

PerformanceMagazine

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Deloitte.



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FOREWORD



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Spring's welcome arrival is unfurling leaves and brightening evenings, demonstrating nature's resilience in the face of a cold, dark winter. As the investment management industry weathers intense volatility and growing scrutiny, our latest edition of *Performance* sheds light on the latest innovations, strategies and solutions to get the lay of the land, nurture new growth, and sow the seeds for a greener future.

Ultra-high-net-worth individuals' (UHNWI) art and collectible wealth is predicted to reach an estimated US\$2.861 trillion in 2026. With NextGen art collectors prioritizing social impact models and art financialization methods, **Deloitte Luxembourg's Adriano Picinati di Torcello** explains how wealth managers can pivot to attract new collectors and prepare for the greatest intergenerational wealth transfer in history.

Amid rising costs and governance scrutiny, many small to medium-sized

institutional investors are turning to outsourced chief investment officer (OCIO) models for strategy advice and management services.

Deloitte Australia's Brian Nolan and Tom Wright leverage their deep knowledge of the delegated consulting industry to lay out the pros and cons of these arrangements, while ensuring investors maintain their oversight and accountability.

With sustainability taking center stage, some forward-thinking players are examining the real-world impact of their investments to mitigate risks and drive positive change at scale. In the first article of a series, **Ophélie Peypoux of Deloitte France and Isabelle Jeannequin Morin of Deloitte Switzerland** dig into how impact investing differs from ESG, recognized standards, and Europe's emerging regulations in this space.

With long-term investment returns exposed to myriad systemic and economic risks, infrastructure assets play a key role in building resilient, sustainable portfolios. **Deloitte's interview with David Neal, Chief Executive of IFM Investors**, uncovers how the energy transition's vast capital flows make infrastructure investing a non-negotiable for healthy returns in a net-zero world.

Today's asset managers face a post-pandemic vista marked by historic inflation and geopolitical volatility. To help guide the industry through the next decade, **our colleagues at Casey Quirk** revisit the 2007–2009 global financial crisis to pinpoint the strategies that winning firms leveraged, helping them differentiate and thrive.

Anti-money laundering and counter-terrorism financing (AML/CTF) remain top of Luxembourg regulators' agendas. **Deloitte Luxembourg's Maxime Heckel, Nicolas Marinier and Andreas Schmitt** predict the regulatory priorities of 2024 and help asset managers sidestep compliance pitfalls and tackle rising scrutiny.

Amid the turbulent geopolitical landscape, growing regulatory burden and rising interest rates, this issue of *Performance* lights the way for forward-looking asset managers to harness disruptions, embrace emerging approaches, and flourish.

We hope this 43rd edition puts a spring in your step.





EDITORIAL

Asia-Pacific is the third-largest region in the world regarding assets under management. While not fully sheltered from the industry's global economic headwinds, the region still holds a significant market position, particularly in the cross-border distribution of European funds. As a result, many global asset managers continue to tilt towards Asia-Pacific.

In this *Performance* edition, we highlight some of the key trends shaping the global asset management industry by exploring new opportunities and emerging trends in Asia Pacific. Boasting more than A\$4.5 trillion in the managed funds industry, Australia showcases the region's rising significance in the international investment arena. The role of its compulsory national savings scheme drives soaring capital investment into global markets.

In our exclusive interview with the Chief Executive of IFM Investors, David Neal shares insights on how a leading global investment manager continues to create sustainable long-term value in uncertain times. This illuminating discussion reveals the secrets of successful infrastructure investment and the asset's role as a resilient, inflation-hedging foundation for long-term returns. We also delve into how infrastructure's momentum is driven by significant macro trends, including aging infrastructure in the developed world, the need for improved infrastructure in emerging

markets, and the surging capital demand for the energy transition.

Current trends in global outsourcing include a pivot to the outsourced chief investment officer (OCIO) model. Between 2016 and 2021, the global OCIO industry almost doubled from USD\$1.3 trillion to over USD\$2.5 trillion. While its rise in popularity among small to medium-sized institutional investors is undeniable, informed decision-making remains essential.

In this issue, we take a deep dive into the OCIO landscape, exploring governance, cost savings and transparency considerations alongside the potential benefits and drawbacks, so that asset managers can better evaluate the right approach.

It is our privilege to share our insights with you!



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An industry
re-arranged:
Successful financial
management
in a post-pandemic era



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Separation from the pack: Successful financial management

The last time the industry experienced this kind of disruption was during the global financial crisis (GFC) of 2007–2009. In the decade that followed, we witnessed a critical shift in the competitive landscape that we had not seen before in the asset management industry, where a select group of winning firms leveraged the crisis to separate themselves from the pack. Our research suggests there is much to gain from this era. Our aim is to isolate the strategies that winning firms deployed and provide a useful framework to guide asset management executives today as they look toward the next decade.

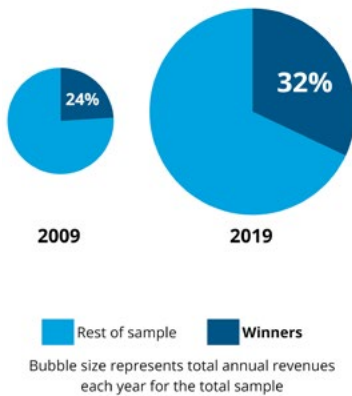
The GFC: An industry inflection point

We analyzed 50 of the largest asset managers globally in the decade following the GFC. This group represented slightly more than 55% of the industry's total revenues as of year-end 2009 and grew to slightly more than 60% by year-end 2019. But an interesting phenomenon, which we did not observe meaningfully in the periods preceding the GFC, emerged clearly in the research — winning firms captured all the net consolidation gains. Winning firms, which we define as those that grew net new revenues (revenues associated with positive net flows) at a rate greater than the industry average for the 10-year period — amounting to about 20 firms in total, grew

their total industry revenue share from 24% to 32%. These firms also exhibited superior financial performance in other critical metrics, giving them a leading advantage. They grew annual dollar profits at a 10% rate (versus 8% for others in the sample) over the 10-year period, exhibited 1.3 times higher productivity (as measured by revenue per full-time equivalent) as of year-end 2019, and invested 2% more of their revenues each year in technology as of year-end 2021. Interestingly, winning firms varied in size and type, with representation from various sectors including, alternatives, passive, fixed income, and solutions-focused firms.

Winning firm consolidation

Winning firms share of industry revenue



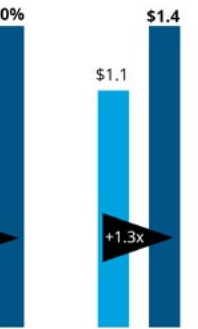
Profit growth

CAGR %



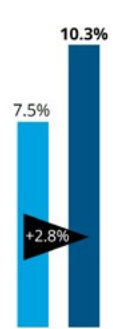
Productivity

Average revenue per FTE, \$mm



Technology investment

Average tech/data spend as % of revenue



Three essential ingredients for success

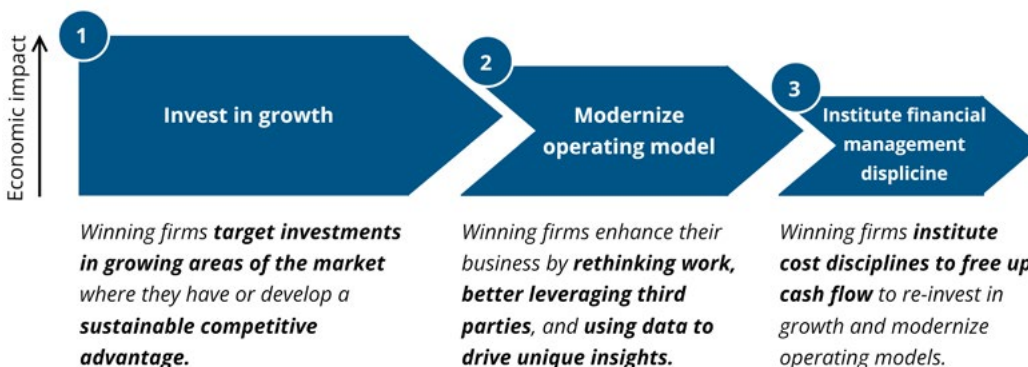
Based on our extensive research and experience working with many of the leading firms over the past several decades, there were three essential ingredients that drove separation of the winners from the pack during the decade following the GFC: these firms (1) more effectively invested in growth,

(2) were better at modernizing their operating model, and (3) instituted better financial disciplines.

These three ingredients for success will remain largely the same in the coming decade. However, the best strategies for the next decade will need to account for both the evolving competitive landscape that has emerged since the GFC and the unique changes in the current operating environment. We are facing a very different investment

environment, where business models are being redefined. The workforces is adapting to the emerging hybrid work environment, operating models are being reimagined, and the growing influence of deglobalization and fragmented regulations are increasingly challenging firms' legacy models. Today's changes present an opportunity for managers to recalibrate their strategy and define how they will compete to win in the next decade.

