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 MESSAGE FROM AIMA’S CEO

Welcome to the 119th edition of the AIMA Journal – a collection of insightful commentary from our members on several key developments currently impacting the alternative investment industry. I would like to thank all the contributors for their time and effort.

Inside you will find analysis on a wide range of topics. These include ESG due diligence, the path of US monetary policy, what impact Brexit may have on the European asset management industry and the value that artificial intelligence can create for private clients.

The journal starts with an interesting piece of macroeconomic analysis from CME Group’s Chief Economist, who seeks to answer an important question on the minds of most asset managers: “Will the Fed cut rates in 2019?”

How sustainable finance and ESG are being implemented by fund managers are also covered. In an engaging article, Man Group discusses how discretionary portfolio managers can structure their strategies to account for climate change risks.

In the same vein, INDOS Financial Limited explores the key growth drivers supporting ESG investing, as well as some of the pitfalls that investors should avoid. Clifford Chance writes about consistency and harmonisation in global regulation governing the fast-growing sector of sustainable finance. Both IOSCO and ESMA are continuing to work on a regulatory framework to support the increasing demand for investment products structured around sustainable finance goals. Castle Hall Diligence provides some insightful commentary on the due diligence needed on ESG investing, capturing the essence of the process as “trust but verify”.

On the operational side, SS&C provide an excellent overview on the process of setting up an alternative fund in Europe. The article is a guide for US-based managers that want to domicile their product in Europe in order to attract capital from European investors. However, this is a market which is more stringently regulated than North America.

Oligo Swiss Fund Services looks at the process of distribution to investors in Switzerland, touching on the upcoming regulatory changes such as the Swiss Federal Financial Services Act (FinSA) and the Swiss Federal Financial Institutions Act (FinIA) – both of which will impact the distribution process.

Looking at the world from a geopolitical angle, asset managers must still consider Brexit. Maples Group offer their take on the impact the UK’s departure from the European Union may have on the asset management industry in Europe. The good news is that asset managers continue to prepare themselves for any event by developing robust contingency plans.

Finally, Leith Wheeler provides timely analysis on the impact that artificial intelligence technologies continue to have on the relationship between client and asset manager. Looking into the future, artificial intelligence is here to stay – but not without causing some industry disruption.

I hope you find this edition of the AIMA Journal interesting and I wish you all the best for the next quarter.

Jack Inglis
Chief Executive Officer, AIMA
All examples in this report are hypothetical interpretations of situations and are used for explanation purposes only. The views in this report reflect solely those of the author and not necessarily those of CME Group or its affiliated institutions. This report and the information herein should not be considered investment advice or the results of actual market experience.

CME Group’s Fed Watch tool shows a strong probability of two rate cuts by the Federal Reserve (Fed) in 2019. Many analysts agree with the indications from the federal funds futures market, but they have concerns. Will the trade war weaken the U.S. economy? Is the flat yield curve signaling a recession is coming in 2020? Will there be a debt ceiling or government shutdown crisis in the fall of 2019? These are real risks, and the futures market reflects these concerns. Nevertheless, it is worth noting that futures markets provide a view into the current consensus expectations of market participants, but expectations have a way of changing over time as new information becomes available.

Here we take a different approach based on the observation that the Fed is data dependent, with the implication that the Fed does not try to anticipate economic data. Thus, instead of providing reasons why the Fed might cut rates in 2019, we work through the Federal Open Market Committee (FOMC) policy meetings in 2019 and provide our analysis of why the Fed might cut rates or stand pat based on an analysis of only the historical data they will be examining as they meet. Our conclusion is that lower rates are coming, the Fed may cut rates sooner rather than later.

**June 19, and July 31, 2019 FOMC Meetings**

The June FOMC meeting occurs against a backdrop of trade war worries and slowing job creation. The problem is new jobs are not being created as fast as in 2018, but layoffs are minimal as reflected unemployment holding at 3.6%. When the FOMC meets on July 30-31, it will have received a few days earlier (July 26) the Bureau of Economic Analysis (BEA) advance report on Q2/2019 GDP. It will also have seen data on the employment situation for June (released on July 5) by the Bureau of Labor Statistics. And, it will have in its possession a variety of metrics on inflation and hourly wages for the month of June. Job creation is a question mark. The unemployment rate is likely to still have a reading at or below 4%. Q2 Real GDP may turn out to be a little lower than the 3.3% posted for Q1/2019.

Inflation, or the lack of it, will probably be a part of the FOMC debates, as in previous meetings. We do not see the core inflation rate or sluggish wage growth being sufficiently weak as to prompt a rate cut, at least not yet. All in all, there are no signs suggesting the data is likely to be weak enough to stir a sudden desire in the FOMC to cut rates.

If the Fed decides to cut rates in the summer of 2019, the Fed will have to break with precedent and do so based on the forecast that in the second half of 2019 the trade war will result in weak job growth, rising unemployment and sluggish real GDP growth. This will be a very tough decision for the Fed to get into the forecasting business because of a trade war about which they may have decidedly mixed feelings.

There is a second consideration for the Fed. Will the rate cuts make any difference to the economy? If the main reason that jobs are not being created is corporate worries about the weaponization of tariffs and retaliation from impacted countries, then it may not matter if the federal funds rate is 2.4%, 1%, or even zero. Businesses worried about the trade war are not going to expand jobs while their supply chains are being disrupted and global demand is falling. So, if the Fed does cut, it will have to break precedent, base its case on forecasts, and yet appreciate that the rate cuts may not help.

**September 18, 2019 FOMC Meeting**

More than likely in September, President Trump and Congress may be fighting over the debt ceiling and funding the Government. The debt ceiling stands at $22,028,945,980,301.65 or just over $22 trillion. The U.S. Treasury has been managing its cash carefully to stay under the ceiling. With annual trillion-dollar budget deficits occurring as a direct result of the December 2017 corporate tax cuts, time will run out on the U.S. Treasury’s ability to stay under the debt ceiling around September 2019, give or take a few weeks either way. And there is also a government funding crisis brewing. Authorized U.S. Federal Government funding will end on September 30, 2019, unless the U.S. Congress and the President can agree on new funding for Fiscal Year 2020.

The Fed will have absolutely no desire to step into the debt ceiling and funding political debate. If the Fed had decided to cut rates in the summer, the Fed is unlikely to cut again. If the Fed remained on hold in the summer, the data-dependent Fed may just stay on hold and see whether there is a compromise or whether the federal government shuts down again, as it did for 35 days in December 2018 through late January 2019, and also whether a debt ceiling crisis causes any missed coupons or redemptions that could put US Treasury securities into a technical default.

**October 30, 2019 FOMC Meeting**

There are two scenarios of what the Fed will be debating at its meeting just before Halloween, and possibly the day before the UK crashes out of the European Union with a nasty, hard Brexit. Of course, the Fed does not care about Brexit for making U.S.
interest rate policy, it is just an interesting aside occurring at the same time as the FOMC meets.

So back to the two scenarios. One, the federal government is shut down and there is a full-blown debt ceiling crisis, which means the Fed will do absolutely nothing until after the crisis has been resolved, the government re-opened, and a full quarter of GDP data available to assess the economic damage. Or two, a compromise was reached between the Democratic-controlled House of Representatives, the Republican-controlled U.S. Senate, and President Trump. With the debt ceiling raised and the government funded for fiscal year 2020, the Fed will sigh with relief, express optimism about the economy, expect inflation to creep higher in 2020, and so the Fed will do nothing.

**December 11, 2019 FOMC Meeting**

In December, the Fed will be waiting on Q4 real GDP and inflation data before making any decision on cutting rates. Remember, this is now the longest U.S. economic expansion on record, and economic expansions do not die from old age, they typically end due to policy mistakes. Doing nothing and letting the economy continue to grow, albeit modestly, with subdued inflation below the Fed’s 2% target is the likely course of action. The available data are unlikely to convince the few remaining “hawks” on the FOMC who are still worried about future inflation to switch to a “dovish” vote. Most FOMC members will occupy the undecided middle ground, because the economic data is conveniently mixed and unlikely to make a convincing case.

**Bottom Line**

- The Fed prefers to be data dependent.
- It will be a tough call for a data-dependent Fed to anticipate economic weakness from the trade war and take pre-emptive action that it knows may be ineffective.
- If a data-dependent Fed does break precedent and cut rates over trade war fears and forecasts of coming economic weakness, the Fed is more likely to act in the summer of 2019 rather than later in the year when debt ceiling and government shutdown debates kick into gear.
- Consequently, if the Fed cuts rates, it may be sooner rather than later. But, there will be some FOMC members who will be uncomfortable with a pre-emptive rate cut based on uncertain forecasts of the trade war’s impact on job creation.

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INTRODUCING CLIMATE CHANGE IN DISCRETIONARY PORTFOLIOS

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Introduction
Climate change, and how to address it, within investment strategies are becoming ever more important for investors, money managers and financial regulators alike. Indeed, climate change was considered to be the most important specific environmental, social and governance (ESG) issue by money managers, according to the US SIF Foundation.1 For institutional investors, climate change was the third-most important issue.

