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Investment Fund Distribution White Paper

Where now for fund distribution?

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**CROSS-BORDER
DISTRIBUTION
CONFERENCE**

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Introduction

Distribution of investment funds and asset management services is a complex and partially fragmented activity.

Initially, several decades ago, demand drove product development and attracted distribution. That demand was from banks acting as intermediaries or managers looking for adequate solutions for the smaller saver, the investor with sufficient assets to be an attractive banking client but insufficient available savings to justify full discretionary management or a bespoke portfolio.

That pattern slowly morphed as Anglo-Saxon promoters with a more B-to-C distribution legacy, entered European markets favoring more diverse intermediated and direct retail distribution. It developed further with new and different distribution channels, and a complex and varied landscape emerged. It was and is a landscape populated by platforms and IFAs, by banks and insurers. It was and is a world of wrappers and retirement plans, of currency share classes and national reporting requirements. It is a landscape that has finally come full circle and started to reinvent itself, growing into an export, re-exporting that same expertise and diversity around the world that it originally imported to grow and thrive.

In many respects, the development has been opportunistic, almost haphazard. If crafted around the central pillars and point of reference that were and are the UCITS Directives; it has also extended into alternative, non-UCITS sectors, it has matched supply to demand across borders and continents, and has seen over 25 years of flourishing growth in UCITS alone.

In that time it has survived earthquakes and major geo-political upheavals, it has been through the dot.com bubble, and bear and bull markets alike. It has weathered the initial phases of one of the most ambitious experiments in economic history, the Euro.

By the efficient channeling of savings to productive investment, it has played its role in the economic progress of first and third world alike—perhaps not perfectly, but incrementally, consistently, doggedly.

Over those years it has accompanied technological, political and social change. It has channeled investment to new areas such as emerging and frontier markets. It has tentatively watched the development of social media, and has embraced notions of social responsibility in investing alongside creating alpha.

If the financial crisis of 2008 taught us one thing, it was the inter-connected nature of financial markets. The depth and dimension of those interactions no doubt surprised the world and spawned legislation and reflection on a regional and global scale in an attempt to avoid a repetition of what had gone before.

For distribution this has brought legislation designed to introduce greater transparency, greater investor protection, greater accountability to the mix that already encompasses demographics, technology, culture and many other factors. It has brought even greater change at a time when the enablers and accelerants to change are already picking up speed.

“War” it has been said “is too serious a business to be left to the generals.” Distribution is perhaps too serious to be left entirely in the hands of the distributors. With the catalyst of regulation and change as stimuli, it would seem opportune to pause, to examine in some detail at least the main drivers with which the industry must contend, now and in the foreseeable future and reflect what distribution may mean in a changing age.



1. Distribution in a changing age...

The distribution of investment products, and of funds in particular, will have an increasingly important role to play in the economic infrastructure of Europe and potentially beyond in the years to come.

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The extent to which asset managers “engage” with clients, either as regards direct sales of funds, the provision of solutions as well as products, or a direct involvement in offering solution/product packages will arguably help to shape the future. The engagement with both retail and institutional players has a key role to play in achieving the aspirations, inter alia of Europe’s Capital Markets Union initiative¹. The shape, form and nature of that engagement will be fashioned by many factors. New generations no longer think and act as did their forebears, and the idea that inherited wisdom will ultimately make the younger generation move towards the thought patterns of the previous ones is no longer valid. But age and the technology divide are but two of the influences that distribution is likely to see, by which it is likely to be “disrupted”, not only in years to come but right now.

The influences at work are both conscious, unconscious, intended and unintended. Their impact taken together will transform the way societies operate, by changing the way they save to accumulate wealth and the way they redistribute capital within markets nationally, in the context of the EU’s internal markets, and globally.

The vectors that will influence savings and investment will be client preference of course, but how that articulates around legislative change, demographic imperatives, accessibility and speed of adaptation

will be as key to the way products and solutions are distributed as the role those same products and solutions play in the future structure and wealth of society.