Winning strategies





Ingredient No. 1:

Targeted investment in growth

Winning firms exhibit the ability to target growth opportunities. A clear view of structural changes in the investment environment and future buyer demand shifts are central to identifying future opportunities. Coming out of the GFC, some favorable trends appeared more evident than others. Low rates and banks reducing their lending, for example, fueled growth opportunities in active fixed-income and private-market strategies. The investing experience during the GFC changed perceptions around the value of active investing, fueled by a substantial shift from active to passive investment approaches, and drove the popularity of the exchange-traded fund. The rapid growth in individual-driven markets, including retail, wealth, and retirement, rewarded firms that were best able to pivot their businesses into these segments. Winning firms successfully identified these growth trends early in the cycle, enabling them to harness superior growth.

Moving forward, leaders will separate themselves from the pack by better targeting product and market expansion opportunities, establishing a differentiated brand of investment excellence, investing in a superior client experience, and executing business transformation with precision.

Ingredient No. 2:

Operating model modernization

The second substantial initiative that winning firms embraced in the decade following the GFC was a willingness to disrupt the status quo of how their businesses operated. These firms embraced new and innovative capabilities that improved their investment processes, product quality, investment returns, client experience, sales productivity, operational efficiency, client tenure, business decision-making, internal controls, and talent experience. Over the past decade, operating model changes were motivated by aspirations around growth, flexibility and business agility, improved scale, reduced cost, and risk.

Looking forward, leading firms will aggressively seek to further simplify and modernize their operating model, and align core activities with client preferences, rather than traditional business functions or products. The transformation for the next decade will tackle five priorities:

1. **Rethink work:** Redesign where and how work gets done to drive efficiency and speed and reduce risk.
2. **Strategically leverage third parties:** Reimagine core vs. non-core functions to make the most of external providers.
3. **Build insight:** Modernize the data environment and technology stack to drive innovation, insight, and scale.
4. **CEO ownership:** Leading CEOs recognize the importance of technology as a competitive advantage and own the vision.
5. **Progress over perfection:** Embrace change as a normal course of business.

Ingredient No. 3:

Financial management discipline

Asset management remains one of the most financially attractive industries in the world, with median profit margins exceeding 30%, very robust levels of compensation, revenue growth tied to typically rising capital markets, and high cash-flow-generating/low capital-intensive business models. However, it is these characteristics that can encourage poorly conceived spending policies. For winning firms, the decade following the GFC saw the rise of robust financial management disciplines to improve profitability and successfully free up cash flow for reinvestment. As fixed costs in the industry rose (for example, non-compensation and benefit costs have risen from representing, on average, 22% of revenues during the GFC period to more than 30% of revenues in the past five years), winning firms established a fit-for-purpose operating model, created a culture of financial accountability and stewardship, and provided a robust financial toolkit, empowering business leaders to make sound decisions.

Tomorrow's leaders will continue to address these priorities:

- **Build a "Fit for Purpose" operating model:** Establish teams to target increased efficiency across people, process, and technology
- **Embrace a robust financial toolkit:** Create high-quality centralized data repositories and reporting capabilities to manage the business, assess profitability, and improve decision-making.
- **Drive financial accountability:** Incentivize employees to act as business owners and create a culture of financial responsibility and efficiency-driven mindset.

CONCLUSION

The decade following the GFC permanently rearranged the asset management industry's competitive landscape. A select group of firms demonstrated that acting boldly and decisively was a winning formula. But future success for these same firms is hardly a foregone conclusion—investors' needs change and their search for the best products, solutions,

and partners is constant. The firms that best execute on building visions with enduring competitive advantage, investing successfully in targeted growth areas, modernizing their operating models to deliver outstanding client experiences, and leveraging strong financial management disciplines will be the asset management industry's winners in the next decade.



TO THE POINT

2022 was a year of substantially down equity and bond markets, historic inflation, geopolitical instability, and recovery from a pandemic. Given this, a central question arises: As investors in the asset management industry rethink investment strategies and portfolios, how can asset managers overcome business challenges, maximize transformation opportunities, and reach financial success?



Infrastructure: an asset class for today's needs

NAVIGATING CHANGE WITH STRATEGIC INFRASTRUCTURE INVESTMENTS



DAVID NEAL
CHIEF EXECUTIVE
IFM INVESTORS

INTRODUCTION

To borrow from Ernest Hemingway when he described a character's misfortune as occurring "gradually, then suddenly," the current climate for infrastructure investing has similarly seen a slow buildup of nice-to-haves rapidly evolve into a series of non-negotiables.

Themes like climate change, the energy transition, technological change, and resilience to economic cycles were once considered useful and interesting and are now correctly recognized as fundamental drivers of investment outcomes. In this environment, the role of long-term investors, how they navigate and take advantage of these themes to continue delivering returns, becomes more important.

As a pioneer of open-ended funds and infrastructure investment, taking a long-term approach is core to IFM Investors' ethos. When we invest, we think in decades, not years. We were created by Australian superannuation funds to meet their long-term investment needs, with a clear purpose: to invest, protect and grow the retirement savings of the millions of working people they represent.

By investing in infrastructure for the long-term on behalf of like-minded investors, we're giving their members — the nurses, teachers, construction, and hospitality workers — the opportunity to invest as though they are millionaires and billionaires.

In doing so, we take an unflinching, prudent, and long-term view of investment portfolios in the pursuit of maximizing their retirement savings, so they can look forward to a retirement where presents for the grandkids, dining out and holidays are not unreachable.

Question 1: Australia is seen as a leading infrastructure investor. What has driven investment in this area?

Australia's reputation as a leading infrastructure investor can be attributed to several key factors that have driven investment in this sector. These factors include:

- **Major economic reforms:** through the 1980s-1990s under the Hawke-Keating Labor governments there was a focus on increasing efficiency in government. This led to the privatization of large federal and state government-owned assets across multiple sub-sectors, including banks, airlines, airports, telecommunications, and power utilities.
- **Multi-decade economic growth:** Australia has experienced more than two decades of strong and resilient economic growth and its recent economic strength has been supported by its proximity to Asia Pacific markets, particularly in China. Along with economic growth, the country's growing population and urbanization has created significant demand for various infrastructure projects.
- **Stable political and regulatory environment:** Australia's economic fundamentals, stable political and legal system and positive policy settings have made it an attractive destination for both investors.
- **Accommodating foreign investment regime:** Australia operates a foreign investment regime which is open, transparent, and welcoming of inbound investment.
- **A progressive public/private partnership model:** To finance and develop projects, Australian governments (both state and federal) have partnered effectively with the private sector, including industry superannuation funds. This approach allowed for risk sharing, leveraging the private sector's expertise, and has attracted significant investment into infrastructure. Australian governments have actively encouraged infrastructure investment through policy measures, incentives, and commitments to develop critical infrastructure.
- **Robust secondary market and development of infrastructure as an asset class:** Australia has also developed a robust secondary infrastructure market, primarily driven by the public-to-private sale of infrastructure by federal and state governments looking to rationalize government balance sheets and improve efficiency of service delivery. The Australian financial sector (with early entrants in this market, such as IFM) has successfully developed a deep set of expertise in owning and investing in infrastructure assets. This led to the establishment of infrastructure as an asset class.
- **The impact of the domestic superannuation sector:** It's important to consider the significant role that the Australian industry superannuation funds play in driving infrastructure investment in the country. Their size, stability, and commitment to achieving stable long-term returns position them as substantial investors in the infrastructure investment landscape. These funds not





only provide a stable capital source but also contribute to developing and maintaining critical infrastructure assets, benefiting both the funds' members and the broader Australian economy. It also plays a key role in the industry super funds surpassing the performance of their domestic peers.

Question 2: Tell us about IFM and how you have grown. What has been the secret of your success?

IFM Investors is a global investment manager owned by Australian superannuation funds, with a history dating back over 30 years. In 1990, a group of Australian funds came together to develop what was then called "Development Fund Australia." Their goal was to invest in infrastructure and other growing companies in Australia, pooling resources to make long-term investments.

The aim was to give their members — the nurses, the teachers, the construction, and hospitality workers — the opportunity to invest as if they were millionaires or billionaires. This ownership and sense of purpose has set IFM apart and has been key to our success.

This is so important because it means the value proposition to our owners goes beyond generating a stream of dividends. Instead, the focus is on delivering exceptional long-term investment outcomes for them. This simple alignment equation ensures our daily business operations are geared toward managing all aspects to achieve excellent long-term outcomes. Most importantly, we pursue these excellent long-term outcomes with the culture, values, sense of purpose and responsibility expected of a business

founded and owned by long term investors.

Across our team, we talk about how important it is for us all to come to work every day remembering that it's not our money we manage; it's often the money of an individual worker saving for a particular purpose, such as a dignified retirement. Reflecting on these principles, IFM Investors today has grown significantly, managing A\$215 billion in funds as of 30 June 2023, on behalf of 626 like-minded institutions worldwide.