While most of the attention so far has been on whether controls on carbon emissions will strand the assets of fossil-fuel companies,2 we believe it is important to widen that net and look at climate change across an investment portfolio.

Climate change investing follows two main principles. First, climate change investors seek to invest in those companies which make a positive contribution to combating climate change. Second, climate change investors seek to strengthen their portfolios against the future environmental, political and social effects of climate change.

In this article, we explore the three main challenges investors encounter when aiming to introduce climate change into their discretionary portfolios – engagement versus divestment; the lack of data; and tracking error – and how to address them.

Challenge 1: Engagement versus Divestment

Perhaps the most important unspoken in climate change investing is the ‘engagement versus divestment’ debate. Indeed, this debate is something that comes up over and over again. Listen to what Harvard Management Company’s Michael Cappucci and Fiona Reynolds, the CEO of the UN Principles of Responsible Investment, have to say on this matter in our ‘Perspective Towards a Sustainable Future’ podcast series.

Traditionally, socially responsible investing (SRI) has incorporated the use of negative screening to avoid investing in sectors which are controversial. Using this framework, climate change investors would divest themselves from or avoid investing in industries such as coal mining, oil companies, mining firms, auto manufacturers and other emissions-producing firms.

Whilst this approach helps avoid the perceived moral contagion of owning controversial stocks, it doesn’t necessarily help to promote better behaviour within these sectors. Deciding to exclude any particular industry requires qualitative judgement and also reflects the interaction of wider ESG factors with climate-change investing. Managers might consider some sectors to be entirely irredeemable.

By contrast, some highly polluting sectors are arguably indispensable to a green economy. Improved battery technology is essential if we are to replace the world’s reliance on fossil fuels. However, these batteries use lithium, alongside large quantities of nickel and graphite. Nickel mining has had a bad reputation in recent years: the Philippines closed 17 nickel mines in 2017 due to environmental concerns, especially deforestation.3 This leaves the climate change investor in something of a quandary – by supporting a key part of the supply chain for electric vehicles, one might actively contribute to deforestation.

In our view, the way forward is to be actively engaged with sector-leading companies to encourage better practices from the sector as a whole. By using ratings to provide a screen, investors could then create portfolios weighted toward companies who are ESG leaders within their sectors. This could help avoid restricting the investment universe, and allow for engagement. Nickel mining in the Philippines is again a good example: in September 2018, the government introduced rules to ensure companies re-forested land they had worked.4 If prepared to engage with mining companies, environmentally conscious investors could contribute to similar initiatives and improve the impact of the sector as a whole. To set up the portfolio in this manner, managers would operate a positive rather than a negative screen, actively seeking out companies with stronger ratings and assisting them to improve further.

With engagement, responsible investors can actively vote at companies’ annual (or extraordinary) general meetings, for example, to improve ESG policies and behaviours. Indeed, shareholders can mandate corporate disclosures on a number of issues, such as improving the quality and timeliness of emissions data, assessing the environmental risks in the company’s business model and mandating disclosure of other sustainability metrics such as water usage and energy efficiency. One such example is oil major Royal Dutch Shell, which – in December 2018 and after discussions with institutional investors acting on behalf of Climate Action 100+ – agreed to link executive pay to short- and long-term targets for reducing carbon emissions.5 Additionally, a shareholder vote in May 2018 required natural gas company Range Resources to issue a report on its policies related to methane emissions and management.6 By enhancing disclosures, investors highlight environmental issues, whilst the data released can be used to perform an accurate assessment of company performance.

A key point to note is how important institutional investors can be in effectively advocating change. In ‘Political, Social and Environmental Shareholder Resolutions: Do they create or destroy shareholder value?’, Joseph Kalt and Adel Turki detail the increase in the number of activist resolutions filed on environmental issues, from 51 in 2006 to 100 by July in 2018.7 However, only four climate change-related proposals passed in shareholder meetings between 2006 and 2017.8 Of these, the paper analyses the three successful proposals which occurred in 2017, which required Occidental Petroleum, Exxon Mobil and PPL to publish assessments of the impact of climate change on their business in the event of global warming in the range of two degrees Celsius. Tellingly, all three successful proposals were supported by institutional investors.

Indeed, in their paper, Kalt and Turki say that without the votes of these three asset managers, the proposals would not have passed. Retail investors only voted 10% of their shares in favour of all environmental proposals in...

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2. Dietz, Bowen, Dixon & Gradwell, Climate value at risk of global financial assets, Nature Climate Change, April 2016
2017, compared with 32% of asset managers. We believe asset managers using their concerted voting power will continue to provide the best chance of changing corporate behaviour on environmental issues.

Man GLG currently assesses how a proposal may enhance or protect shareholder value in either the short, or long term, when deciding how to vote. Considerations of climate change and ESG remain a factor within this framework. Over time, we hope to continue to use these shares to better promote good governance and sustainability, and to support initiatives that improve the environmental performance of companies in our portfolio.

**Challenge 2: Data (or the lack thereof...)**

While there has been a leap in the quality and quantity of ESG data in recent years, disclosing, reporting and aggregating ESG data still remains a significant challenge, not just to climate change investors, but to responsible investors generally. Complaints about ESG data often centre around:

- Absent or incomplete data;
- Data that is available, but incomparable across firms, industries and sectors;
- Too much unnecessary and/or irrelevant information;
- High cost of obtaining the data.

At Man GLG, we currently use two main data providers: Trucost and Sustainalytics. Trucost, a part of S&P Global, provides company ratings based on carbon emission data, alongside information on water use, pollution impacts and waste disposal. Sustainalytics also provides carbon portfolio analytics, alongside wider ESG ratings such as diversity, labour concerns and governance analysis.6

Both firms use proprietary models to create a sector benchmark for climate change performance, against which to compare corporate disclosures.7 However, models to produce final ratings rely on disclosures from companies about their supply chain and production methods as large inputs. As such, investors should beware of greenwashing. The 2015 auto emissions scandal provides a perfect example of how companies can disclose incorrect environmental data. It therefore remains vital that investors are able to conduct their own environmental due diligence alongside that of environmental data providers. Indeed, these vagaries can create potential opportunities for generating alpha for those willing to do detailed research. Man Numeric, for example, has created a proprietary model to assess companies on their sustainability.

As well as scoring companies on their impact on the environment to promote change, responsible investors have to understand the potential impact of climate change on companies’ business models. In this area, the FSB Task Force on Climate-related Financial Disclosures (TCFD) is making strides by encouraging companies to voluntarily disclose climate-related information. It also advises companies to disclose the governance, strategy, risk management tools and the metrics and targets they are using to try and manage the impact of climate change.

Again, this presents some challenges. Given that even leading climate scientists are unable to predict the pace of climate change with accuracy, it is difficult for non-experts to assess how climate change will affect their business. Secondly, it takes time to develop consistent standards. For context, the International Financial Reporting Standards (IFRS) were first published in 2001, more than 30 years after the concept of international accounting standards was first mooted. Granted, climate change is a pressing issue, so it is possible that TCFD standards will become widely adopted more quickly than IFRS.

**Challenge 3: Tracking error and carbon pricing**

Investing in climate-friendly companies also presents the problem of tracking error – the potential for green portfolios underperforming relative to their benchmark indices.

A smaller investment universe is often thought to lead to a higher tracking error, and vice versa. This leads us to the question: do green portfolios actually underperform conventional benchmarks? To answer that, we compared the performance of the MSCI Low Carbon Target Index with the MSCI ACWI Index (Figure 3). Since 3 December, 2010, the MSCI Low Carbon Target Index has outperformed the MSCI ACWI Index by 48 percentage points. December 2010.

However, even if a low-carbon portfolio underperformed or generated similar returns to a conventional index, that could mean investors essentially get a free option on carbon. We believe that by investing in low-emission companies when their environmental status may be undervalued by the market, investors could benefit if the full cost of being a highly polluting company is eventually realised and incorporated into share prices.

**Conclusion**

Christiana Figueres – best known for her successful coordination of the Paris Climate Agreement in 2015 – once said that “climate change increasingly poses one of the biggest long-term threats to investments.”

At Man GLG, we believe that climate change is a threat, but also an opportunity. Introducing climate change in portfolios is not without its challenges, but we believe solutions exist, and by introducing climate change in portfolios, money managers and investors can work with a forward-looking vision together to try and achieve more sustainable growth.

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6 [https://www.sustainalytics.com/esg-ratings/](https://www.sustainalytics.com/esg-ratings/)
BREXIT AND ITS IMPACT ON THE EUROPEAN ASSET MANAGEMENT INDUSTRY

Introduction
The outcome of the UK's 2016 referendum has already lead to significant changes to the European asset management industry (the “EAMI”). These changes and decisions made by numerous financial services firms to relocate staff, operations and balance sheet to other European financial centres such as Luxembourg and Ireland and the outflows from UK domiciled investment funds are likely to remain in place irrespective of the ultimate form of Brexit. Brexit and its consequences may be considered as the single most significant concern for participants in the EAMI.

