateness tests
- Documentation and accountability requirements
- Transparency and due diligence obligations

The existing Collective Investment Schemes Act (CISA), seconded by applicable self-regulation, already required collective asset managers to apply similar rules of conduct. In comparison to the FinSA rules, the latter are more comprehensive, yet the applicable basic concepts—such as duties of loyalty and care and duties to inform—were already present in the CISA.

However, depending on their business model and organizational maturity, medium and larger companies should not underestimate the potential impacts. For example, information requirements are now considerably more burdensome, and much more information must be obtained from customers. In addition, the scope of suitability and appropriateness assessments is broader than ever before.

With the CISA conduct rules transposed into FinSA, the new rules aim to protect customers when they acquire securities or financial instruments. In turn, a scaled-back version of CISA continues to apply and aims to protect investors by serving the interests of collective investment schemes.
FinSA also introduces a requirement to issue a prospectus for all new products, not just for collective schemes. The new prospectus requirement is triggered by merely offering a product, instead of the criteria around distribution. Asset managers offering a new product need to be aware that strict liability rules apply.
In general, the impacts mentioned above are mitigated when exclusively serving professional and institutional clients, but producing basic information sheets may turn out to be a mammoth operational undertaking.

FinSA client segmentation is broadly aligned with the framework introduced by MiFID II (professional clients, eligible counterparties, retail investors) and it distinguishes professional clients from institutional and retail clients. FinSA provides a precise list of the types of customer classed as professional clients, based on MiFID II and the CISA list of qualified investors. The CISA definition of a qualified investor will essentially correspond to that of the professional client in FinSA. Institutional clients (a term that does not exist in CISA) may be seen as a subset of professional clients as defined in FinSA.

However, there are a few nuanced differences between the two definitions. Investors with an asset management or investment advisory agreement with a prudentially supervised asset manager are qualified investors according to CISA—but not professional clients according to FinSA. When acquiring new private clients, asset managers must treat them as retail clients—with consequences regarding information transparency duties—unless these clients waive some of their customer protection rights by opting out.

One new development under FinSA is the introduction of the dogmatic concept of offering and the abandonment of the former distribution regime.

Asset managers must mirror the behavioral rules set out in FinSA with adequate organizational measures (now provided within FinIA).

Once customers are classed as clients and consequently as qualified investors, asset managers must respect the client's right to opt in to become non-qualified investors again—with consequences regarding the selection of securities and investment restrictions.

Of course, asset managers must mirror the conduct rules set out in FinSA with adequate organizational measures (now provided in FinIA); however, CISA already provides precise rules for the internal organization of licensees. We think that at least former CISA-regulated asset managers should not be fundamentally challenged by the new FinIA requirements—in contrast to IAMs.

Four significant changes for independent asset managers resulting from FinIA

FinIA aimed to lift the independent asset management sector to the same (prudential) supervisory level as the rest of the industry ("level playing field"). The Swiss IAM sector includes an estimated 3,000 units, most of them operationally small entities. On the other hand, about 200 asset managers of collective investment schemes are already supervised by FINMA. Both types of asset managers are permitted to manage assets of occupational pension schemes, but in order to do so they must apply for an additional license from the Federal Occupational Pension Supervisory Commission (OPSC).

Old legal regime	
IAM	**CISA-AM**
• Managing individual assets • Managing collective assets up to CHF 100 Mio.	• (Managing individual assets) • Managing collective assets from CHF 100 Mio. upwards
• No authorisation required	• Authorisation required
• No minimum capital and no capital adequacy rules	• Minimum capital and capital adequacy rules
• No specific organisational requirements	• Organisational requirements: Compliance, Risk-Management, ICS
• Depth of supervision: Self-regulation	• Depth of supervision: Prudential supervision
• Supervision by: SROs & Professional Organisations	• Supervision by: FINMA
• Legal basis: AMLA, SRO-regulations	• Legal basis: CISA, CISO, CISO-Finma, FINMASA
• Distribution of financial products/rules of conduct: Code of Conduct of a professional organisation	• Distribution of financial products/rules of conduct: CISA, CISO, Code of Conduct of the SFAMA