We invest across four asset classes, including infrastructure, debt investments, private equity, and listed equities. Proudly, we stand as one of the largest listed equity shops in Australia. We have also grown to become one of the largest infrastructure managers in the world, with well-established portfolios across both infrastructure equity and debt that span core infrastructure, such as airports, seaports, utilities, toll roads, renewable energy, and digital technology.

We continue to grow and are evolving from an Australian business with global ambitions to a global business with a proud Australian heritage. When you're investing and owning complex assets for the long term, local presence becomes incredibly important. Therefore, we have 12 offices around the world, with a large presence in London and New York. Our footprint extends to major Asian cities, such as Seoul, Tokyo and Hong Kong. The intensity of our effort working with the management teams on our assets is important not only for existing assets but for originating new investments.

Question 3: When you consider assets and markets to invest in – what considerations do you make?

Our investment strategy centers on building robust portfolios that will deliver long-term returns to our investors. This involves identifying and acquiring core infrastructure assets, distinguished by their strong market positions and high barriers to entry. We seek assets with long concession life, inherent inflation protection, the ability to benefit from economic growth, and a history of stable and predictable revenues. We also focus on investing in countries with established regulatory environments and strong rule-of-law. Before any new country entry, we undertake extensive risk analysis and implement continuous monitoring programs for ongoing assessment of country risk.

Our strategy also closely aligns with the open-ended structure of our funds, and we actively seek opportunities to establish platforms that enable us to unlock synergies and pursue value-accretive bolt-on acquisitions. This approach, characterized by a focus on long-term value creation without imposing artificial exit timeframes, allows us to capitalize on strategic opportunities, ultimately enhancing the overall performance of our assets.

We also use a proprietary risk management and portfolio construction framework called InFRAMETM to guide the decision-making process in constructing a balanced core infrastructure portfolio. InFRAMETM analyses the underlying revenue streams that drive the performance of portfolio assets. It enables us to gain a deeper understanding

of the revenue drivers and risks that the assets are exposed to and build quantitative insights into the way assets and sub-sectors respond to macro-economic drivers and scenarios.

Question 4: How do you think investment managers can help with global energy transition?

When examining the world's current and most influential secular trends, it becomes clear that the energy transition is a focal point requiring our attention and proactive execution. We do this with a clear-eyed focus on achieving strong risk-adjusted returns for our clients and their millions of beneficiaries.

While energy security has posed a short-term challenge

in recent years, it has also crystalized longer-term, systematic risks and an understanding that healthy long-term investment returns are dependent on healthy environmental and social systems, now and in the future.

In other words, the quality of investment returns in ten-and-twenty years' time, depends on the quality of the system in ten-and-twenty years' time. It is in this context that we need to consider the role of institutional investors and how they can collaborate to address systemic risks and the global transition to clean energy.

This means that alongside individual investments in the energy transition, long-term investors, such as pension funds should also address challenges at the systemic level. At the asset

or investment manager level, investment managers can take two approaches. The first one involves taking and transitioning old assets. At IFM, we explore every way to reduce emissions from our existing assets, committing capital and supporting their reduction strategies.

Alongside investing in existing assets, we need to build the infrastructure essential for a net-zero world. This involves investing in renewable generation and updating the grid needs to accommodate the electrification of everything. It also includes thinking about the infrastructure that supports new fuels like hydrogen, biofuels and the necessities for carbon capture.

This presents significant opportunities in both infrastructure equity



and debt. For example, we anticipate attractive relative value opportunities in sub-investment grade infrastructure debt. This includes originating opportunities in a broad range of sectors, such as the energy transition, the electrification of transport, energy efficiency and environmental management. At a system-wide level, governments and pension capital need to continue driving collaboration and taking a system wide approach to help deliver on the energy transition.

CONCLUSION

Climate change, the energy transition, technological change, and resilience to economic cycles are prominent concerns for investors.

As they consider asset allocation in response to these themes, infrastructure presents an opportunity to invest in long-term, resilient assets crucial to daily life. For asset allocators, its strategic importance lies in its resilience through economic cycles and its effectiveness as an inflation hedge.

We believe the infrastructure asset class can serve as a foundation portfolio asset class aimed at securing diversified, less volatile, low correlation long-term returns. In addition to its defensive and diversifying characteristics, infrastructure boasts a strong growth momentum.

There are meaningful macro trends that contribute to this momentum, such as

ageing and underinvested infrastructure in the developed world, a need for a significant ramp-up in emerging markets infrastructure, and the unprecedented scale of the energy transition requiring a huge amount of capital.

These trends have the potential to generate an extraordinary supply of deal flow in the next decade or two. This unfolds against the backdrop of fiscally strapped governments right across the globe, with government's actively seeking partnerships to help drive capital into core infrastructure.

These tailwinds represent an incredible opportunity for institutional investors, and the millions of people they invest on behalf of.

TO THE POINT

- Long-term investors need to be concerned with systematic risks in the economy to help protect long-term returns.
- The energy transition will require a tremendous amount of capital, generating significant deal flow.
- The role of infrastructure in portfolios has never been stronger as it continues to be resilient in the face of economic challenges.



Navigating the landscape of impact investing

IMPACT INVESTING SERIES



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INTRODUCTION

Investors are increasingly putting Sustainability at the top of their agenda and recognising that factoring in environmental, social and governance (ESG) considerations can help mitigate investment risks and support companies actively driving sustainable transformations. Many investors have already adopted a range of strategies from excluding high risk companies or tilting portfolios toward companies that score better on ESG metrics. Some investors are now exploring opportunities beyond ESG and turning their attention to the real-world impact of their investments to address challenges in areas ranging from climate to inequality and healthcare.

In this first article of a series on impact investing we look at the fundamental difference between ESG and impact, the recognised standards in the field, and emerging regulations in Europe.

What exactly is impact investing?

The world needs companies that can drive positive change at scale through innovative products, services and business models. Impact investing can spur the growth of such companies and help advance solutions to address the social and environmental challenges the world faces today.

Impact investing has been defined by the Global Impact Investing Network (GIIN) as “investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return”. To complement this definition, the GIIN’s developed four Core Characteristics of Impact Investing to outline what constitutes credible impact investing:



Intentionality

Investors intentionally contribute to positive social and environmental impact through investment alongside a financial return. This includes:

- Setting transparent financial and impact goals
- Articulating an investment thesis that is explicit about these goals and the strategies used to realize them



Impact Measurement

Investors use research-based evidence and data to inform and quantify the impact of investment decisions. This includes:

- Setting targets about an investment’s contribution to impact
- Identifying indicators to gauge performance against targets



Impact Management

Investors use impact performance data in decision-making to manage investments towards achievement of social and environmental objectives. This includes:

- Identifying risks to achieving the stated impact goals
- Disclosing actual impact performance to investors and investees



Collaboration

Investors take action to enable more investors to make impact investments effectively. This includes:

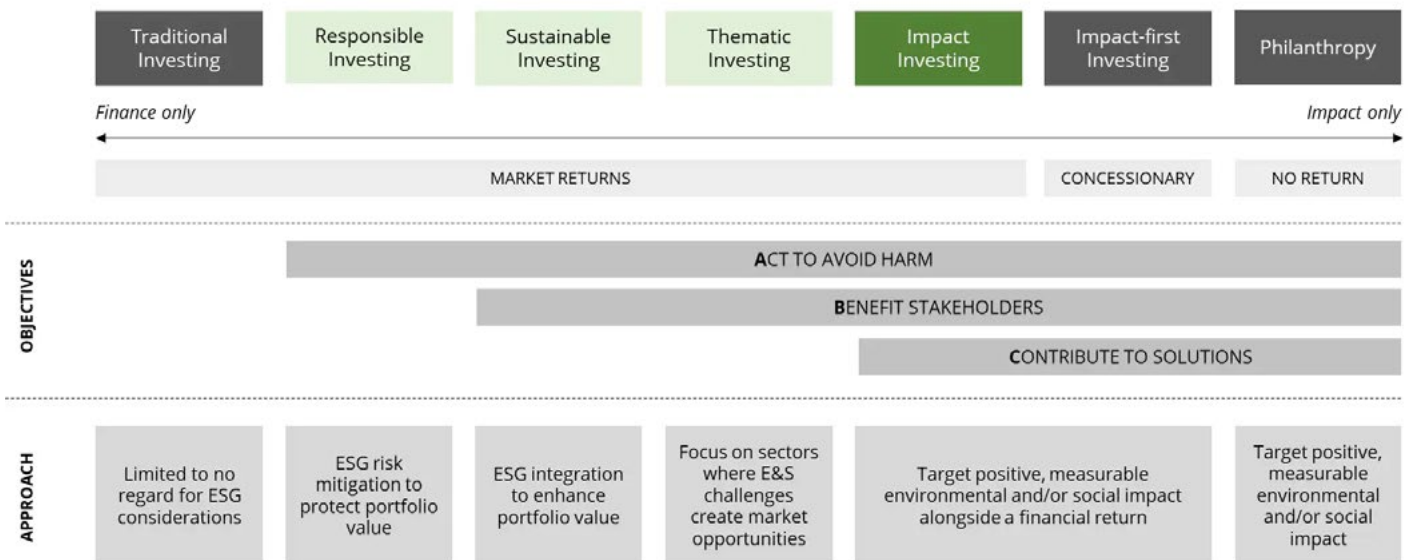
- Committing to using shared approaches, and standards for describing impact goals, strategies, and performance

Building upon these core characteristics, other initiatives have emerged to provide clear reference points and help investors understand the essential elements of impact investing.