It would be reassuring to believe that there could be a single approach that would answer the needs of current and future generations, a form of one size fits all solution that could be achieved by the “right” legislation. That, however, is to ignore the fact that the only certainty in this context is change. One of the most striking examples of this is the way markets and providers have reacted to legislative change in the case of the inducements element of MiFID II. The impact is interesting at several different levels—firstly by the fact that there is an impact; MiFID II à priori is not about asset management. There is nevertheless an element of overlap via customer protection and transparency measures that makes MiFID II a central concern for asset management. And MiFID II is not the sole legislative instrument to demonstrate this tendency to spread beyond initial scope with both CRD IV and Solvency II to name but two, resulting in additional demands and/or constraints on asset managers. With MiFID II the ink is not even dry on the legislative instrument, it is still two or three years away from full implementation, and yet new solutions are emerging in the form of various robo-advice solutions to already today offer solutions to tomorrow’s challenges. The established order, in seeking to change by legislative reform or innovation, is itself a disruptor and enabler. Robo-advice is nothing new. Social media is not new. The catalyst for change has been the accelerated need for alternative solutions to old problems once regulation has opened new avenues by closing or restricting existing ones.

There is the need to
achieve sustainable growth
without systemic risk





Speculation as to a possible delay in the implementation of MiFID II has been ended by the legislative instrument brought forward by the European Commission on 3rd of February postponing the implementation of all MiFID II measures for twelve months; they will now come into effect in January 2018. It is unlikely that the initiatives that MiFID II has generated as potential solutions to a more complex advice and distribution landscape. As work will still progress as anticipated on Delegated acts and RTS alike, with even taking additional delays into consideration, delivery of both anticipated by April of 2016 the likelihood that solution will out-distance and even pre-empt regulation becomes more and more probable. At the same time, within that regulatory hiatus the temptation for Member States to “go it alone” with gold-plating measures must certainly increase.

As ever, innovation and adaptation in the market will precede regulation - for good or ill. In this case however, with the entry of Fintech into the equation, the “race” is likely to be that of the tortoise and the hare rather than a sedate session of companionable leap-frog.

Within the original context of the European Union’s Financial Services Action Plan, written and laid out decades ago, progress toward a coherent internal market has been sporadic, sometimes patchy, and not infrequently waylaid by financial or political events (and sometimes by a heady combination of both). CMU is the first effective redraft of that action plan since it was first articulated, and as such for the distribution of

fund and asset management products and services a much needed reconfirmation of intent to add design and coherence to what in many cases have been the intended and unintended consequences of piece by piece legislation as described above.

What are the vectors with which distribution strategies must contend? What are the changes, intended and unintended?

There are the knowns—the needs of an aging population to secure retirement income, the needs of an increasingly middle class population worldwide to provide for life-cycle needs before retirement—education, business creation for the next generation, aspirations that are now shared by a growing percentage of the world’s population.

There are the needs of government at national, and in the case of Europe, at regional level, to stimulate growth, to insulate growth as far as possible from negative global influences, via efficiently operating capital markets and the injection of savings into productive investment. There is the need to achieve sustainable growth without systemic risk.

Those are the macro-economic imperatives. But clearly markets, legislators and fund promoters are not dealing with a blank sheet of paper; they are working in an evolving environment, an environment that already has a capital market however disjointed in some cases. They are dealing with varied and diverse savings patterns and possibilities, they are dealing with infrastructural



change in the wake of the financial crisis. Thus business and asset gathering strategies must accommodate regulatory change, and adapt to it. Increasingly with the pace of innovation, strategy must also address the threat and opportunity of solutions as much as they do the issue that gave rise to those solutions. This is specifically the case where existing distribution channels and methods are called into question. In this sphere, strategy must also take into account not only consumer preference as to method but also as to content; in reaching out to a wider population. In looking to reach that population directly, the attitudes, political, social, and cultural of that greater franchise must be taken into account.

These are the knowns—but what of the unknowns? To what extent might unknowns undermine a current vision of distribution in the future, is it possible to care for them in a vision of the future?