Impact on the European Asset Management Industry
The EAMI is heavily regulated at European Union (“EU”) level by three primary regulatory regimes:

(b) Alternative Investment Fund Managers Directive (2011/61/EC) (“AIFMD”); and

A significant number of FCA regulated UK firms and funds (“UK Entities”) and European domiciled firms and funds (“EU Entities”) have structured their operations on the basis of the passport available under the UCITS Directive, AIFMD and MiFID. In the aftermath of the Brexit vote, there was much uncertainty as regards the manner in which UK Entities and EU Entities could continue to do business in the EU and the UK respectively. The loss of these passports (and therefore access to the European single market or the UK market, respectively) being the most significant concern for participants in the EAMI.

The EAMI is heavily regulated at European Union (“EU”) level by three primary regulatory regimes: therefore, post-Brexit UK authorised UCITS will no longer qualify as UCITS but as non-EU AIFs and will lose their access to the passport. To address this potential consequence, a UK UCITS with European investors may need to consider providing an alternative solution, such as establishing an EU domiciled UCITS clone, to those investors.

Furthermore, UK UCITS management companies will no longer be permitted to manage EU UCITS post-Brexit. Therefore, the UK UCITS management company of an EU UCITS must be replaced by an EU UCITS management company or the EU UCITS could become self-managed.

AIFMD Management and Marketing
Unlike the UCITS Directive, the AIFMD recognises the concepts of ‘non-EU AIFs’ and ‘non-EU AIFMs’. As a result, UK AIFMs managing non-EU AIFs may continue to do so post-Brexit.

However, to continue marketing in Europe, the UK AIFM would need to rely on the national private placement regime (“NPPR”) of each EU Member State in which it intends to market the AIF. The NPPR is not a harmonised regime and EU Member States have adopted a variety of approaches in respect of the operation of the NPPR with certain EU Member States gold-plating the NPPR and others putting an outright ban on the marketing of AIFs that have not appointed an authorised EU AIFM in their jurisdictions.

The eventual extension of the passport to non-EU AIFs and non-EU AIFMs is contingent upon positive advice from ESMA which may only be given once ESMA is satisfied that there are no significant obstacles regarding investor protection, market disruption, competition and the monitoring of systemic risks. As the AIFMD has already been implemented in the UK it stands to reason that it could be granted equivalence. However, the granting of such equivalence to the UK and the likely timing thereof is an eminently political decision that is not certain. Other jurisdictions such as Switzerland and Hong Kong have been deemed equivalent but have not, to date, been able to benefit from the extension of the AIFMD passport.

Where a UK AIF is managed by a UK AIFM but is not marketed in the EU, it will fall outside the scope of the AIFMD.

MiFID
A significant number of EU UCITS management companies and EU AIFMs delegate the portfolio management function to UK MiFID firms. UCITS and AIFMD permit the delegation of this function to third country firms (“TCFs”) provided the TCF is appropriately authorised and a cooperation agreement between the relevant competent authorities is in place. On 1 February 2019, ESMA confirmed that a multilateral memorandum of understand (“MMoU”) had been put in place, which will enable TCFs to continue to provide the UCITS and AIFM MiFID services on a cross-border basis.

1 The focus of this article is solely on the asset management industry. As such, the implications of Brexit on the wider financial services industry have not been considered.

2 It is expected that a new UK retail regime equivalent to the existing UK UCITS scheme will be introduced.
agreed between ESMA and the European securities regulators and as such, delegation of portfolio management to TCFs (including UK MiFID firms) could continue.

The provision of services covered by MiFID to European clients by UK MiFID firms may prove more difficult, especially if such services are currently provided under the freedom to provide services out of the UK. Although MiFID foresees the possibility of TCFs such as UK MiFID Firms providing their services in the EU post-Brexit, this possibility is subject to harmonised conditions that may be imposed by EU Member States individually, depending on the type of clients the UK MiFID firm is targeting. Each EU Member State will need to make a political decision as to the approach such EU Member State will take. As with AIFMD, any equivalence decision by the EU Commission remains highly political.

UK MiFID firms that wish to continue providing their services in the EU post-Brexit have several options available to them. These include the setting up of an EU based MiFID firm, the establishment of a branch in each Member State in which they wish to provide their services and, if and when an equivalence decision is taken, the provision of services on a cross border basis (but then only to certain types of clients).

EU Asset Management Industry

Broadly speaking, the effect of Brexit on EU Entities will be less severe than the effect on UK Entities as EU Entities may need to comply with UK specific requirements to access the UK market, whereas their access to the EU market remains unchanged.

There is a risk, however, that if UK funds cannot be marketed in certain EU Member States through the NPPR, the funds domiciled in such EU Member States may not be permitted to market in the UK.

UCITS Management and Marketing

EU UCITS will no longer be permitted to appoint UK UCITS management companies nor will they have access to the UK market through the passport. Under UK law, EU UCITS will qualify as AIFs and will only be able to be marketed to retail investors if the EU UCITS is granted recognition under section 272 of the FSMA. In other cases, a notification for marketing to non-retail investors will need to be made under the UK NPPR regime. Furthermore, EU UCITS management companies managing UK UCITS may need to consider whether they require an additional licence to continue doing so post-Brexit.

AIFMD Management and Marketing

As the passport attaches to the AIFM rather than the AIF, the impact of Brexit in the context of AIFs differs to that of UCITS. EU AIFs managed by UK AIFMs may continue to be managed by UK AIFMs; however, they will lose access to the marketing passport. Furthermore, any UK AIFs managed by EU AIFMs will also lose access to the passport. In such circumstances, UK AIFMs managing EU AIFs and EU AIFMs managing UK AIFs would need to rely on the NPPR to continue marketing the AIFs in the EU. Essentially: any EU AIF that has appointed a UK AIFM, any UK AIF that has appointed an EU AIFM or any UK AIF that has appointed a UK AIFM that is currently in a marketing phase in the EU will be the most affected.

UK’s Temporary Permission Regime

The FCA has provided significant clarification in respect of the manner in which EU Entities may continue to access the UK market in the event of a hard Brexit. The UK’s temporary permissions regime (“TPR”) will allow EU Entities that currently provide services or are registered for sale in the UK via a passport offered by the UCITS Directive, AIFMD or MiFID to continue operating, for up to three years, in the UK post-Brexit, while they seek the appropriate authorisation from the UK regulators.

The TPR will also allow UK Entities to rely on possible equivalence decisions in the various areas discussed above to retain access to the European or UK markets, such decisions are eminently political, uncertain and unpredictable.

This has been recognised by UK Entities and EU Entities as they continue to copper fasten their Brexit contingency plans and safeguard their access to the European and UK markets respectively.

Conclusion

Brexit continues to pose many challenges for participants in the asset management industry. While many are hoping for the best and preparing for the worst, it is clear that the post-Brexit asset management landscape will be different to what it was before Brexit.

Although it may be tempting to rely on possible equivalence decisions in the various areas discussed above to retain access to the European or UK markets, such decisions are eminently political, uncertain and unpredictable.

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Sustainable finance, in broad terms investments which take into consideration environmental, social and governance (ESG) factors alongside financial ones, are becoming increasingly popular with investors, resulting in a significant increase in demand for sustainable financial products and investment funds in recent years. This trend is likely to continue, driven not only by growing institutional investor demand, but also from the retail sector, particularly from younger, ‘millennial’ investors. Another driver has been the increased focus by policymakers and regulators on sustainability and the role played by ESG factors, which has led in some instances to the strengthening of voluntary codes, such as the UK Stewardship Code for example, or the introduction of specific regulatory rules, such as the EU Disclosure Regulation.

In these circumstances, there is the potential for overlapping or inconsistent requirements to arise, which can be cumbersome and costly for global firms to overcome. This can also harm competition by raising barriers to entry, with consequent cost implications for investors.

This prompts the question of what could be done to avoid these potentially negative consequences. In this article, we outline some recent attempts by policymakers, legislators and regulators to co-ordinate on sustainable finance regulation and guidance, with a view to achieving a degree of international consistency and harmonisation. These recent developments build upon earlier co-ordination efforts such as the FSB Task Force on Climate Related Disclosures, which was launched in 2015 and the Central Banks and Supervisors Network for Greening the Financial System, launched in 2017.

Further moves towards global regulatory co-ordination

IOSCO
In their 2018 Final Report Making Waves – Aligning the financial system with sustainable development, the UN Environment Programme noted some of the global policy measures to advance aspects of sustainable finance and the striking growth in international initiatives to share experience, stimulate action and promote cooperation on key rules and standards. Given such proliferation, and particularly as this is likely to continue, the International Organisation of Securities Commissions (IOSCO) current work on Sustainable Finance focuses on “stocktaking” existing requirements to ensure as much as is possible a co-ordinated and harmonised approach. In order to assist regulators and other market participants to better understand how sustainability issues may relate to the markets in which they operate, in October 2018 IOSCO established the Sustainability Network to provide a platform for IOSCO’s members to share their experiences and discuss sustainability-related issues. One of the initial tasks of the Network, as outlined in the IOSCO 2019 Work Plan, has been to undertake a survey, essentially a ‘stocktake’ of national initiatives taken by securities regulators and other international organisations in the field of sustainable finance, in order to assess the current position and determine a firm foundation on which to build.