Where does impact investing stand on the investment spectrum?

From an investor’s perspective, sustainable and impact-oriented investments embrace a broad range of strategies, from responsible investing to philanthropy.

- Responsible & Sustainable Investing: Investors evaluate how companies manage risks and opportunities around sustainability issues. ESG factors set the minimum threshold for responsible and sustainable businesses.
- Thematic investing: Investors focus on specific themes or trends where environmental and social challenges create new market opportunities. Thematic investors seek out companies that are well-positioned to benefit from these trends, with the goal of generating returns from the growth of these companies.
- Impact investing: Investors go beyond ESG and a thematic approach. They set measurable



Source: Based on the Impact Management Project, CIIP and adapted by Deloitte

environmental or social goals and seek to achieve them with their capital via the projects or companies they invest in.

What are the main differences between ESG and impact investing?

- **Public vs. private market:**

As ESG investing relies on ESG data that are mainly available for publicly listed companies, ESG approaches are more common in the public market. On the other hand, impact investing has traditionally been focused on private investment markets. This is largely because these asset classes allow investors to directly fund and support the growth and development of impact-driven companies and therefore gain a clear understanding of their contribution to the overall impact being generated.

- **ESG vs. impact evaluation:**

While sustainable investing aims to screen companies based on their ability to manage ESG issues or risks, impact investing seeks to select companies based on their ability to deliver a specific environmental or social impact. ESG investors therefore rely on third party ESG data to categorise investments, while impact investors rely first on evidence-based research to map and assess the positive outcomes of an investment and then collect data to monitor impact performance.

- **Backward- vs. forward-looking approach:**

ESG ratings and data (provided by third party companies) aim to reflect the ESG performance of companies based on their annual sustainability reports – therefore their past performance and progress to date. Measuring impact in the investment process, on the other hand, requires investors to quantify the impact that a company in which it invests can generate.

What are the relevant industry standards for impact investing?

Despite the increased interest in and number of product launches claiming to be impact investments, there has been little alignment on how to manage investments for impact and the systems needed to support this. This has created complexity and confusion, as well as a lack of clear distinction between impact investing and other forms of sustainable investing approaches.

Since 2019, **industry standards** have emerged providing clarifications for what constitutes an impact investment, helping to mitigate the risks of “impact-washing.”

- The International Finance Corporation (IFC) has developed the **“Operating Principles for Impact Management (OPIM)”**.

These principles establish a common discipline and market consensus around the management of investments for impact. There were 58 founding signatories in 2019. Since then, the number has nearly tripled to 163, spanning 38 countries and representing \$470 billion in impact assets by year end. The OPIM provides a reference point against which the impact management systems of funds and institutions may be assessed. OPIM also promotes transparency and credibility by requiring annual disclosures of impact management processes, with periodic independent verification.

- In France, the Institut de la Finance Durable (IFD, formerly known as Finance for Tomorrow) developed an **Impact Charter**¹ to promote transparent impact finance and harmonise practices. The impact charter is built upon the key principles of intentionality, additionality,

1. Impact Charter, IFD: F4T_Investor-impact-charter_december-2022.pdf (institutdelafinancedurable.com)

and impact measurement, and defines a common framework for all asset classes, existing funds or new funds that wish to be designated as “impact funds”. Based on these principles, an evaluation grid² has been developed to assess the potential contribution of a fund to sustainable transformation. It is important to note that all funds to which this charter applies will endeavour to be classified as Article 9 within the meaning of the SFDR (unless the investor can provide a valid justification – for example,

when investing in companies considered to have significant negative environmental or social impacts with clear measurable objectives to support and track their transformation).

- The **Sustainable Development Goals (SDG) impact standards** are another voluntary internal management standard designed to help investors embed SDGs into their management systems and make high-level impact management principles actionable and guide the choice of

which methodologies and tools should be used to appropriately measure and manage SDG impact.

Can we consider Article 9 SFDR funds impact funds?

An Article 9 fund is not an impact fund by default; it is defined by the Sustainable Finance Disclosure Regulation (SFDR) as having a sustainable investment as its primary objective. A sustainable investment needs to satisfy three criteria:

1. contribute to an environmental or social objective.
2. do no significant harm (DNSH) to any of those objectives,
3. follow good governance practices

As these funds are considered the “greenest” funds in the marketplace, they are often assumed to be impact funds. The confusion may also stem from the SFDR text itself as Article 9 funds are referred to as financial vehicles which have as their objective “a positive environmental or social impact”³.



2. Assessment grid, IFD: [F4T_Fund-impact-assessment-grid_december-2022.xlsx \(live.com\)](#)

3. REGULATION (EU) 2019/2088 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 27 November 2019 on sustainability-related disclosures in the financial services sector (Text with EEA relevance)

However, the SFDR requirements for Article 9 funds do not fully align with the core characteristics of impact investing from the GIIN. Above all, SFDR does not fully distinguish between the sustainability impact of the company in which the fund has invested ('buying' impact) and the investor's positive influence on that impact ('creating' impact / impact management). In addition, SFDR introduced concepts such as DNSH analysis and principle adverse impacts monitoring without addressing investors' core investment and process duties to generate a positive impact.

Will regulators step up scrutiny of 'impact-washing'?

The practice of making misleading impact claims (so-called "impact washing") carries increasing risks.

In a sign that regulators are taking the problem seriously, the three European Supervisory Authorities (ESAs) launched a Call for Evidence on greenwashing⁴ which questions, among other issues, the risk of impact washing. Early June, the ESAs published their Progress reports⁵ in response to this consultation. In particular, the European Securities and Markets Authority (ESMA) has been assessing which areas of the sustainable investment value chain (SIVC) are more exposed to greenwashing risks – with key focus on misleading claims related to impact:

- Misleading claims about real-world impact relate

to product-level claims (in relation to investment funds, ESG securities or benchmarks) as well as to entity-level claims (applicable to issuers, asset managers and investment service providers)

- Some of the most frequent misleading claims relate to exaggeration based on an unproven causal link between an ESG metric and real-world impact. These often consist of implying that ESG metrics mean more than what they do.
- In most situations impact claims often would lack clarity of what impact is expected (what type of positive environmental or social outcomes) and how it is considered (which part of the investment process or portfolio construction for funds).
- Impact claims also often lack essential information about the main aspects of any impact framework which are intentionality, additionality, and impact measurement
- Impact claims can also stem from a confusion about the impact strategy whether 'buying impact' (investing in impact companies) or 'creating impact' (such as buying "brown" transitioning companies and turning them "green")

ESAs' final reports on greenwashing will be published in May 2024 and will consider final recommendations, including on possible changes to the EU regulatory framework.

In November 2022, ESMA also published a consultation paper on guidelines in relation to funds' names using the word "impact" or "impact investing"⁶.

4. ESAs Call for evidence on Greenwashing (europa.eu)

5. ESMA progress report: ESMA30-1668416927-2498 Progress Report on Greenwashing (europa.eu)

EBA progress report: EBA progress report on greenwashing.pdf (europa.eu)

EIOPA progress report: Advice to the European Commission on Greenwashing – (europa.eu)

6. Guidelines on funds' names using ESG or sustainability-related terms (europa.eu)





In the UK the Financial Conduct Authority (FCA) will introduce in Q3 2023 a package of measures aimed at clamping down on greenwashing. This includes sustainable investment labels, disclosure requirements and restrictions on the use of sustainability-related terms in product naming and marketing. A new sustainable investment labelling regime for investment products will be implemented with three labels: “Sustainable Focus”, “Sustainable Improvers” and “Sustainable Impact”. Products with sustainable impact “will have an objective to achieve a pre-defined, positive, and measurable environmental and/or social impact”, alongside a “financial risk/return objective”⁷.

In the U.S. the SEC is similarly working on rules for greater clarity⁸. It has proposed ESG Fund definitions and distinguished between ESG integration, ESG-focused and ESG Impact funds⁹.

There is currently little clarity on the extent to which firms are making exaggerated or misleading sustainability-related claims about their investment products. A recent study from Novethic (published in December 2022) has however analysed nearly 200 Article 9 French funds and warned that a large majority of investors currently using the term “impact” or publishing an “impact report” do not meet the key characteristics of impact investing¹⁰.

CONCLUSION

As investors are turning their attention to impact investing, the need for a common language to combat the risk of impact washing is on the rise. The next articles in this series will look at the greatest challenges and best practices across different asset classes.