By definition an unknown is just that—unknown. However, if we look to the vectors mentioned above and the context in which this reflection is taking place, we can determine trends within which any “unknown” is likely to be found. Those unknowns are to be sought in the extent to which CMU can deliver a new dynamism, how far back FinTech and other developments can push the boundaries of current investor experience, how engaged asset management may become both in direct contact with end investors and in replacing traditional providers of saving solutions including pensions. The probably unknowns are in the speed of travel rather than the direction, with the ever-present imponderable as to how constraining inertia to necessary change may prove.

Finally, strategy must embrace the possibilities offered by innovation and technology which continues to develop at a phenomenal rate, and may not develop where it is most expected. Technological innovation is geographically neutral. Possible solutions imagined locally to specific challenges may become global by this very mobility of innovation. FinTech as a concept at the end of the day is as simple as a brain with an idea and the minimum technical facilities needed to translate idea to test bench to product. The only real limiting factor to innovation in the sector is the combined reticence of the established order and established stakeholders to change.

In addition to this innovative aspect to technological advance, there is the convergence of trends that have long been identified as potentially complementary, but which so far, have lagged behind when it has come to harnessing two potentially powerful forces—investment and global reach—into a single offering. Social media and mass reach internet based applications have intrigued promoters for many years already. The emergence of FinTech solutions to specific problems brings that junction of social media and investment management closer, and will almost inevitably result in significant joint progress in the near future.



2. The role of regulation

One of the catalysts for change in distribution patterns and even philosophy is as mentioned regulation. Several pieces of legislation or quasi legislative initiatives have come together to change the existing landscape and indicate the need for a new approach and open new opportunities.

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These include MiFID II² in several regards, and the broader context of gold plated MiFID II such as it applies to AIFMD³ and the implications of the passport; Capital Markets Union (CMU) and along with it ELTIFs⁴ and the potential reflection on extending the role of EuSEFs⁵ and EuVECA⁶ products as well as the EU Commission consultation on retail financial products⁷.

We see the role of regulation as a codifier, introducing within an accepted brand such as UCITS, notions of complex and non-complex with resulting impact on the client segment not only to whom they may be sold but also who may legitimately buy them, an encroachment by not even the state but the European Union per se in investors rights and obligations. We see the impact of the initial over-simplification inherent in classifying all Alternative Investment Funds as complex put into context, and called into question by a more accurate examination of product characteristics, driven at least in part by the desire and objective to allow ELTIFs to play the full role for which they were conceived. Regulation is beginning again to be an enabler, even a positive disruptive force; it remains to be seen just how far that positive energy can be harnessed to push the boundaries of fund distribution.

All of these legislative instruments, and others, will have an impact.

MiFID II is set to change the way we think of distribution in several ways:

In its simplest expression, MiFID II will modify existing distribution channels, although less so than national gold plated initiatives. It will certainly change the way distribution is remunerated and structured for certain segments. The ban on inducements for discretionary asset management and independent advice will probably have an impact on the products used in both services, and will be more far-reaching in countries with a culture of Independent Financial Advisers (IFA).

Certainly the implementation of MiFID II has been formally delayed with the issuance of the relevant legislative instrument. Nevertheless its content will not change, or will only change in detail and not in depth; distribution strategy needs more than ever to take into consideration its potential effect, both for MiFID II per se and for the broader context.

At the same time, growing complexity around advice and the need to demonstrate enhanced value to customers as a result of regulatory change, even within the context of tied or non-independent advice will inevitably put pressure on open architecture models, especially for that sector that previously combined discretionary asset management and advisory services in a single model and which derived not inconsiderable income from retrocessions.