IOSCO’s second main workstream on sustainable finance focusses on growth and emerging markets, which are considered key to future global sustainability. The Growth and Emerging Markets Committee (GEMC) has been investigating the challenges impacting the development of sustainable finance in capital markets in emerging markets and the role of securities regulators. In June 2019 it published a report containing 10 recommendations aimed at facilitating the development of sustainable finance and to help achieve a degree of international consistency and harmonisation. These recommendations are shown in Table 1.

Aside from these two main workstreams, in January 2019 IOSCO published a statement on issuer disclosure on ESG matters (see Figure 1 below). This illustrates attempts by IOSCO to address the difficulties caused by differing voluntary and compulsory ESG requirements at the national level, which are often problematic for asset managers seeking to obtain consistent and accurate ESG data from issuers.

The European Commission - International Platform on Sustainable Finance

The European Union has been at the forefront of regulating for sustainable finance with a package of regulatory proposals announced in May 2018 to further the objectives of the European Commission’s Action Plan for Sustainable Finance in order to harmonise practices across the EU.

In January 2019, IOSCO issued a statement on the inclusion of environmental, social and governance matters when issuers disclose information material to investors’ decisions.

The statement notes that there is an increasing demand from investors for ESG disclosures to help inform their investment and voting decisions. The number of issuers disclosing ESG information, either on a voluntary basis or as a result of compulsory requirements at a local level, is also increasing. However, IOSCO notes that the type and quality of ESG information disclosed varies in and between markets, depending on, amongst other things, the disclosure frameworks used, the disclosure requirements and the definition of materiality imposed by the jurisdiction. IOSCO therefore encourages issuers to:

• Consider the materiality of ESG matters to their businesses, as well as the risks and opportunities they pose in light of their business strategy and risk assessment methodology;
• Disclose the impact or potential impact of ESG matters considered to be material;
• Provide insight into the governance and oversight of ESG-related material risks by, for example, disclosing risk assessment methodologies and the steps take to mitigate any identified risks; and
• Clearly disclose the framework(s) that have been used in preparing and disclosing material ESG information.

Figure 1: IOSCO publishes statement on issuer disclosure of environmental, social and governance matters

In January 2019, IOSCO issued a statement on the inclusion of environmental, social and governance matters when issuers disclose information material to investors’ decisions.

The statement notes that there is an increasing demand from investors for ESG disclosures to help inform their investment and voting decisions. The number of issuers disclosing ESG information, either on a voluntary basis or as a result of compulsory requirements at a local level, is also increasing. However, IOSCO notes that the type and quality of ESG information disclosed varies in and between markets, depending on, amongst other things, the disclosure frameworks used, the disclosure requirements and the definition of materiality imposed by the jurisdiction. IOSCO therefore encourages issuers to:

• Consider the materiality of ESG matters to their businesses, as well as the risks and opportunities they pose in light of their business strategy and risk assessment methodology;
• Disclose the impact or potential impact of ESG matters considered to be material;
• Provide insight into the governance and oversight of ESG-related material risks by, for example, disclosing risk assessment methodologies and the steps take to mitigate any identified risks; and
• Clearly disclose the framework(s) that have been used in preparing and disclosing material ESG information.

The Commission has now been given the green light to push ahead with its plans to create an International Platform on Sustainable Finance, which was initially referred to in its reflection paper of January 2019 “Towards a sustainable Europe by 2030”. The aim of the Platform is to create an international network to advance sustainable finance, bringing together developed and developing countries to deepen international cooperation on sustainable finance. The Council

Source: IOSCO
5. Eligible projects and activities: Funds raised through sustainable instruments should be used for projects and activities falling under one or a combination of the broad ESG categories listed below:

- Environmental (renewable resources; combatting/mitigating climate change; pollution and waste; and other environmental opportunities)
- Social (human capital; product liability; and other social opportunities)
- Governance (corporate governance; corporate behaviour)

It will be up to each GEMC member to define the list of eligible projects and activities for their jurisdictions, taking into account that an eligible project or activity cannot, at the same time, do any significant harm to any of the other ESG categories.

6. Offering document requirements: Regulators should establish requirements for the offerings of sustainable instruments including, among others, the use and management of the funds raised through the issuance of such instruments; and the processes used by issuers for project evaluation and selection.

7. Ongoing disclosure requirements: Regulators should establish ongoing disclosure requirements regarding the use of the funds raised through the issuance of sustainable instruments including the extent of unutilized funds, if any. This could include the use of scenario analysis in the context of the recommendations made by the Task Force on Climate-related Financial Disclosures (TCFD).

8. Proper use of funds: Regulation should provide for measures to prevent, detect and sanction the misuse of the funds raised through the issuance of sustainable instruments.

9. External reviews: Issuers should consider the use of external reviews to ensure consistency with the definition of the sustainable instruments and eligible projects as provided in Recommendation 4 and 5.

10. Building capacity and expertise for ESG issues: Regulators should analyse the gaps in capacity and expertise with regard to ESG-related issues, mention the absence of sustainable instruments including the extent of unutilized funds, if any. This could include the use of scenario analysis in the context of the recommendations made by the Task Force on Climate-related Financial Disclosures (TCFD).

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Source: IOSCO

Table 1: IOSCO recommendations for emerging markets jurisdictions to consider when issuing regulations on sustainable finance

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Integrating ESG-specific issues in overall risk assessment and governance: Issuers and other regulated entities should integrate ESG-specific issues, where these are material, in the overall risk assessment and governance of these entities including at the Board level.</td>
<td></td>
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<tr>
<td>2. Institutional investors: Consistent with their fiduciary duties, institutional investors, including asset managers and asset owners, are encouraged to incorporate ESG-specific issues into their investment analysis, strategies and overall governance, and take into account material ESG disclosures of the entities in which they invest.</td>
<td></td>
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<tr>
<td>3. ESG-specific disclosures, reporting, and data quality: Regulators should require disclosure with regard to material ESG-specific risks (including transition risks) and opportunities in relation to governance, strategy and risk management of an issuer. This information should be part of the overall disclosure that the issuer makes under Principle 16. Where regulators determine that ESG-specific reporting is needed, regulators and issuers should aim to ensure adequate data quality for ESG-specific reporting, including, among others, through updating listing rules, the use of external reviews and through the operation of other information service providers e.g., ESG rating providers, benchmarks and auditors.</td>
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<tr>
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<td></td>
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The EU Sustainable Finance Action Plan – key regulatory measures for asset managers

- The Disclosure Regulation, which formalises investor duties and disclosure obligations in relation to ESG factors
- Requirements to integrate ESG factors in investment decision-making processes as part of the asset manager’s fiduciary duty towards investors and beneficiaries. These will be further specified through delegated acts amending MiFID2, AIFMD, UCITS, IDD and Solvency II
- Requirements to incorporate sustainability when providing financial advice. These will be implemented through delegated acts amending the suitability requirements in MiFID2 and IDD.

The possibility, given the stance taken by the European Commission so far on this topic as reflected regulatory proposals that came from the Action Plan.

ESMA Co-ordination Network on Sustainability

While sustainable finance has been at the forefront of the Commission’s political agenda, steps have also been taken at the national level by several EU member states including, for example, Germany and France. The UK has also taken steps to further ESG and sustainability objectives, which are likely to continue in a similar tack post-Brexit. This prompted the EU Securities Regulator, ESMA, to establish the Co-ordination Network on Sustainability (CNS) in May 2019, in order to foster the co-ordination of national competent authorities’ work on sustainability. The CNS will be responsible for the development of policy in this area, with a strategic view on issues related to integrating sustainability considerations into financial regulation.

Co-ordination or more regulation?

With the increasing global focus on sustainability, together with ESG measures being introduced in more and more countries, it is perhaps inevitable for there to be calls for greater international co-ordination and harmonisation of the many ‘hard’ and ‘soft’ rules. In some respects, clearer regulatory guidance could help to promote consistency that would be beneficial to the market e.g. on the scope of ESG disclosure requirements. However, this does not necessarily mean that new regulations are required, as it could be argued that market demand, from both investors and customers of portfolio companies, has resulted in ESG factors being integrated into their dealings in any event, without the catalyst of regulation. Investors increasingly demand ESG disclosures from managers, for example, often in relation to the manager’s own ESG credentials, as well as in relation to their investments and such managers are often contractually bound to report on ESG to their investors under negotiated fund agreements. In addition, achieving international co-ordination and harmonisation across the spectrum is likely to be difficult, not least because the political appetite for introducing regulation on sustainable finance and in precisely what form, varies considerably from country to country and from sector to sector. This explains the preference in the market for a ‘principles-based approach’, being a practical and flexible way forward which allows a tailored solution to the ESG considerations relevant to a particular scenario, rather than imposing a ‘one-size fits all’ set of overly prescriptive and granular regulatory requirements. At this point, it seems that standard setters and regulators are for the most part at the ‘fact-finding stage’, attempting to establish a baseline of global ESG initiatives and the ways in which these can be better co-ordinated. Working towards a degree of global co-ordination and minimum standards could be beneficial, particularly if predicated by a principles-based approach. As such, the output of the various initiatives currently in progress could provide a valuable contribution to global understanding and promotion of sustainability issues and drive the development of ESG practices globally.
FRIEND OR FOE: WHAT DOES ARTIFICIAL INTELLIGENCE MEAN FOR THE PRIVATE CLIENT?