The impact investing landscape is complex, yet vital, to create measurable value for your stakeholders and build a more sustainable future. Deloitte can support your company in developing a comprehensive impact investing strategy which includes mitigating investment risk, identifying investment opportunities and accelerating your sustainable transformation. Contact us to discuss how we can help guide you and your company to drive both financial returns and positive social impact.

This article was written by Ophélie Peypoux, Director at Deloitte France specialising in investment management services and sustainable finance, and Isabelle Jeannequin Morin, Director at Deloitte Switzerland specialising in impact finance and sustainable development.

7. CP22/20 <https://www.fca.org.uk/publication/consultation/cp22-20.pdf>

8. Proposed rule: Investment Company Names (sec.gov)

9. Name That Boon: SEC Proposes Rules on ESG Fund Names & Disclosures (harvard.edu)

10. <https://www.novethic.fr/finance-durable/publications/etude/sfdr-les-debuts-poussifs-du-marche-des-fonds-article-9.html>

Understanding Outsourced CIO

A CALL FOR ENHANCED
OVERSIGHT AND
ACCOUNTABILITY



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INTRODUCTION

Global investment consultants have sought to diversify their businesses through the development of delegated consulting offerings. These delegated consulting offerings go by different names including implemented consulting, fiduciary management, and Outsourced CIO (OCIO) and are rising in popularity, especially amongst small to medium-sized institutional investors (<US\$1billion).

Under an OCIO arrangement, responsibility for setting investment objectives and strategic asset allocation (SAA) continue to rest with the institutional investor, albeit with reliance on advice from their OCIO. However, the OCIO also takes on responsibility for implementing the agreed SAA, often using their own range of multi-manager funds.

Many institutional investors have moved from traditional investment consulting arrangements to the OCIO model either for governance reasons (they may not feel equipped to make investment decisions) or to access, in the words of the OCIO, sophisticated investment portfolios at reduced investment management fees. The global OCIO industry nearly doubled between 2016 and 2021, from US\$1.3 trillion assets under management to more than US\$2.5 trillion.

In this article we will use our knowledge of the global delegated consulting industry, and experience reviewing OCIOs on behalf of existing and prospective clients, to explore the benefits and drawbacks of these OCIO arrangements in more detail.



Why choose OCIO?

As discussed in our introduction, OCIO arrangements are primarily targeted at small to medium-sized institutional investors across the full range of sectors, including pension schemes, insurers, endowments, charities and other “for-purpose” clients.

These investors are often sold on several claimed benefits of OCIO, specifically:

- **Governance:** The boards or committees responsible for the investor’s assets often don’t feel suitably knowledgeable or have

sufficient capacity to make informed and timely investment decisions.

- **Speed of execution:** OCIO’s can use their delegated authority to respond to investment market and investment manager developments in a more timely fashion.
- **Cost savings:** OCIOs commonly use their own suite of multi-manager funds, enabling them to combine investor commitments in a relatively small range of investment vehicles. This increased scale facilitates negotiations for reduced investment manager fees which can be passed onto their clients.

Testing the rationale

In our experience, does OCIO offer the promised ease of governance and cost savings?

The governance burden on the institutional investor may have decreased given that boards and investment committees are no longer required to review and select multiple investment managers. However, a more pertinent consideration is whether the investor’s governance requirements are reduced or merely shifted.

When appointing an OCIO, institutional investors are reliant on their investment strategy advice and are

delegating significant levels of investment decision-making to their OCIO covering areas, such as dynamic asset allocation, investment manager selection, portfolio construction, risk management and monitoring. To ensure accountability, OCIOs should undergo monitoring proportional to the breadth of their delegated powers.

On potential cost saving, while the increased scale of the OCIO model can create savings, investment decisions made by the OCIO can also add cost. For example, we have observed that the belief among many OCIOs in the superiority of active management can result in higher fees paid to underlying investment

managers. It is also important to note that the appointment of an OCIO introduces an additional layer of fees. Consequently, the institutional investor should primarily consider the total fees payable to implement their chosen investment strategy.

Recognizing OCIOs as delegated investment managers

OCIOs are providers of whole-of-portfolio investment management solutions, not dissimilar to individual investment managers offering multi-asset funds. However, in our experience, OCIOs are not always subject to the same level of scrutiny as specialist investment managers. Specific areas of focus should include the following:

Enhancing reporting

OCIOs typically invest their clients' assets in multi-manager funds marketed as sophisticated investment solutions. The inherent complexity of these solutions and the prevalence of active management creates a barrier to transparency and increases the importance of effective monitoring. However, in our experience, investment reporting often lacks detailed insights into the return and risk impact of investment decisions made by the OCIO, such as short-term asset allocation tilts or investment manager selection decisions.

Portfolio construction

The OCIO's ability to select and combine externally managed investment mandates is key to future performance outcomes. Our observations

note that many OCIOs can often lag their peers within investment management when it comes to portfolio management tools and investment risk management systems and processes. This may be a consequence of the traditional investment consulting origins of many of these providers. However, with the increasing popularity of OCIO models, a lack of investment in appropriate portfolio management tools is probably the primary obstacle to quality portfolio construction processes with additional challenges owing to the operational complexities of a multi-manager approach.

Fund range

Investment strategy is widely considered to be the primary driver of investment outcomes. The investment strategy advice provided by the OCIO can be often constrained by their own range of multi-manager funds. In a recent case, a global OCIO lacked passive investment options due to its belief in the benefits of active management, while many OCIOs do not offer a full suite of diversified private markets building blocks. While OCIOs can generally complement their diversified multi-manager asset class building blocks with externally managed funds, this dilutes their purported benefits of scale (access to a diversified pool of assets at a competitive fee). OCIOs, through their fund range, should ensure that investors have access to a suitably comprehensive range of asset class building blocks.

Cost transparency

There is a significant lack of transparency when it comes to the fees charged by OCIOs via their range of multi-manager funds. The OCIO will be charging a basis point fee in addition to underlying external

investment management fees but there is no obligation to disclose their charges. This makes it difficult to assess the impact of the OCIO's scale on investment management fees.

What steps should institutional investors take when considering or having already appointed an OCIO?

For those considering OCIO

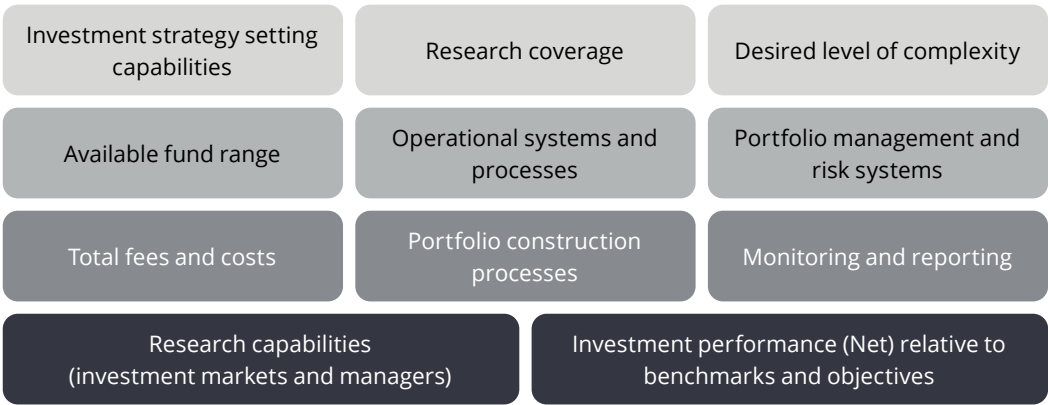
OCIO may be the right solution for some but less optimal for others. The decision to transition to OCIO represents a significant investment choice with implications for the future performance of the entirety of the investor's assets. If the OCIO underperforms, transferring the entire portfolio to a new provider is likely to result in significant transition costs for the investor.

It is therefore vitally important that the board or committee considering the move to OCIO undertakes a fair comparison with other potential approaches. This comparative analysis should be tailored to the requirements of the investor, but should certainly consider differences in:

- Governance requirements, including any required changes to the governance structure;
- How assets will be invested, including the flexibility of the investment structure; and
- Total investment related costs, including a potential allowance for future transition costs.

Navigating OCIO adoption

If the investor decides to adopt an OCIO approach, the focus shifts to selecting the best candidate for the role. The investor must recognize that they are appointing both an investment consultant to provide investment strategy advice, and an investment manager. Consequently, there are a wide range of key considerations including:



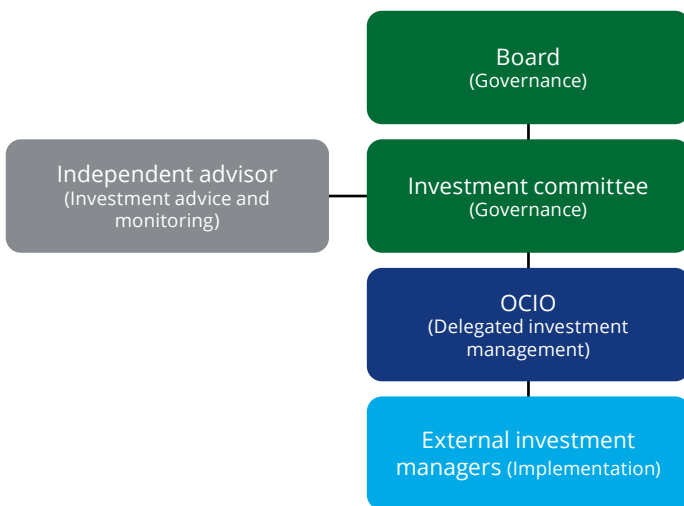
Similarly, the investor must ensure that there are clear and appropriate governance structures in place prior to the OCIO's appointment. We suggest that detailed investment reporting requirements be agreed in advance as part of the initial contract negotiations.