2 http://ec.europa.eu/finance/securities/isd/mifid2/index_en.htm

3 http://ec.europa.eu/finance/investment/alternative_investments/index_en.htm

4 http://ec.europa.eu/finance/investment/long-term/index_en.htm

5 http://ec.europa.eu/finance/investment/social_investment_funds/index_en.htm

6 http://ec.europa.eu/finance/investment/venture_capital/index_en.htm

7 http://ec.europa.eu/finance/consultations/2015/retail-financial-services/index_en.htm

“MiFID II will change the way financial markets work in Europe fundamentally. To be ready for the challenges ahead market participants need a sound implementation strategy”

Markus Ferber,
MEP





AIFMD has also changed distribution by the added focus it has drawn toward the whole question of private placements

The jury is still out as to what the specifics of MiFID II implementation may look like with regard to permissible retrocessions or inducements and resulting business models, but it will certainly look different to what it is today. This effect will be accentuated where the basic notions are gold plated. It is likely also that the number of countries intending to gold plate may grow (especially with regard to execution only where there are increasing discussions about the ethical position of an execution only client finally paying more via a retrocession than other cases whereas in fine he is looking for the least service offering). It can also be expected that reflections similar to MiFID II will emerge in other parts of the world. Similar regulations exist in India, and are currently under discussion in South Africa, and the choices made are not always the same.

One of the issues that is exercising the attention of commentators and legislators alike is the creation of an advice gap. Research has shown that in the United Kingdom (UK) this has been one of the unintended consequences with a whole raft of investors effectively disenfranchised, and cut off from any form of advice, both because advice (previously funded opaquely through retrocessions) would be expensive to provide for this client segment and also because a part of the population is not prepared to pay for advice. This effect has been exacerbated by the coincidental UK pension reform that has left many savers with an investment “pot” at their disposal but no advice as to what to do with it. In many cases, this investment pot is being eroded by market movements which renders more urgent the review that is underway into this effect. A number of solutions have been proposed to help span this advice gap.

Similar considerations exercise minds on continental Europe where investors are simply not accustomed to pay explicitly for advice. It is a point that is expressly addressed in the proposals that are currently being put forward in South Africa (with the idea of a “cap” below which it would still be permissible to remunerate advice via what are considered in other cases as inducements). Gold plating as in RDR in the UK cannot be considered an unqualified success, irrespective of one’s view on inducements, if as a side effect it has effectively cut off a whole swathe of the population from financial advice especially at a time when pension change has so dramatically increased the number of impacted clients.

The most notable reaction to the general issue of how to finance distribution in the absence of traditional retrocessions was first found in the Netherlands. In this case, there is no perceptible intention to modify the terms of the current restrictions, and in answer to this we have seen the emergence of many “robo-advice” solutions—a trend that had already been developing rapidly in many different contexts from the United States to an increasing number of offerings in Europe. Linking neatly into the interest generated by FinTech in a number of contexts, robo-advice is likely to play an increasing role in distribution patterns to come.

- Robo-advisors employ algorithms such as Modern portfolio theory
- FinTech is a line of business based on using software to provide financial services.

Source: Wikipedia



Finally, and also in a context of technological innovation, some of the other notions encapsulated in MiFID II may prove of significantly greater value and scope with the passage of time than was perhaps originally envisaged or intended. The product governance measures were probably designed simply as a tool for investor protection, the assumption being that with precise target market transparency and evaluation requirements, there is less chance that an inappropriate product ends up in the “wrong hands”. However, as markets evolve, it will become apparent that future product governance and target market designation could take on a new meaning, extending to the means of distribution or the purpose of investment, rather than simply a geographical and market segmentation definition.

Target market may well be defined in the future as cross-border virtual retail, or long-term pension provision of which potential examples could be a global equity fund in the first case and infrastructure or real estate debt in the second.

AIFMD

AIFMD has also changed distribution by the added focus it has drawn toward the whole question of private placements. It has modified the landscape significantly for UCITS as well as for Alternative Investment Funds.

Hand in hand there has been the passport for professional investors which has for the most part performed well and at the same time added constraint in the distribution of non-UCITS. The limitation of the passport to the institutional or equivalent client segment has left a void; even a relatively superficial overview of AIFMD shows how it was conceived and initially drafted with hedge funds in mind. There is of course much more to the non-UCITS sector than hedge funds, including in many countries and in the cross-border universe, many non-UCITS retail schemes that fall outside UCITS for specific investment objectives, sometimes for flexibility, but that correspond to a very real need and demand from the retail and retail related sector.