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These days there’s no shortage of articles and white papers on how artificial intelligence (“AI”) is dynamically altering both our personal and work environments. From IBM’s Watson to Apple’s Siri and Amazon’s Alexa, AI development and adoption is rapidly accelerating. In fact, worldwide spending on AI systems is expected to grow to $52.2 billion by 2021.1

But what does AI mean for the private client? Not much is written from a client’s perspective. Will your future portfolio strategy be determined by an intelligent machine? Will human holograms and android replicants represent the next generation of Investment Advisors and Portfolio Managers? If they look like the cast in Blade Runner 2049, will you even care?

AI in a nutshell

In broad terms, AI is the ability of a machine to copy intelligent human behavior. It is not a single technology, but rather a family of technologies, including natural language processing, computer vision, automated speech recognition, advanced machine learning, image recognition and robotics. Progress in AI has been driven by significant improvements in computing power, the explosion of big data and advances in algorithmic science.

Today’s AI is more accurately defined as artificial ‘narrow’ intelligence because it performs specific tasks and operates within limited, predefined ranges. For example, Siri uses natural language processing to enter your specific information request into a search engine and provide you with the results. Siri cannot perform other tasks, such as order Uber Eats, or respond to general queries that require more comprehensive knowledge.

In contrast, most fictional AI represents artificial ‘general’ intelligence, because it has the cognitive ability to perform a broad variety of intelligent tasks with some level of human consciousness.

The main advantage of narrow AI applications in use today is their ability to quickly scan extremely large quantities of data, discover patterns and make reasonable predictions. For example, a human loan officer generally looks at a few criteria to evaluate your credit application (e.g., assets, credit score, income, age). However, an AI application determines your creditworthiness from thousands of variables, including your internet browsing, social media activity, shopping habits, geolocation data and more. Taken alone, the predictive power of each variable is not meaningful. But when combined, these variables can lead to accurate assessments about your status as a borrower. This capability has countless uses, such as automated customer support, self-driving cars and rapid medical diagnosis.

AI in Wealth Management

The most well-known example of AI in wealth management today is the robo-advisor platform. Robo-advisors (or “robo”) emerged in 2008 as a low-cost, digital alternative to a personal financial advisor for retail investors. Today, robo-advisors allocate approximately US$398 billion of worldwide investment assets using automated, rules-based models.2 You fill out an online survey about your age, investment goals and risk tolerance, and the robo application selects an assortment of exchange-traded funds (ETFs) for your portfolio.

For new investors who are still accumulating assets and do not meet private client portfolio minimums, robo-advisors have helped broaden access to formal investment advice, as the systems can scale to take on extremely large numbers of clients with any size of portfolio. For private client investors, who are accustomed to working with human professionals, the advance of robo-advisors has helped fuel more widespread investment in robust, automated service delivery tools by their wealth management providers.

While financial journalists and big-name consultants have got great mileage out of the potential disruptive impact of robo within the investment industry, the reality is that this narrow form of AI cannot replace human advice. Even with recent advances, robo software still relies on the individual investor to provide the data necessary to determine their risk profile and asset mix. This model works well in rising markets, when it’s easy to love risk, but what happens when there’s a significant market pullback and your portfolio of ETFs drops by 15%? Will you rush to log into your digital advisor and modify your profile to “LOW RISK” at the worst possible time? Who will prevent you from making this irrational investment decision that could materially impact your net worth? Who will give you the big picture?

Along with robo-systems, financial institutions have been investing in AI to extract value from big data and better understand what products and services their clients want. For

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example, Australia and New Zealand Banking Group Limited (ANZ) was an early adopter of AI technology with the use of IBM’s Watson to understand client behaviour.² BlackRock acquired a digital advice platform in 2015 to enhance and inform their investment decision.² UB claims to use a technology called Squirem (Sequential Quantum Reduction and Extraction Model) to identify typical patterns in unstructured data.² More and more, fintech startups are unveiling applications that use AI to synthesize news, market data and product information for wealth managers to share with their clients.

So, what does this all mean for you, the private client? At the very least, you should expect to receive, in real time, more tailored, personalized insights that reflect the knowledge and expertise of the entire firm, delivered through your preferred channel. Your wealth manager will become better at predicting your financial needs and life-changing events based on your digital footprint. Armed with dashboards that push through relevant data, portfolio metrics, alerts and automated decision-making, advisors and portfolio managers will spend less time preparing for meetings and more time providing proactive advice and recommendations.

You’re not alone if the thought of this radically improved service experience triggers some privacy alarms. However, today’s private client is a digital immigrant at best, who still likes voicemail, turns off auto location settings and remembers the original Blade Runner cast. Social experts say that the next generation of private clients is far less likely to have digital-spying qualms, provided they see value, such as better service, from their data being used.³ At the same time, financial institutions have no choice but to continue investing in data privacy and governance programs to maintain client trust.

An existential threat?

Tech leaders like Elon Musk, Stephen Hawking and Bill Gates have issued vocal warnings about AI advancing beyond human control (for some of you, this may evoke fond Terminator memories). Unfortunately, we don’t have room to explore their hypothesis in this blog. However, it does bring us back to our opening question: Will the next generation of investment advisors and portfolio managers be represented by some form of intelligent machine?

We believe the advisor and portfolio manager role will evolve, not disappear. While AI is superhuman at dynamically processing information and doing digital detective work, it is unable to choose its own goals or think creatively – not to mention the fact that AI outcomes are devoid of empathy and entirely based on the data and assumptions with which they are shaped. The complex, interpersonal nature of investor risk profiling requires a flexible and robust understanding of human needs and emotions. For this reason, wealth management will remain both an art and a science, balancing technological progress with the human touch.

In conclusion, private clients need not worry that AI will completely take over their investing process and experience. More realistically, robo- and intelligent systems will eventually work alongside investment professionals, allowing them to focus more on high-value tasks such complex decision making and relationship building. The concept of a flawless, intelligent replicant advisor with human-like consciousness will have to remain as sci-fi movie material – at least until we have artificial ‘general’ intelligence. And if this day ever comes, let’s just hope we’re prepared.

3 The evolution of Robo-advisors and Advisor 2.0 model ©2018 Ernst & Young LLP
4 “The evolution of Robo-advisors and Advisor 2.0 model” ©2018 Ernst & Young LLP
5 “Transformative Nature of Artificial Intelligence (AI) in Wealth Management” ©2017 The Capital Markets Company NV (Capco)
6 “Applying Artificial Intelligence in Wealth Management: Compelling Use Cases Across the Client Life Cycle”, WealthBriefing, December 2017

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SETTING UP AN ALTERNATIVE FUND IN EUROPE: A GUIDE FOR US-BASED MANAGERS

Europe calling

By most measures, the US is the largest market for alternative funds, encompassing hedge, private equity, private credit, real estate and real asset funds. Europe runs a close second, and beckons many US managers looking to tap into new sources of investors and capital. It’s not that easy, however. US funds cannot simply invite Europeans to invest and watch the euros flow in. Europe is quite different from the North American market from a regulatory and structural perspective. The private fund marketplace is more tightly regulated and investor protections far more stringent in Europe than US managers may be used to.

In particular, in order to obtain investment from a European institutional or private investor, you are expected to have a Europe-domiciled investment vehicle. That in turn raises questions of how to structure such a fund, the regulatory hurdles you need to go through, and where it makes sense to domicile the fund among Europe’s major domiciling centers – Luxembourg, Ireland or the Channel Islands of Jersey or Guernsey.

It certainly pays to have an on-the-ground guide with experience across the European market to help you navigate these issues. In the meantime, this paper is intended to serve as an introduction to the regulatory requirements and domiciling options for US managers contemplating setting up a fund for European investors.

First step: Get to know AIFMD

The Alternative Investment Fund Managers Directive (AIFMD) is the primary pan-EU governing regime for alternative investment funds. The main feature of AIFMD is a “passport” that allows complying firms to market their funds to professional investors across the EU as a single market. A US manager seeking to attract or accommodate European investors may need to set up an EU-based, AIFMD-compliant entity that essentially replicates that manager’s US fund’s strategy. Under AIFMD, the fund must have a registered EU-based manager (AIFM) and use a depositary and fund administrator licensed by the EU authorities. The fund will further be subject to AIFMD disclosure and reporting requirements, most notably the Annex IV report, comparable to the US Form PF.

Where to domicile? A quick tour of Europe’s top fund destinations

Europe’s prominent alternative fund domiciling locations – Luxembourg, Ireland (specifically Dublin), and the Channel Islands of Jersey and Guernsey – have much in common. All have committed substantial resources to servicing the alternative fund sector. All claim to have tax structures favorable to investors and flexible regulatory frameworks. Each has a sizeable, well-educated professional corps engaged in the fund industry. And each has a well-developed infrastructure of specialized expertise to support investment funds, including banks, depositaries, administrators, tax advisors and legal experts.