Optimizing OCIO engagement

If you have already appointed an OCIO, the first consideration should be to ensure that the

investor's board or committee feels suitably equipped to challenge their OCIO. If governance considerations were a key driver behind the initial decision to move to an OCIO model, the investor may conclude that additional external support in the form of an independent investment advisor is required to help in monitoring the appointed OCIO. The diagram below describes the ideal governance structure under an OCIO model, in our view.

OCIO governance structure



Providers of investment advisory and investment management services should be subject to periodic reviews. A detailed review of investment performance may be warranted to better understand the key drivers of recent investment performance

trends and the impact of the appointed OCIO's decision making. However, investment performance shouldn't be the primary consideration with the OCIO's core capabilities and costs ultimate determinants of past and future investment outcomes.

CONCLUSION

Like all investment advisory and investment management approaches, OCIO offers a series of potential benefits and potential drawbacks. While acknowledging its suitability for many, our experience highlights the need for increased scrutiny, both initially and on an ongoing basis. Once appointed, substantial reliance is placed on OCIOs, necessitating institutional investors to ensure not only their financial strength to fully research all asset classes, develop new and sufficiently diversified pooled vehicles and retain key personnel, but also their use of wide-ranging discretion to ultimately improve investment outcomes. In our view, external independent specialists providing informed insights promotes greater accountability, and should ultimately improve the generally quality of the OCIO industry.



TO THE POINT

- Outsourced CIO (OCIO) represents a form of delegated consulting where the appointed OCIO provides both investment strategy advice and investment management services.
- Small to medium-sized institutional investors have adopted an OCIO model to reduce the governance burden and investment costs.
- OCIOs require greater scrutiny due to the delegated decision making and limited cost transparency.
- Boards and investment committees should assess their OCIO; if challenging, appoint an independent investment advisor, to hold the OCIO to account and to a level commensurate with the breadth of their delegated powers.



A snapshot of the last Deloitte Private and ArtTactic Art & Finance Report

TWELVE YEARS OF ANALYSIS IN THE REARVIEW



**ADRIANO PICINATI
DI TORCELLO**

GLOBAL ART & FINANCE COORDINATOR,
DELOITTE PRIVATE
DELOITTE

INTRODUCTION

The 8th edition of the Deloitte Private and ArtTactic Art & Finance Report brings our readers directly to the intersection of culture and capital. Spanning 438 pages and featuring 54 leading experts who contributed to 31 articles, plus survey results from more than 435 art and finance stakeholders (ranging from art professionals, family offices, wealth managers, to collectors and representing locales across the world), readers will find new insights on a wide range of initiatives and models that tackle the opportunities and challenges facing the art market and the wealth management industry over the next decade. The report also includes a 12-year retrospective look at how the industry has changed.

It is clear that – despite continued challenges concerning transparency, regulations and the need for modernization of existing art business practices – the art and finance industry continues to innovate and evolve. It is well-positioned to reap the benefits of the global wealth transfer over the coming decades and a finance industry increasingly oriented to holistic wealth management. Read on to discover the key findings of the 2023 report and five conclusions to take into advisement.

Thanks to [Jonathan Prince](#) for elevating our report with his artworks.

2023 Key Report Findings

Globally, ultra-high-net-worth individuals' (UHNWIs)' art and collectible wealth is estimated to exceed US\$2 trillion.

We estimate that UHNWIs' wealth associated with art and collectibles was US\$2.174 trillion in 2022 and predict this figure could grow to an estimated US\$2.861 trillion in 2026, due to the increased number of UHNWIs across the world and their increased allocation of wealth to art and collectibles.

Luxury collectible sales reached new heights in 2022 and could signal new opportunities for the art and finance industry.

The growth potential of the luxury collectibles market is evident in the surge of auction sales over the last two years, reaching a record high in 2022. We expect to see growing interest in the financialization of luxury collectibles and potential to tap into the much broader and larger luxury goods industry.

Of the stakeholders surveyed from wealth managers and collectors to art professionals, 89% believe art and collectible wealth should be part of a wealth management offering. This marks the highest percentage recorded in the Art & Finance Report's history.

The need to develop a holistic advisory relationship with clients was one of the primary

reasons for including art and collectibles into wealth management offerings. This underscores the rising demand for holistic wealth reporting and the crucial adaptation needed to provide clients with a comprehensive outlook of their art and collectible portfolios. Already, 63% of wealth managers have begun integrating art into their wealth management offerings.

A significant share of wealth is associated with art and collectibles, as revealed by family offices reporting an average allocation of 13.4% to art and collectibles (compared to 8.6% for Private banks).

While only 53% of private banks reported that their clients expect them to consolidate art and collectible wealth into their overall reporting (down from 73% in 2021), family offices tell a different story, with 61% indicating that their clients had similar expectations (up from 44% in 2021). More than one-fifth of family offices (22%) see a robust appetite for art investment services, which include art funds, managed accounts, impact investment, fractional investment, and more.

There is a shift toward the underlying economics of art ownership.

Emotional value remains the key driver for buying art (according to 60% of collectors), but for the first time in 12 years, 41% of collectors said financial value is their primary

motivation, overthrowing social value (at 36%) as the second highest motivation.

The younger generation of collectors prioritize financial gain and social impact.

NextGen collectors (35 and under) are more open to new art investment models, with a growing interest in art investment funds and fractional ownership, in which the cost of an asset is split between individuals. They're also making their preference clear with 41% showing interest in social impact investments and seeking purpose-driven strategies (up from 31% in 2021). They are also driven by digital advancements and an innovative approach. These collectors are not just enthusiasts, but strategic investors reshaping the market.

Art-focused estate planning is urgently needed.

Only 24% of the surveyed collectors have a long-term plan for their collections, indicating the urgency for wealth managers to have conversations with their clients about art and estate planning. So, how can wealth managers address the challenges of intergenerational wealth transfer? They should start conversations on art and estate planning with their clients without delay. Notably, 60% of family offices possess detailed knowledge of their clients' art collections for estate planning purposes, compared to 31% of private banks.

The art-secured lending market could reach a market size between US\$29 billion and US\$ 34.1 billion by the end of 2023. Continued growth of 8% is expected in 2024.

Art-secured lending is on the rise despite higher interest rates, with the market expected to grow by 11% in 2023. In uncertain times, liquidity is driving this growth: 80% of private banks and 83% of asset-based lenders identify it as a key factor. The art-secured lending market has gone global, with Asia — especially Hong Kong — and Europe emerging as strategic markets for expansion. In fact, 39% of art-secured lenders regard Asia as a strategic market for growth, a significant increase from 10% in 2021, while 78% see Europe as an untapped opportunity.

Sustainable impact investment in art and culture could become a more attractive investment model, especially for the younger generation.

The 2023 G20 summit in India underscored how cultural and creative sectors are key drivers of sustainable socioeconomic recovery, contributing significantly to global economic growth. Our latest report highlights a growing interest among younger generations in sustainable impact investments within the arts and culture sector. This shift is not just driven by a passion for the arts; it's a strategic financial move. In fact, 66% of collectors under 35 and 31% of family offices

express a strong interest for socially responsible investment in culture. In response, wealth managers and family offices are expanding their sustainable investment offerings to attract and engage younger clients. The question that arises is whether they could embrace social impact investment products in culture.

In the intersection of art and finance, technological innovation is driving sectors closer together.

Witnessing this revolution, wealth managers identify blockchain (58%) and big data analytics (48%) as pivotal to the future of art and wealth services. While only 18% of wealth managers considered blockchain technology impactful in 2019, the majority (58%) now agree. Leading this shift in mindset are the NextGen (collectors under 35). 80% trust blockchain for art and collectibles asset registration, and 79% endorse the rapid development of artwork identification technologies to address current inefficiencies. Additionally, younger collectors express growing enthusiasm for fractional ownership (+7% over two years, reaching 50%). As new platforms emerge, NextGen collectors will have greater opportunity to participate without possessing physical ownership. **81% of wealth managers, 79% of collectors, and 83% of art professionals acknowledge that technology could catalyze transparency in the art market.**

There is an urgent need for modernization of business practices.