AIFMD: Funds domiciled in the EU or sold to EU investors that are not UCITS



To some extent, these have been temporarily disenfranchised, and the complexity of distributing these products in different countries, depends entirely on individual Member State regulation and preferences. This, in conjunction with the MiFID II “complex— non-complex” qualification could significantly change both product and distribution possibilities going forward— restricting investor choice as we discuss elsewhere in some detail, with both direct and indirect effects (it is one of the paradoxes and unintended consequences alluded to previously that this is happening while work continues on the PRIIPs regulation which inter alia seeks to define European wide transparency standards for alternative funds when sold to retail investors when at the same time the selective passport in many cases closes down that opportunity).

There has been the additional unintended consequence that renewed focus on what is and is not permissible under National Placement Regimes has certainly resulted in certain “tolerances” being discarded and much more attention paid to the letter of existing or new restrictions.

The opportunity has been taken in some cases to reinforce restrictions or simply ban private placements within certain Member States, with a parallel result that the co-existence of private placement and passport for UCITS regimes, successfully circumventing some of the cost and administrative constraints to accessing specific client segments or geographies, has ceased to be an option.

Some of the most interesting aspects of AIFMD (and in parallel of the initial Green paper consultation on CMU) were the responses elicited as a result of the consultation on the functioning of the passport, and of private placements. Both consultations threw up a raft of evidence underlining the complexity of cross-border distribution.



These include but are not limited to cost, varying definitions of marketing, pre-marketing, additional disclosure obligations and a whole host of un-harmonized requirements and regulations that have limited the effectiveness of passports in creating a true internal market for investment funds, either those owing their origins to the internal market or imports from elsewhere in the world.

Furthermore, AIFMD introduced a certain expectation that at some future point—somewhere post 2018— there was a very real likelihood that the private placement for funds would become a thing of the past, a politically motivated aspiration that seems to owe its origins to a lack of perceived transparency in the wake of the financial crisis. Much of the strategic thinking that has gone into adapting to the implications of AIFMD, especially for non-EU managers or EU managers with non-EU product has been predicated on the expectation that the Private Placement may no longer be available per se at some point in the not too far distant future. This, however, is something that is increasingly questioned and which may be in contradiction of some of the aspirations of CMU.



Capital Markets Union (CMU)

Of all current or future regulation that affects distribution Capital Markets Union (CMU) may well be the one that has the potential to have the greatest impact. It sits astride the usual divide of regulation as a constraint and regulation as an enabler.

It is perhaps not strange that the traumatic events on 2008 have so fundamentally changed the way we think of legislation in Europe and the Western hemisphere, perhaps to a lesser extent in Asia and Australasia. We have gone through almost a decade of considering legislation and change to be by definition constraint, cost and limitation. We have almost lost sight of legislation in its primary purpose of enabler. It is hard today to remember that the first three iterations of UCITS were enablers—that the Investor Services Directive and MiFID II opened up the internal market for other financial services.

In Europe, that memory has been further pushed back and seems more remote with the subsequent Euro crisis adding to the woes of 2008 and underlining with austerity politics the already deflationary impact of crisis response—in economic, aspirational and innovative terms.

But this, prior to 2008, was the purpose of legislation. Both UCITS III and more specifically UCITS IV were designed to promote convergence and consolidation in the fund sector, designed to attract greater investment flows to a smaller number of funds to encourage the creation of a fund market element to capital markets more akin to that to be found in the United States and to some extent elsewhere such as Australia. UCITS IV in particular, with the exception of KIID provisions although not entirely excluding even those, was about things the markets were asking for, and nothing about constraining markets. It was about passports and cross-border mergers—even impacting the sacrosanct area of taxation (with respect to cross-border mergers) in an indirect way but one that is almost unique for that most sensitive of all subjects in the European context.