BVG-AM
• Managing assets from occupational pension funds
• Authorisation required
• Body of authorisation: Occupational Pension Supervisory Commission (OPSC)
• Legal basis: BVG, BVV2

New legal regime	
AM	**Collective-AM**
• Managing individual assets • Managing collective assets up to CHF 100 Mio. • Managing assets from occupational pension funds up to CHF 100 Mio. or up to 20% of the assets from an individual pension fund	• Managing individual assets • Managing collective assets from CHF 100 Mio. upwards • Managing assets from occupational pension funds from CHF 100 Mio. upwards or > 20% of the assets from an individual pension fund
• Authorisation required	• Authorisation required
• Minimum capital and capital adequacy rules	• Minimum capital and capital adequacy rules
• Organisational requirements: Compliance, Risk-Management, ICS	• Organisational requirements: Compliance, Risk-Management, ICS
• Depth of supervision: Prudential supervision	• Depth of supervision: Prudential supervision
• Supervision by: FINMA & supervisory organisations	• Supervision by: FINMA
• Legal basis: FINIG, FINMASA	• Legal basis: FINIG, FINMASA
• Distribution of financial products/rules of conduct: FinSA	• Distribution of financial products/rules of conduct: FinSA

Legend
(I)AM: (Independent) Asset Managers
CISA-AM: Asset Managers of collective investments schemes
BVG-AM: Asset Managers of pension assets
Collective-AM: Asset Managers of collective assets (according to FinIA)

That authority in turn supervises this type of activity only indirectly by watching over the occupational pension schemes themselves.

We think that with FinIA the permitted range of asset management activities and its supervision has finally been clarified for all financial institutions. In future, all domestic asset managers will be regulated by one regulator only: FINMA. The ability to manage occupational pension scheme assets is included in this license. The former CISA-regulated sector is now referred to as "collective asset management".

With FinIA, Swiss IAMs have become subject to FINMA licensing for the first time.

Currently, IAMs are free to determine their legal form, from sole proprietorship to corporate entity status. With FinIA, their firms must, as a minimum, be registered with the Swiss Trade Register.
In terms of regulation and supervision, IAMs so far (only) have to fulfil their due diligence requirements under the Anti-Money Laundering Act (AMLA) and are thereby supervised in the vast majority by 11 "self-regulatory organizations" (SRO), approved and supervised by FINMA, to which IAMs have to adhere to conduct their business lawfully.

With FinIA, Swiss IAMs have become subject to FINMA licensing for the first time, whilst supervision is delegated to between two and four "supervisory organizations" (SOs, run by former SROs). Adherence to one of these organizations is part of the license requirements. SOs in turn will have a duty to interact with IAMs applying for FINMA licenses and—in contrast to the former SROs—have no independent power in licensing, de-licensing and enforcement. The material licensing requirements for IAMs can be grouped into four main challenges:

1. **Experienced management body**
   FinIA requires management bodies to comprise at least two qualified individuals. Qualification is assumed if the person has received adequate asset management training that provides for equivalent experience as required for being admitted as an asset management auditor. Additionally, at the time of assuming management duties, the person must have at least five years of professional experience in asset management for third parties or trusts. On top of that, they must retain their acquired skills through regular training.

   We believe that for many pre-existing one-man IAMs this requirement alone may pose a challenge for business continuity and it is certainly a strategic issue when founding a new asset management company. However, FinIA allows management bodies to consist of only one qualified person subject to evidence that continuation of business operations on a going-concern basis is guaranteed. It is expected that this will lead to smart cooperation models, implemented by mergers of pre-existing small-sized entities or to smart business models, by partial or complete delegation of tasks to third parties. Such transfers of tasks must be agreed upon in writing and structured in a way that the asset manager itself, the audit firm, the SO and FINMA are able to review and verify the task(s) assigned.

2. **Professionalizing the second line of defense**
   FinIA requires the establishment of an appropriate risk management function as well as an effective internal control system to ensure, inter alia, compliance with legal and internal provisions. It thus introduces a preferred model for managing operational risk, commonly known as the "three lines of defense", that separates core business from compliance and risk management functions and internal audit to allow for independent assurance. Independence of risk management and internal controls is not required for companies with five or fewer employees or an annual gross income of less than CHF 1.5 million provided that the business model does not entail increased risks. For businesses with an annual gross income of more than CHF 10 million, FINMA may require the appointment of an independent internal audit function. Either way, we believe IAMs should organize their second line of defense in an efficient and effective way to prevent a cost explosion. We think that for many IAMs—especially smaller businesses—the outsourcing of the risk management and compliance functions will become important approaches to consider.