In 2023, a significant 76% of wealth managers, alongside 70% of collectors and 82% of art professionals, called for the modernization of business practices. Strengthening trust and transparency in the art market requires careful consideration of regulations. 50% of art professionals believe that regulation could play a crucial role in restoring trust. But, the debate remains: should it be through self-governance or increased government regulation? Opinions diverge, with 44% of wealth managers leaning toward governmental oversight, while 70% of family offices favor self-regulation. Notably, an increasing number of art professionals (50%, a record high) now perceive regulation as a potential tool for rebuilding trust. Perhaps a hybrid approach could be the solution.

CONCLUSION

Since the first Art & Finance Report issued in December 2011, our understanding of the role that art and collectibles can play in the wealth management sector has evolved. After 12 years and 8 reports, we can conclude that:

Fine art and collectibles are unique assets with specific attributes that elicit and cover a range of motivations. This special asset class offers great opportunities for wealth managers to connect with their clients and create a unique relationship based on emotion and purpose, and also on financial considerations.

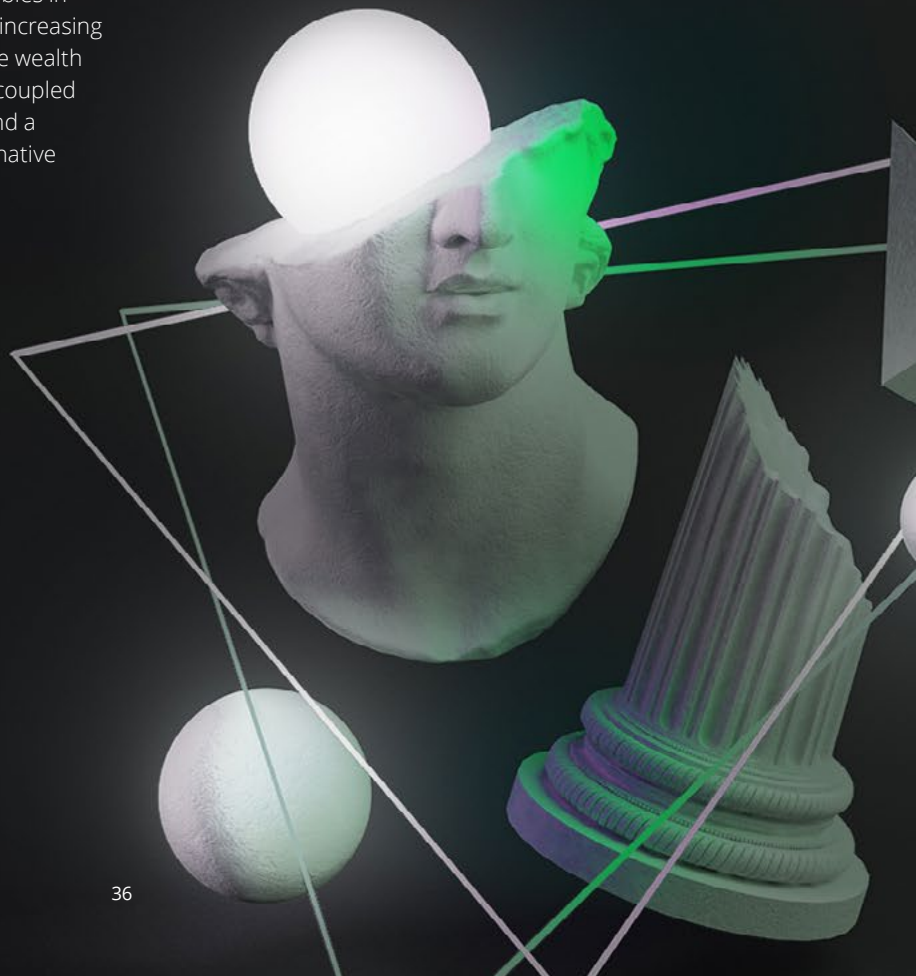
Fine art and collectibles assets are normally poorly addressed, despite representing a sizeable portion of the wealth of HNWIs, especially that of HNWIs collectors. However, in a holistic wealth management service offering, there is a fiduciary responsibility to address this through services that cover wealth protection, monetization, wealth transfer and investment.

It is challenging to incorporate fine art and collectible assets in a wealth management service offering. This is because the benefit of these services is often indirect and hard to measure. Other factors, such as low levels of market transparency and lack of standards and regulation in the art market are hurdles that need to be addressed.

Several trends are slowly, but surely, driving family offices and wealth managers servicing UHNWIs to consider how to incorporate clients' collections and passions into their service offerings for UHNWIs. These include technological developments, increased awareness of the role of art and collectibles in wealth management, increasing competition within the wealth management sector, coupled with client demand and a rising interest in alternative investments.

We see positive signs for the future potential of the art and finance industry. The need to modernize existing business practices to increase trust and transparency in the art market is recognized. Wealth managers see the adjustments required to meet the expectations of a new generation of collectors. Increased emphasis on purpose and social impact investment and growing recognition of the role that culture plays in society could create new opportunities. And the expansion of art and finance to include luxury assets, and even the development of fractional ownership, may evolve how we conceive of this dynamic industry

To further explore the Deloitte Private and ArtTactic Art & Finance Report, and the link between the art market and the wealth management industry, [visit the full report.](#)



TO THE POINT

- Globally, ultra-high-net-worth individuals' (UHNWIs') art and collectible wealth estimated to exceed US\$2 trillion.
- Luxury collectible sales reached new heights in 2022 and could signal new opportunities for the art and finance industry.
- Of the stakeholders surveyed from wealth managers and collectors to art professionals, 89% believe art and collectible wealth should be part of a wealth management offering.
- A significant share of wealth is associated with art and collectibles.
- The younger generation of collectors (35 and under) prioritize financial gain and social impact.
- Art-focused estate planning is urgently needed. The art-secured lending market could reach a market size between US\$29 billion and US\$34.1 billion by the end of 2023.
- Sustainable impact investment in art and culture could become a more attractive model, especially for the younger generation.
- In the intersection of art and finance, technological innovation is driving sectors closer together.
- There is an urgent need for the modernization of business practices.



AML/CTF focal points for the investment fund sector in 2024

RECAP, FORECAST AND CONSIDERATIONS



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How can professionals navigate forthcoming challenges successfully?

This article summarizes the Commission de Surveillance du Secteur Financier's (CSSF) **most recent observations** in the field of Anti-Money Laundering and Counter-Terrorism Financing (AML/CTF), **potential forthcoming focal points**, and steps that professionals could take to **mitigate the risk of non-compliance**.

The CSSF's Annual Report 2022 was published on 25 August 2023 and is the leading source for gaining an overview of recent observations. While its results can help to identify future trends and concerns, they are not the only source for predicting the authority's forthcoming focal points for 2024.

Amongst international efforts to combat money laundering and terrorism financing (ML/TF), the CSSF also considers the Financial Action Task Force's (FATF) mutual evaluation report on Luxembourg's AML/CTF framework, issued at the end of 2023. In addition, the 2022 recommendations in the CSSF's updated ML/TF Sub-sector Risk Assessment for the Collective Investment Sector (SSRA), as well as any information the regulator shares during conferences, serve as further indications for professionals to keep in mind.

Collectively, these sources offer valuable insights into the recent shortcomings concerning AML/CTF, allowing the industry to identify future focal points and ways to tackle various challenges.

Revisiting recent AML/CTF shortcomings

Investment fund professionals' primary way to identify any AML/CTF weaknesses is through the CSSF's annual reports, with the results of both on- and off-site inspections providing valuable insights. Subsequent conferences where the CSSF discussed observed shortcomings offer further background information and an understanding of the CSSF's approach.

Professionals not subject to an inspection during the last financial year(s) should not assume their AML/CTF framework is free of the report's identified weaknesses, especially as they provide a basis for the CSSF to further scrutinize these areas in future on-site inspections.

Therefore, despite the shortcomings being disclosed in August 2023, it remains crucial to provide a concise recap, enabling professionals to (internally) investigate their compliance. In summary, the CSSF's 2022 Annual Report identified the following shortcomings, categorized by topic, that are relevant for investment fund sector professionals:¹

- **Business-wide AML/CTF risk assessment:** professionals were called out for their weaknesses in properly assessing the AML/CTF risks they are exposed to, particularly in addressing the potential risks from their delegates.
- **Name-matching processes/tools:** professionals lack adequate controls to ensure their name-matching procedures and tools provide reliable outcomes. The deficiencies can manifest in various ways, and professionals

1. CSSF, *Annual Report 2022*, August 2023.

must acknowledge there is no tolerance for errors in this area (especially regarding targeted financial sanctions):

- Delayed update of considered official lists (e.g., restrictive measures);
- Non-performance of (or delayed) name-matching controls (including the ongoing name-matching process) over a certain period or in due time; and
- Absence of the compliance function's necessary control of alerts.

Beyond these shortcomings, the SSRA also highlights that the scope of **financial sanction screenings**, when outsourced to non-EU third parties, does not always include sanctions relevant to Luxembourg (EU sanctions lists).