Capital Markets Union or CMU seeks to provide better access to financing for the EU's small and medium sized companies



The process of reaching out to national regulators in the search for harmonization and the removal of barriers has already started

It was about master feeders and simplified cross-border procedures to promote choice and facilitate flows. It says something that so much of this has slipped from our collective consciousness; it can perhaps be the most positive result of the current imposed reflection on change—in distribution and related areas—that these notions are once more accepted as being front and center to an intelligent and enlightened strategy for growth.

CMU is therefore positioned as an enabler, to capitalize on the solidity achieved via the years of rules based regulation in the interests of a growth strategy that will rely as much on light touch principles based enablement as additional detailed codification.

CMU starts from the simple premise of comparing capital markets; it poses the question as to why European capital markets provide so little of the Continent's requirements in financing, with that role occupied mainly by the banking system, whilst in other parts of the world and most notably in North America, capital markets predominate. Making the linkage between available savings in Europe and the needs of the economy, CMU postulates that significant growth could be stimulated in Europe by developing the internal capital market to facilitate greater access to direct financing by especially small and medium sized companies.

First and foremost, CMU looks to tackle impediments to the free circulation of capital within Europe and in a second reflection suggests ways and means to broaden or create a genuine internal capital market. It will do this in a three part process:

- In the first instance, it will examine impediments and where possible address them on a collaborative basis with Member States

- It will review recent regulation for coherence and where necessary, without bringing in fundamental change, it will address issues where legislation is not compatible or has thrown up unlooked for incompatibilities
- It will bring forward additional proposals to facilitate the cross-border distribution of investment products. The Retail Financial Services review is one part of this as is the focus on ELTIFs and their distribution and the reflection on how to expand the role of EuSEFs and EuVECA in contributing to the fabric of European cross-border investing.

The process of reaching out to national regulators in the search for harmonization and the removal of barriers has already started; would it be fanciful to see the recently announced simplification of German tax reporting requirements as an early result? That is as it may be; the tax initiative has already developed traction with the UK HMRC expressing an interest in a solution to replace current reporting which is seen as a constraint without equivalent identified benefit.

CMU is also looking to add liquidity to the financing of small and medium enterprises, especially unlisted companies, with a variety of potential measures to improve harmonization and presentation of corporate and credit information. It looks potentially to the securitization route as a possible solution. This will be combined with a review to assess how a pan-European private placement regime might also further this objective of funding the real, grass roots economy. This is one of the cases where existing legislation may not be strictly aligned with future aspirations; it is difficult to see why securitization should benefit from an enabling private placement regime when one of the most consistent and efficient means of financing SMEs—the private equity fund of all descriptions and horizons, should be partially cut off from such a regime unless domiciled and managed from Europe.



3. The longer term...

In considering the longer term and more ambitious possibilities that might both promote an internal capital market but also contribute significantly to the overall growth objective that was the starting point of the CMU and the overall objective of the current European Commission, the initiative looks at the issue of pension provision. This is potentially an area redolent of possibilities, if one that is likely to encounter significant reticence not to say opposition from existing structures, other stakeholders, political divergence and any number of any factors.

Put simply, countries that have either a mandatory or a highly incentivized savings or superannuation scheme in place firstly show a greater resilience in the private funding of retirement provision, which is hardly surprising, but also provide more efficient direct funding from savers to national small, medium and large cap companies, and contribute to the greater resilience of national markets in times of crisis. They also demonstrate less intuitive positive impacts such as rationalizing to greater or lesser effect the offering of suitable product—or in plain terms, contribute to the consolidation of fund products into fewer and more viable funds.