3. **Minimum capital and solvency requirements**
   FinIA requires IAMs and trustees to have minimum capital of CHF 100,000 in cash. They must also have adequate collateral (own funds). IAMs with little prior experience of prudential supervision may not have difficulty raising the minimum capital yet ensuring continuous solvency capital coverage may become critical. IAMs should consider that capital management measures also need to be assessed from a tax perspective. The required level of own funds may be partially offset by taking out professional liability insurance, insofar as this covers the risks of the business model.

4. FINMA licensing and prudential supervision

Introducing prudential supervision means a significant cultural change for the entire independent asset management sector. The two-fold supervisory regime, with FINMA responsible for licensing and enforcement and SOs in charge of effective supervision and audit, draws on the experience of former SROs and might ease the cultural clash in the industry. However, the concept still needs to prove its merits, and many might ask whether or not it is here to stay. However, three years of transition will allow the SRO-regulated IAMs to gently adapt to the new regime. In order to overcome the upcoming cultural challenge, we think that starting the transformation of their governance framework early is paramount for IAMs and this is easier to achieve with the support of professional and experienced third parties.

To the point:

- FinSA and FinIA aim to establish equivalence with MiFID II, PRIIPS and the EU Prospectus Directive.
- FinSA sets out a series of conduct rules applicable to all providers of financial services participating in the Swiss financial market, encompassing suitability assessment and appropriateness testing.
- The impacts of FinSA vary in intensity depending on an asset manager's business model and organizational maturity.
- FinSA client segmentation is broadly aligned with the framework introduced by MiFID II and distinguishes professional clients from institutional and retail clients. In addition, the CISA terminology relating to qualified investors remains applicable, but FinSA affects how the term is to be interpreted.
- FinIA defines license requirements for asset and fund managers. For the first time, IAMs will be subject to prudential supervision.
- The new FinIA regime requires IAMs to fundamentally challenge and disrupt their business models, operating models, and governance frameworks.

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  21 March
- ESG and SRI
  11 April
- Investment Management Funds
  25 April
- Outsourcing
  13 June
- Regulated PERE funds
  12 September
- AML/KYC
  26 September
- Derivative Financial Instruments
  24 October
- Money Market
  21 November
- Delegation, Oversight & Due Diligence
  05 December

Regulatory

- Embracing complexity: the Asset Management Regulatory Landscape for 2019
  31 January
- MiFID II and Corporate Governance
  07 March
- PRiiPs and KID
  16 May
- Brexit: How this will/could shape/ impact the European and Global Asset Management industry
  27 June

Innovation & Technology

- Technology in IM Industry/ RPA (Robotics)
  07 November

Risk & Asset Management

- Introduction to Risk Management
  10 October

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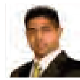

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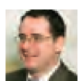

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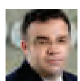

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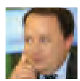

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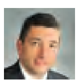

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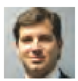

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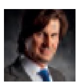

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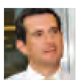

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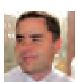

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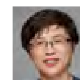

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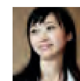

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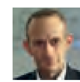

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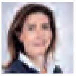
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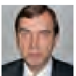
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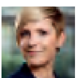
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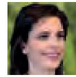
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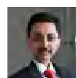
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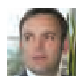
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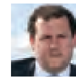
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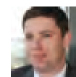
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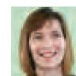
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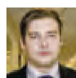
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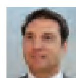
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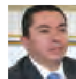
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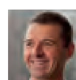
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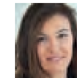
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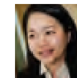
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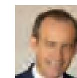
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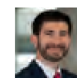
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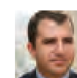
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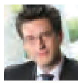
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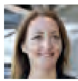
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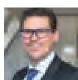
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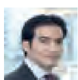
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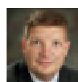
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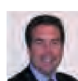
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