- **Due diligence process:** for the second year running, the CSSF identified several weaknesses in professionals' due diligence processes. It is noteworthy that this topic has always been and will continue to be a significant focal point for the regulator:
 - Insufficient due diligence caused by incorrect AML/CTF risk assessments, including insufficient application of enhanced due diligence on intermediaries;
 - Delayed periodic review of high-risk business relationships;
 - Incomplete information (and supporting documentation collection, depending on the ML/TF risk classification) regarding the source of funds and origin of wealth; and
- Weaknesses regarding the AML/CTF risk analysis of an investment fund's assets, the performance of risk-based due diligence measures and sanctions screening.

- **Cooperation with the Financial Intelligence Unit (FIU):** despite professionals' awareness of the strict importance of reporting suspicious activities or transactions without delay—and the FIU frequently stressing this importance—it was identified that this is often not adhered to in practice.

Similar to previous annual reports, the identified shortcomings emphasize the importance of asset due diligence. Two additional observations indicate the CSSF's continued focus on this topic. First, our experience indicates that assistance is frequently sought for the

review, establishment, or advice on the due diligence process for assets (particularly unlisted assets). Second, the SSRA of May 2022 highlights the need for improved AML/CTF due diligence on assets.

Preparing for tomorrow—anticipating forthcoming areas of focus

Previous years' weaknesses are not short-term concerns and should be considered as ongoing focus areas. Professionals should remain

aware of these areas, as they may be subject to future inspections by supervisory authorities. This also includes thematic on-site inspections conducted on politically exposed persons (PEPs), the fight against corruption, and the adequacy of IT tools for ongoing business relationship monitoring.

Areas of great importance for upcoming inspections are those the regulator has consistently focused on in previous financial years (e.g., due diligence on delegates and assets), as this indicates that professionals are struggling to comply with the respective requirements.



While these shortcomings are a significant indicator of the regulator's AML/CTF expectations, international circumstances also act as a guidepost, particularly the FATF's evaluation of Luxembourg's measures to combat ML/TF. The FATF's identified weaknesses must be addressed by Luxembourg, requiring the supervisory authorities to implement relevant measures to remedy them.

Therefore, the following points must be considered when predicting future areas of concern of the CSSF and other relevant supervisory authorities (e.g., the Administration

de l'enregistrement, des domaines et de la TVA, which is scrutinizing vehicles under their supervision similarly to the CSSF):

- An increased focus on detecting ML, prosecutions and asset recovery. This could heighten attention on professionals' methods of identifying suspicious activities or transactions and reporting these to the respective authorities without delay. Professionals must keep in mind that investigations and subsequent prosecutions are only possible if they bring these matters to the authorities' attention.
- An enhancement of the supervision of non-profit organizations, including increasing the awareness of TF in this area. This could lead to an evaluation of implemented measures to ensure they are sufficient to detect terrorists/terrorist groups, etc.
- Risk-based supervision of non-financial sectors, such as trust and company services, real estate and notaries, as they are typically exposed to an increased ML risk. This implies that professionals in these sectors could potentially come under the respective supervisory authority's scrutiny.

To conclude, past regulatory observations and international evaluations guide the CSSF's future focus areas. The following table outlines these and relevant considerations.

Ongoing and potential future areas of focus ²	Points of consideration
<p>The CSSF's on-site inspections and the FATF's evaluation report both highlight the importance of adequate TF prevention. While the FATF recommended raising awareness of CTF's importance (especially regarding non-profit organizations), the CSSF criticized the appropriateness of the industry's sanction screening measures. In addition, the current geopolitical situation heightens this issue. As a multi-faceted topic, TF prevention cannot be addressed by a single, one-size-fits-all measure.</p> <p>A related topic is the importance of cooperating with the FIU and the Ministry of Finance. It has been continuously highlighted there is no room for error regarding correctly identifying and classifying (sanctions) hits, processing them adequately and, of course, reporting them without delay.</p>	<ul style="list-style-type: none"> • Professionals of the investment sector must assess how the current geopolitical situation impacts their business, investor base and asset portfolio, such as adjusting risk appetite statements, and defining mitigating measures and second level of defense controls. • Professionals must review and, if necessary, revamp their AML/CTF policies while stressing the importance of CTF in their annual (or ad-hoc) AML/CTF training. • Professionals must implement clearly described processes for initial and ongoing sanction-list name screening, such as responsibilities, tools, frequency, scope of sanction lists, alert handling, and the internal and external escalation path. This must include but not be limited to applying the four-eyes principle when encoding client information and controls of the completeness and correctness of the underlying sanction lists. • Professionals must ensure that their preventive measures in place are sufficient to deter the financing of weapons of mass destruction.
<p>Business-wide risk assessment (along with risk appetite) is considered a fundamental pillar of the industry's AML/CTF framework and must be continuously adapted to new circumstances. These can include internal changes, such as new products or delegates, or external changes, such as legislation, regulatory requirements or the geopolitical situation. The CSSF's demonstrated shortcomings and our experience from various engagements underscores this topic's importance.</p>	<ul style="list-style-type: none"> • Professionals of the investment sector must ensure their business-wide risk assessment follows a comprehensive structure (identification of the inherent risks, definition of mitigating measures, and conclusion of the residual risks).⁴ • Professionals must evaluate the risk from any type of delegate or intermediary. • Professionals must consider the 2020 National Risk Assessment⁵ and 2022 SSRA as a minimum for identifying risk exposure. These assessments must be aligned with the nature and activities of the business.
<p>Due diligence on and oversight of delegates are as equally important as due diligence on investors or other counterparties. The fact that the CSSF's annual reports have consistently highlighted shortcomings in this area since 2019 indicates the challenges professionals face.</p>	<ul style="list-style-type: none"> • Professionals must implement adequate AML/CTF procedures that cover the requirements for all their delegates. This includes not only the initial risk assessment and due diligence on delegates, but also the definition of the oversight framework applied on a risk-based approach. • Professionals should reassess and implement key risk indicators focused on AML/CTF, if they have not already done so. • Professionals must consider additional measures on a risk-based approach, such as on-site visits and sample checks.
<p>Due diligence on assets is still an area with room for interpretation, especially regarding unlisted assets. Each CSSF annual report since 2019 (apart from 2021) and the 2022 SSRA have referred to shortcomings in the adequate performance of asset due diligence, highlighting this area's relevance.</p>	<ul style="list-style-type: none"> • Professionals should actively exchange with other market participants to better understand market practices. • Professionals should assess the number and type of asset transactions to determine whether a manual risk assessment and due diligence process is suitable, or if an automated solution would be more efficient. • Professionals must remember sanction screening is mandatory, regardless of the assigned risk level. They must also adapt their screening procedures, particularly regarding the range of persons included in the screening process, as this may differ according to the asset type.

2. FATF, Anti-money laundering and counter-terrorist financing measures, Luxembourg, Mutual Evaluation Report, September 2023.

3. CSSF, ML/TF Sub-sector Risk Assessment Collective Investment Sector (Update 2022), May 2022.

4. CSSF, Circular CSSF 11/529: Risk analysis regarding the fight against money laundering and terrorist financing (AML/CTF), December 2011.

5. Ministry of Justice, National risk assessment of money laundering and terrorist financing, September 2020.

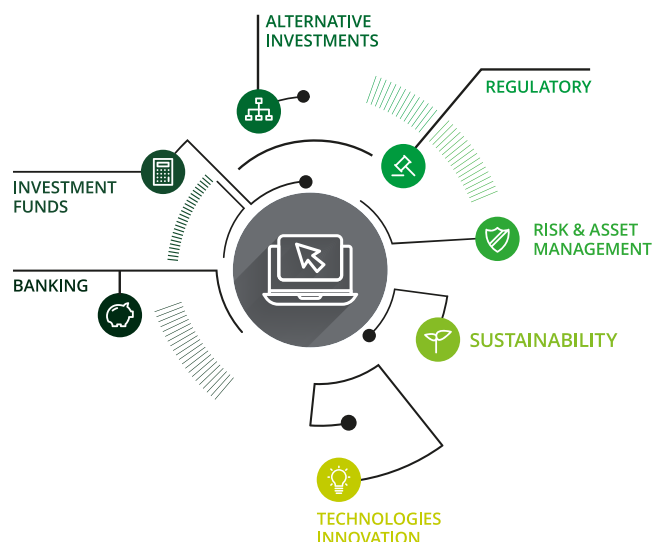
TO THE POINT

- While the results of the CSSF's latest on-site inspections are critical to predict the regulator's upcoming focus areas, the industry should also consider previous years' results, Luxembourg's FATF evaluation, and the CSSF's additional comments at conferences.
- Certain areas, such as adequate due diligence of counterparties (especially delegates and unlisted assets) and effective cooperation with the authorities (especially regarding sanctions), will always remain in focus.

While complying with AML/CTF legislation and regulations is seemingly straightforward, professionals must evaluate the effectiveness of any implementations to avoid pitfalls.

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