The choice of a domicile location may come down to the type of fund you wish to establish and where similar funds tend to gravitate. Proximity to investors is another factor to consider. If you are setting up a European fund at the behest of specific investors, they will likely have a say in the decision as well. However, if you are just starting to survey the landscape, it’s instructive to understand some of the nuances that distinguish each location.

Luxembourg

Bounded by France, Germany and Belgium, the Grand Duchy of Luxembourg is Europe’s largest fund domicile center and the second-largest in the world after the US. In contrast to the tensions experienced by its larger neighbors in recent years, Luxembourg is a comparative beacon of political, social and economic stability. Most of the top US, UK and German asset management brands have chosen Luxembourg as their primary European distribution center.

The tiny country (population: 591,000) has spent decades developing a strong legal and regulatory framework to serve the global investment community. It is host to all alternative fund types, including hedge, private equity, venture capital and real estate funds, as well as funds of funds. Types of structures include: the Investment Company in Risk Capital (SICAR) regime, which allows for the creation of a private or public company to raise funds and invest in risk-bearing capital; Special Investment Funds (SIFs), flexible vehicles that are subject to lighter regulatory supervision and targeted to qualified investors; and most recently, Reserved Alternative Investment Funds (RAIFs), developed as a more flexible form of fund within the AIFMD framework. (See sidebar.)

Luxembourg tends to attract limited-partnership structures and closed-end funds typical of private equity and real estate. The country boasts its noteworthy role in the development of the real estate fund market, offering a range of legal structures and flexible regulatory requirements.

Ireland

Ireland is reportedly the domicile for 5% of global investment fund assets, making it second only to Luxembourg in Europe and third-largest in the world. As the UK wrestles with its decision to leave the EU, Ireland touts its commitment to remain in the Union and continue to provide full market access to all member countries. The Irish fund industry prides itself on an open, transparent and well-regulated investment environment, with a strong emphasis on investor protection and an efficient tax structure. Some 16,000 professionals are employed exclusively in the

RAIF: THE NEW ALTERNATIVE FOR ALTERNATIVES

One way to accelerate the launch of a European fund entity is through the use of a Reserved Alternative Investment Fund or RAIF. Established by Luxembourg authorities under a 2016 law, the RAIF allows you to utilize the services of an authorised Alternative Investment Fund Manager (AIFM) instead of going through the local regulatory approval process under the country’s Commission de Surveillance du Secteur Financier (CSSF). Unlike Luxembourg’s SIF or SICAR fund structures, the RAIF is not subject to CSSF governance. The AIFM can be domiciled in any EU member state. In addition to faster time to market, the RAIF structure affords a greater degree of legal flexibility and lower administrative costs than other types of funds operating under CSSF supervision.

RAIFs may be organised as umbrella funds with one or more compartments or sub-funds, each with its own specifically defined investment strategy and policies. RAIFs are intended for well-informed, professional investors, including institutional and qualified private investors, professional investors and investors investing certain minimum amounts (€125,000) who qualify as well-informed investors.
servicing of investment funds, including 4,000 dedicated to alternative investment funds. Ireland tends to appeal to more open-ended types of vehicles such as hedge funds. There has been much speculation in 2019 about when Ireland will update its legislation for International Limited Partnerships (ILP), which will be attractive to closed-end types of vehicles.

In 2015, Ireland introduced a vehicle designed to reduce the cost and complexity associated with establishing and maintaining a fund. The Irish Collective Asset-Management Vehicle (ICAV) allows for the creation of funds without going through the process of incorporating or becoming public limited companies (plcs), and which therefore are not subject to rules or requirements intended for other company types. Existing alternative investment funds in Ireland can continue to operate as usual or have the option to convert to ICAV status. Non-Irish investment companies can migrate into Ireland and become an ICAV through a relatively straightforward process.

Channel Islands: Jersey and Guernsey

An interesting alternative to Europe’s two larger fund centers, the English Channel Islands are politically and fiscally autonomous British Crown Dependencies, but not part of the UK or the EU. As “third countries” to the EU, Jersey and Guernsey have bilateral agreements with a majority of EU countries that enable marketing across the EU through National Private Placement Regimes (NPPRs). The NPPR provides a quick, efficient and low-cost alternative to the full AIFMD passport. Brexit will not impact upon the Channel Islands’ agreements with EU countries.

Although close geographically, Jersey and Guernsey are two distinct jurisdictions. Funds in Jersey are governed by the Jersey Private Fund regime or JPF. Under JPF rules, a fund can be structured as a limited partnership, company or trust, and may be either open and closed-ended. All investors must qualify as “professional” or “eligible” investors. In most cases, a JPF manager is not required to be licensed in Jersey, but the fund is required to appoint a designated service provider, usually a fund administrator, in Jersey.

Guernsey’s Private Investment Fund or PIF regime is similar to the JPF, but with a few notable differences. A PIF can be structured as a limited partnership, company or trust, and may be either open and closed-ended. It can have up to 50 investors, and they need not be deemed professional. Unlike the JPF, a PIF manager must be licensed in Guernsey. A PIF, too, must appoint a Guernsey-designated administrator. Both the Jersey and Guernsey regimes are intended to enable managers to set up funds more quickly, easily and at less cost.

Jersey and Guernsey host both closed and open-ended funds, plus hybrids. Jersey has traditionally been partial to real assets funds and Guernsey more toward private equity, although that is changing as the Jersey market has grown in size in recent years.

SS&C in Europe

SS&C is one of the few fund administrators with a truly global footprint, including an extensive team of experts across Europe. We are licensed to operate in all of Europe’s key fund jurisdictions and we have specialized expertise in all fund types. Most recently, in response to increasing investor demand, SS&C has dedicated significant resources to support real asset funds, a rapidly growing alternative category that poses unique operational and accounting challenges. If you are exploring European opportunities, we have the knowledge of local regulations, tax laws, customs and resources to provide comprehensive guidance, with no bias toward a particular domicile. Whether you are actively engaged with European investors or simply testing the waters for expansion, contact us to discuss your alternatives.
THE SEC’S FORM PF DATA USAGE: BETTER DATA POLICIES

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Better data means better policies

At the point when Form PF (private fund) was first conceived under the Dodd-Frank Act in the early 2010s, its architects principally viewed it as a resource by which the Securities and Exchange Commission (SEC) could accumulate data on the private funds industry (e.g. hedge funds, private equity, etc.) enabling for better supervision of potential systemic risks. Nearly seven years have elapsed since the first filings began and despite initial misgivings that the SEC would struggle under the weight of all of this reported information, nothing of the sort materialised. In fact, the SEC – like many other regulators – is making good use of the data.

This has happened for several reasons. Firstly, the SEC has developed an extensive range of sophisticated tools to help it sift through the enormous volumes of Form PF data. Through the adoption of automation in these rigorous analytical processes, the regulator is now in a strong position to identify outliers in Form PF submissions, such as anomalies around performance, liquidity, investment exposures, use of derivatives or the extent of leverage.1 Simultaneously, the data itself has improved organically as investment firms achieve better consistency in how they report, again something that has been facilitated by SEC feedback.

Better cooperation across regulatory agencies

One of the biggest criticisms of market regulators in the US in the immediate aftermath of the financial crisis was that they failed to liaise with each other. Since then, there has been deeper coordination and consultation across regulatory bodies. For example, Form PF has been regularly shared with the Financial Stability Oversight Council (FSOC) over the last six years, and the Federal Reserve Board since July 2018. The SEC also passes on Form PF information to the Office of Financial Research (OFR), a unit within the Department of Treasury, along with international bodies such as the Financial Stability Board (FSB). A data sharing agreement was also recently signed between the SEC and the International Organisation of Securities Commissions (IOSCO). Again, this is in marked contrast to pre-2008 behaviour when regulators usually operated in silos.

Nowhere has this collegiality been more apparent than in the recent regulatory consultations on leverage. Following on from an FSB report evaluating the structural vulnerabilities in asset management, the International Organisation of Securities Commissions (IOSCO) began consulting with the industry about developing a framework by which to accurately measure hedge fund leverage.2 This comes as the SEC released data showing that while hedge funds’ cash borrowings had reduced, the role of synthetic leverage has expanded quite significantly from $10.2 trillion in 2017 to $14 trillion in 2018.3 By disclosing data on a cross-border basis, regulators are helping to curtail systemic risks.

The evolution of Form PF

As with nearly every regulatory report, the initial stages are often marred with operational headaches, and Form PF was no exception. At the time, managers complained the form was excessively complex, detailed and risked overlapping with other regulatory reports elsewhere such as the Annex IV, introduced under the EU’s Alternative Investment Fund Managers Directive (AIFMD). Today, the compilation of Form PF is a fairly seamless exercise, which is either performed in-house at managers or delegated to competent third party providers. As firms acclimatised to its requirements, Form PF became less of a burden, and is now a process that is fully integrated into the operations of fund managers.