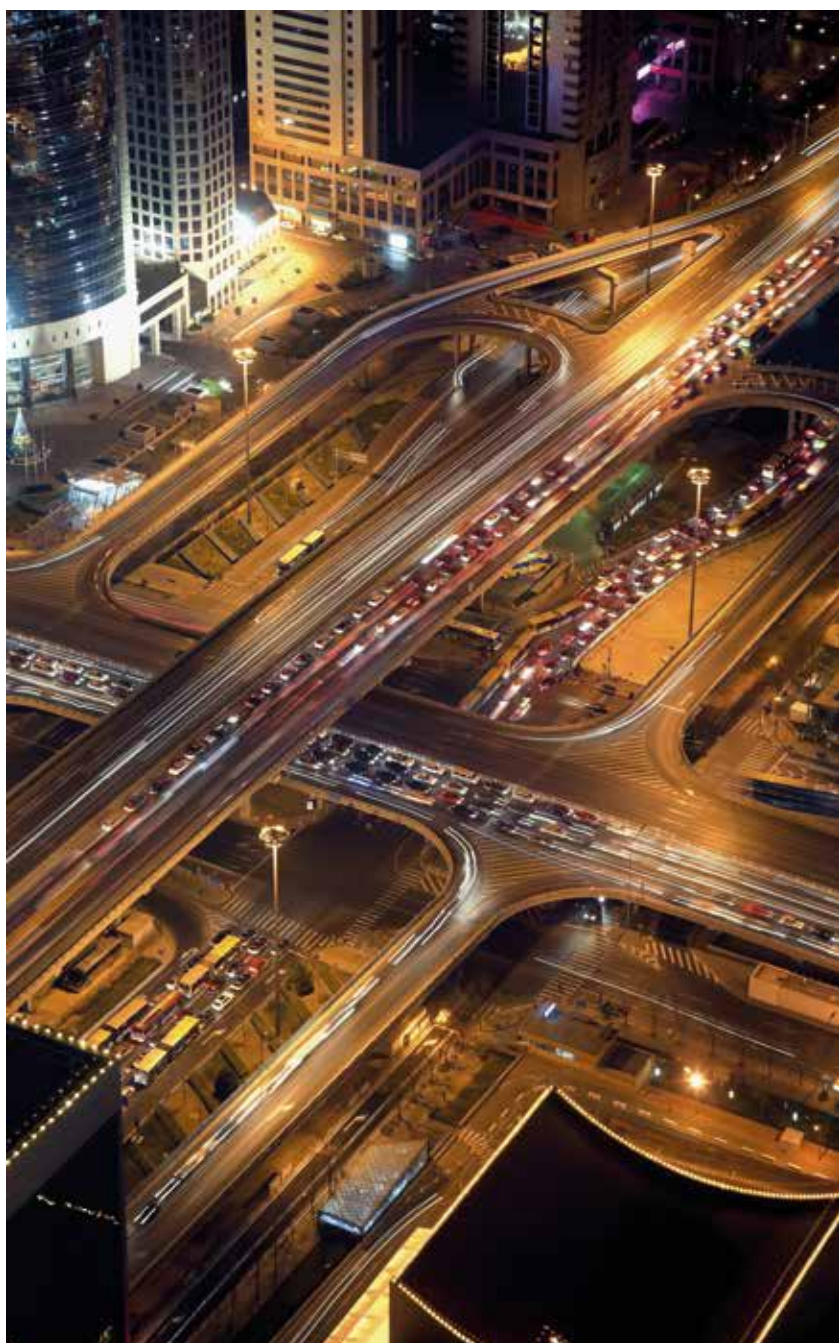
The first point is perhaps self-evident, if people are obliged to allocate a part of their income from employment to pension provision there will inevitably be greater take-up than any purely voluntary system, where serious interest in even the best of cases will only appear later in the employment cycle. The more successful of such schemes include features such as auto-enrolment.

A secondary impact around superannuation and unit linked schemes is also related to the interaction between asset management and insurance industries. Sometimes, in looking at statistics, there is a certain grey zone between the apparent institutional and retail take-up of investment funds and UCITS in particular. Statistics vary but in general it is accepted that there appears to be something of a “glass ceiling” around 10 percent for direct retail investment in UCITS⁸. At the same time, pension and insurance companies account for some 80 percent of product sold. It is one of the paradoxes of the sector that the greatest rival for retail attention, and competitor in the B-to-C space should also be the biggest customer, broadly speaking. In considering the role that asset management might play in pension provision, an issue that despite a worrying lack of progress exercises increasingly the attention of industry and co-legislators alike, there is not infrequently the suggestion that the role of asset management could be relegated to mandate management with transformation toward a form of unitization the preserve of the insurance product provider.