Likewise, the SEC – who faced a barrage of criticism in 2011/2012 from industry stakeholders warning them that Form PF risked overwhelming their limited resources – has proven the sceptics wrong. Not only is the SEC using the data intelligently as a tool to shape policy, but it also recognised it made errors when Form PF was first adopted, and has worked diligently to avoid repeating those same mistakes. In addition, Form PF has abated the SEC with conduct enforcement, and a lot of the report’s contents are now routinely being circulated with domestic and international regulators, thereby helping agencies with market surveillance. As a result, Form PF is playing an instrumental role in suppressing systemic risk.

1 SEC (2017) Annual Staff report relating to the use of Form PF Data
2  IOSCO (November 14, 2018) IOSCO seeks feedback on proposed framework for assessing leverage in investment funds
3 SEC (2018) Annual Staff report relating to the use of Form PF Data
4 SEC (2018) Annual Staff report relating to the use of Form PF Data
5 IOSCO (November 14, 2018) IOSCO seeks feedback on proposed framework for assessing leverage in investment funds
6 Financial Times (January 13, 2019) Hedge fund leverage risk comes under scrutiny
ESG DUE DILIGENCE – “TRUST BUT VERIFY”

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Environmental, Social and Governance (ESG) issues have rapidly become central to the stated priorities of many large asset owners around the world, leading the asset management industry to increasingly offer responsible investment strategies to their clients. Today, new ESG, SRI, and Impact funds are being launched weekly, with alternative investment firms now participating in the trend. Though responsible investing is more common in long only, private equity and real assets, AIMA, in its recent ESG Primer, has highlighted how hedge funds are increasingly seeking compatibility with responsible investment strategies – from screening the investment universe to short selling companies due to poor ESG performance. Given the myriad of responsible investing strategies and the lack of agreed definitions around ESG criteria, however, investors are acutely aware of the risk of “greenwashing” – when an asset manager exaggerates integration of ESG factors into their investment decision making process, or merely offers “green” platitudes without any real substance behind them. Distinguishing virtue signaling from a genuine commitment to sustainable investment has become a new focus in the external manager selection process.

Against this background, investors are transitioning to more detailed “trust but verify” due diligence on the ESG capabilities of asset managers in their portfolios or proposed for new allocation. Castle Hall has observed a bifurcated approach emerging in ESG due diligence. First, as would be expected, investors are reviewing the sustainable investment strategy of an asset manager during the investment due diligence process. At Castle Hall, we don’t believe it is enough to simply ask whether the manager has implemented a responsible investment policy or if they are a UN PRI signatory. Though these matters are important and may demonstrate a firm’s opening commitment to ESG, it is merely a starting point. Can the manager actually evidence the application of their ESG policy and the 6 UN Principles for responsible investing throughout their investment approach (at a more basic level, a manager may say that they update their ESG policy every year – yet the document supplied is dated from early 2017)? Key questions posed by allocators include: Who is responsible for gathering and analyzing ESG data to integrate into risk management and valuation models? What data is obtained? When does the manager consider ESG during the investment process – at the very beginning, or only at the end as a negative screen? Where does the manager source their data from?

Second, investors are also moving to assess the governance, culture and behaviours of asset managers themselves, entirely separate from the ESG characteristics of their investment mandates. For asset owners, it is increasingly important to ensure cultural alignment with the asset managers to whom they delegate capital. Large pension and sovereign wealth investors have begun to question, for example, whether their beneficiaries would support plan assets being allocated to a manager with little gender diversity and one or more examples of MeToo allegations. Equally, would plan members (the ultimate asset owner) support buying a product from an asset manager who has failed to adopt policies related to whistleblowing, workplace harassment or provision of same sex benefits?

One immediate example: virtually every large, institutional investor we have spoken to has, over the past year, conducted systematic training around issues such as workplace bullying, unconscious bias, microaggressions and mental health. Equally, virtually none of the independent asset managers we have spoken to appear to have implemented formal training programs in these areas, as of yet. This illustrates a clear gap between investor and asset manager priorities.

For hedge funds, relatively modest changes can work towards improving ESG culture. For example, carbon offsets on flights are relatively cheap and could easily assist towards decreasing environmental footprint. In the S, or social, area, a policy on sexual orientation discrimination could be beneficial to attract employees that might otherwise feel excluded. The manager could also conduct a formal gender pay gap survey (this is increasingly required by law in certain countries) to address any disparities in pay within the organization. From a governance perspective, a documented training policy on HR matters could also be beneficial not only to external perceptions but also to improvements in culture at the firm. Indeed, we believe ESG criteria can be used as a valuable proxy for assessing the culture of a manager. A large hedge fund we spoke to recently put it this way: many of their staff are highly talented and have a choice of where to work, thus having an employer with strong, positive, culture characteristics is highly important.

In this nascent space, “best practices” are a journey: investor expectations today around ESG issues are likely greater than they were five years ago. Equally, five years from now, asset manager practices which are likely “acceptable” today may have been superseded. However, the starting point to due diligence is a baseline understanding of current behaviours across the asset managers included within an asset owner’s existing portfolio. With that information, investors can enhance their decision making, helping better align the external manager selection process with the values of the asset owner.
DISTRIBUTION TO INVESTORS IN SWITZERLAND

Switzerland is an attractive market for foreign investment funds with very specific, yet easy to fulfill, requirements for distribution. Switzerland is not part of the EU, and distribution legislation is different. To ensure that all regulatory requirements, including representation, paying agent and regulators authorization are met, choosing a reliable Swiss representative is essential. Once funds have been authorized for Swiss public distribution, fund managers and fund distributors will expand the scope of potential investors through access to big Swiss distribution platforms, including those from well-established banks.

Switzerland ranks fourth among the largest asset management locations in Europe. The total volume of assets entrusted by investors in Switzerland amounted to CHF 1,129.3 billion (as of 23 April 2019). At the end of February 2019, the total volume was CHF 1,121.5 billion, which represents an increase of CHF 7.8 billion or 0.7% in only two months.

The Swiss Regulatory Framework today

Switzerland is not subject to the AIFMD rules. The distribution of foreign funds in Switzerland is regulated by a specific set of rules, where the function of the Swiss representative plays a central role. The Collective Investment Schemes Act (CISA) came into full force on 1 March 2015. The modifications introduced by the CISA require that all foreign funds distributed to Swiss investors have a Swiss representative.

Under the CISA, Swiss investors are segmented into three groups, as shown in table 1.

The 2020 upcoming regulatory highlights

The Swiss Federal Financial Services Act (FinSA) and the Swiss Federal Financial Institutions Act (FinIA) are expected to enter into force in 2020. They were drafted as a response to the 2009 financial crisis and with the purpose of meeting international standards, most importantly the recognition of the so-called “equivalence” under the “third-country rules” under MiFID II. Through the legislative proposal, Switzerland envisions the harmonization of its financial markets regulation with MiFID II in order to facilitate cross-border activity to enhance the Swiss financial center’s competitiveness, while taking due account of the desire for enhanced client protection.

FinSA redefines the client categories in table 2. Professional investors under FinSA will be considered regulated qualified investors and some private investors, with financial assets exceeding CHF 500,000, that have sufficient knowledge about the risks of investments as a result of their personal training and experience in the financial sector, may “opt-out” and be considered Professional Clients.

Table 1

<table>
<thead>
<tr>
<th>Qualified Investors</th>
<th>Unregulated</th>
<th>Non-Qualified Investors</th>
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<tbody>
<tr>
<td><strong>Regulated</strong></td>
<td><strong>Non-Qualified</strong></td>
<td></td>
</tr>
<tr>
<td>Banks</td>
<td>Pension funds with professional treasury management</td>
<td>Investors other than Qualified Investors</td>
</tr>
<tr>
<td>Security dealers</td>
<td>Family Offices</td>
<td></td>
</tr>
<tr>
<td>Regulated fund management companies</td>
<td>UHNWI (subject to conditions)</td>
<td></td>
</tr>
<tr>
<td>Insurance institutions</td>
<td>Independent wealth managers</td>
<td></td>
</tr>
<tr>
<td>Other regulated companies</td>
<td>Companies with professional treasury management</td>
<td></td>
</tr>
<tr>
<td><strong>Requirements</strong></td>
<td><strong>Requirements</strong></td>
<td><strong>Requirements</strong></td>
</tr>
<tr>
<td>None</td>
<td>Appoint a Swiss representative</td>
<td>Appoint a Swiss representative</td>
</tr>
<tr>
<td></td>
<td>Appoint a Swiss paying agent</td>
<td>Appoint a Swiss paying agent</td>
</tr>
</tbody>
</table>

Table 2

<table>
<thead>
<tr>
<th>Professional Clients</th>
<th>Private Clients</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent wealth managers</td>
<td>Individuals and HNWI</td>
</tr>
<tr>
<td>Regulated insurance institutions</td>
<td>Family offices without a professional treasury management</td>
</tr>
<tr>
<td>Banks</td>
<td>All non-Professional Clients</td>
</tr>
<tr>
<td>Pension funds and companies with a professional treasury management</td>
<td></td>
</tr>
<tr>
<td>Security dealers</td>
<td></td>
</tr>
<tr>
<td>Regulated fund management companies</td>
<td></td>
</tr>
<tr>
<td>Other regulated companies</td>
<td></td>
</tr>
<tr>
<td><strong>Requirements</strong></td>
<td><strong>Requirements</strong></td>
</tr>
<tr>
<td>Register the fund advisors</td>
<td>Register the fund promoters</td>
</tr>
<tr>
<td></td>
<td>Appoint a Swiss representative</td>
</tr>
<tr>
<td></td>
<td>Appoint a Swiss paying agent</td>
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</table>

Two critical pieces of legislation in the financial sector are expected to enter into force in 2020. The Swiss Federal Financial Services Act (FinSA) and the Swiss Federal Financial Institutions Act (FinIA) are expected to enter into force in 2020. They were drafted as a response to the 2009 financial crisis and with the purpose of meeting international standards, most importantly the recognition of the so-called “equivalence” under the “third-country rules” under MiFID II. Through the legislative proposal, Switzerland envisions the harmonization of its financial markets regulation with MiFID II in order to facilitate cross-border activity to enhance the Swiss financial center’s competitiveness, while taking due account of the desire for enhanced client protection.

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The new register of fund advisors

Within six months of FinSA/FinMA taking effect, fund promoters of those financial service providers, not subject to supervision in Switzerland in accordance with Art. 3 FINMASA and client advisors of foreign financial service providers, will be required to sign up to a client advisors’ registry (Art. 22 FinSA). This body will verify that advisors have sufficient expertise and knowledge of the FinSA rules of conduct, that they have no entry due to criminal offences against assets under the Swiss Penal Code and no ban on activity or profession imposed by FINMA, that they are properly insured and that they are affiliated with an ombudsman’s office.

For more information about the register, the website of www.regiswiss.ch can be consulted.

Professional or Public Offering

Professional offering

With the updated regulation in 2020, foreign funds only being offered to most Professional clients will no longer be required to appoint a Swiss representative and a Swiss paying agent. However, they will not be able to be offered to private clients. To avoid undesired publication to private clients, any communication with Swiss investors, including mailing lists and website content, requires strict monitoring. HNWIs and family offices will require special care to understand whether they opt-out of the private client category (and require a paying agent and representative) or if they are to be considered private clients (and require a full authorization for public offering).

Fund platforms of major banks and large pension funds typically prefer funds authorized by FINMA for public offering.

Public offering

A foreign fund authorised for public distribution will gain access to big Swiss distribution platforms, thus accessing a broad scope of potential investors. In addition to the requirement of appointing a Swiss representative and a paying agent, an authorization from FINMA is required. Due to the regulatory fees, the cost of a Swiss representative and a Swiss paying agent, foreign funds authorized for public offering face higher initial and recurring costs. These funds also have the most complete registration in Switzerland; they comply with all the points that institutional investors like insurance companies, banks and pension funds may require. They can be offered to professional and private clients alike, reach a broader scope of potential investors and are exempt from the obligation of checking the status of each investor. UCITS and Hong Kong mutual funds have a fast-track approval for distribution to private clients. FINMA has cooperation and information exchange agreements with the supervisory authorities in 17 countries.

Setup for public offering in Switzerland

Once a fund manager takes the decision to approach the Swiss market, the first step is generally to appoint a Swiss representative, which will discuss with the fund manager about aspects which are specific to the type of the fund. A list of Swiss paying agents will be provided for the client to choose from. An onboarding process follows, which typically takes a few weeks, during which the representative executes due diligence work on the fund, a representation contract is established, and the fund’s legal and marketing documents are amended for distribution in Switzerland. This also entails filing of the documents with FINMA and requesting that the fund be authorised for public distribution in one of the Swiss official languages.

In line with the EU regulation on PRIIPs, the publication of a KIID is compulsory if a financial instrument is offered to private clients. From 2020, if a financial instrument is offered publicly, only the KIIDs will need to be translated into a Swiss official language and published. Other fund documents will no longer need translation.

Choosing a Swiss representative

The role of the Swiss representative is to ensure that the funds’ distribution activities comply with Swiss laws. In addition to the legal and procedural expertise, Swiss representatives can:

• Help fund managers who wish to distribute to private clients find the best professional translation service provider;
• Update the funds on regulatory changes and help adapting to them;
• Help gaining access to big Swiss distribution platforms, including the ones from well-established banks;
• Help building relations between funds, Swiss-based distributors and investors;
• Organise cap intro events and conferences to connect funds with investors;

For any question concerning funds representation and distribution in Switzerland, please feel free to contact Oligo Swiss Fund Services (a regulated Swiss representative for funds addressed to both professional and private Swiss investors) at info@oligofunds.ch.
Environmental, Social and Governance (ESG), three words with wide ranging definitions, interpretations and impact in the eyes of investors, regulators, governments and investment managers, has been thrust into the spotlight during the past 18 months, having previously existed in the shadows of bespoke funds and niche investments.

The increased visibility of ESG within the financial sector is due to many reasons and, in part, the result of influential supporters acting as disruptors in otherwise tried and tested fields of asset management. In a speech by the Bank of England Governor Mark Carney, titled “A New Horizon”, the Governor set out the wider systemic risk that can occur to the financial system due to the climate crisis. Elsewhere prominent investment group BlackRock is now championing the integration of ESG investing into the mainstream market with the launch of six highly publicized ESG exchange traded funds. Both BlackRock and the Governor have set a trajectory of how they envision ESG will affect the financial world and the need to be proactive in its adoption to ensure success and survival.

Regulatory drivers

Jurisdictions such as the European Union continue to encourage institutional support for sustainable investment via the EU Commission’s Action Plan on Sustainable Finance. Political agreement has been reached on a proposal that will introduce disclosure requirements on asset managers in relation to sustainability. Changes to regulations such as AIFMD and UCITS are expected to be introduced that will require investment firms to consider sustainability factors in investment due diligence and to develop engagement strategies that are consistent with the ESG needs of their investors.

In the UK, the Government has introduced legislation, with effect from October 2019, that will require pension scheme trustees, as part of their fiduciary obligations, to consider sustainability factors in their investment decision making and capital allocation processes. Furthermore, the Financial Conduct Authority is currently consulting on proposals that will require financial services firms to publicly disclose how they manage climate financial risk.

Changing demographics

Beyond governmental policy and regulation, there is a continuing shift in attitudes towards investing as the transfer of wealth from the Baby Boomer generation to Generation X and Millennials accelerates. Many of these younger investors are more conscious about the source of investment returns, which in turn is prompting a shift towards ESG mandates. Pension funds also need to adapt to meet the investment needs of their more “sustainability conscious” beneficiaries.

Barriers to adoption

Whilst the increased awareness of responsible investing and wider ESG factors is a positive development, there are several issues hampering its widespread adoption. At the heart of these issues is the availability of consistent, quality data across market sectors, strategies and asset classes. This stems from a lack of breadth and quality of ESG data reported by listed companies, that in turn acts as the foundation of ESG data analysis used to determine ESG scores and ratings. Difficulties in obtaining relevant disclosures from companies, the “cherry picking” of ESG data to report and the ability to not report, creates a skew in the quality and reliability of the market data available. Whilst listed equities are highly represented by the largest ESG data providers, inconsistencies and differences are common. In addition, many asset classes such as private equity, unlisted debt / credit and distressed assets are not represented within existing ESG data sets.

Industry research has shown that the current quality of ESG data may also increase the risk of tracking error within a portfolio, due to a reduced universe of stocks rated as best in class based on ESG scoring methodologies. This in turn may unintentionally skew the geographic allocation of a portfolio's investments, as more developed markets, where ESG screening and scoring is more prominent, achieve greater visibility and higher scores.
The question of segregating returns generated by either E, S or G factors must also be considered holistically against wider macro and micro economic factors such as exchange rates, interest rates, media exposure etc., to ensure performance attributed to ESG strategies is appropriately identified.

In order to help breakdown these barriers and achieve its Action Plan, the European Commission has enlisted a High-Level Expert Group ("HLEG") to devise a taxonomy to help classify a sustainable investment. However, a taxonomy, whilst potentially solving some issues for industry stakeholders, also presents some challenges.

**Greenwashing**

At a recent industry conference, experts warned that a taxonomy may result in, or exacerbate “greenwashing”, (the act of falsely promoting a product / service as environmentally friendly, by asset managers and / or issuers) if “green” definitions are classified too vaguely. Alternatively, barriers to adoption of sustainable investments could be created if classifications are too rigid thereby stifling product development and hindering wider adoption.

Regardless of the direction the taxonomy takes, greenwashing has been noted throughout the industry as a key concern to investors looking to identify an ESG focused fund. However, until such guidance is clearly defined and is applicable across both developed and emerging markets, asset classes and sectors, it is likely to continue.

**ESG momentum set to continue**

The integration of ESG within the asset management industry is here to stay and its materiality for the decision making of investors and asset managers will continue to grow. The core barriers to wider integration remain the lack of a consistent methodology, data quality and the application of a taxonomy for classifying and implementing ESG factors. Whilst challenges remain, the direction of travel is clear for the future of ESG integration and the investment industry will need to adapt accordingly.