By removing the insurer from at least a part of the pension provision paradigm via a mandatory or heavily incentivized auto-enroll system, the incipient systemic risk is alleviated and the scheme becomes a useful financing tool at the same time resulting in more competitive pressure for appropriate charges and costs, and of course performance, in the complimentary insurance driven sector.

Within the schemes available for analysis, notably Australia which in many ways is held up as the “poster child” of retirement provision, there are secondary effects that are in themselves thought provoking. Not least among these is the surprising fact that there are only nine “default” funds within the system, adding to the powerful consolidating impact of the scheme in general, and that at least in part capacity was one of the reasons why Australian schemes began to open increasingly to investing in non-Australian assets. When one considers that in parallel to the proliferation of funds in Europe and the somewhat anomalous fact that of all major sectors European equities are one of those that show the greatest divergences in both performance and the capacity to create value via active management, then one begins to understand the extent that such schemes may benefit the long-term and efficient funding of the real economy.

Sometimes, in looking at statistics, there is a certain grey zone between the apparent institutional and retail take-up of investment funds and UCITS in particular





4. ...retirement provision in a deflationary environment

Another example worthy of study is Japan, and not least because Japan is further along the aging demographic curve than Europe and has been obliged to meet its attendant challenges over the last three decades or more in a largely deflationary environment, a fact that will not be lost on observers looking at current circumstances in Europe. The most noteworthy feature of the Japanese experience is that pension structures and savings continue into retirement in the phase of wealth creation and do not show an immediate switch from wealth creation to de-accumulation at a specific age.

There is much more that could be said in favor of the long-term pension aspirations of CMU; suffice perhaps to point to those elements already enumerated to suggest that this initiative could be a “game changer” not just for the distribution of investment funds, but for the overall European investment/savings landscape. Clearly some of the schemes considered go further than a mere portable pension plan that is envisaged under CMU. However, if the structure of such a plan is established, there is no reason why the incentive or mandatory element could not appear at some future point to leverage the infrastructure as a cost effective route to implementation.

Finally the European Commission’s consultation on Retail Financial Services further develops some of the themes addressed in the original Green Paper, and raised by respondents as impediments or needs.

These legislative initiatives and the reactions they cause must be seen in a demographic context. Demographics in terms of numbers, affluence and wealth are one thing, but they do not capture the sociological aspects of demographic change. Never has the generation “gap” been more relevant. Expectations, aspirations, even basic understanding and communications mean different things to generation Y than they did to the Baby Boomers—who in turn were already distanced from the wartime generation and the survivors of the depression. It will be interesting to see how the subsequent generation differs from Y. One only has to observe the efforts of a toddler in front of a current television screen, seeking to resize the image with its fingers to realize how far intuitive learning can lead expectations.

There will also be the influence of culture; the acquisition and enjoyment of wealth may well be a global aspiration; the acquisition of the essentials may be an imperative, but the context in which those aspirations are exercised is a result of many additional factors. Factors that become more and more relevant as asset managers look further for investment opportunities, especially de-correlated investment opportunities, and to sell investment products and solutions in diverse markets that were not open or functioning yesterday and that tomorrow will be seeking to acquire their own infrastructure and capabilities.

- Generation Y birth years ranging from the early 1980s to the early 2000s
- BRICS: Brazil, Russia, India, China, South Africa

Finally, there is the geo-political context. The end of the Cold War brought with it new certainties—collaboration and co-operation, at worst competition in place of confrontation. A world order where the developed world was increasingly challenged first by the BRICS with other emerging markets queuing up behind them and the dynamics of economic growth shifting basically from North to South—from old-developed to new-developed (or formerly emerging). Today those certainties have disappeared; we see once again major rift lines of confrontation but new ones, we see the complexity of the Islamic world, we see the maneuverings of the west and Russia in the context of both Europe and the Middle East—we see again the resurgence of political aims that are not necessarily limited to growth, and wealth and development. These factors will impact how and where product is distributed, and how it is made up. For the generation that went through the first several re-iterations of the oil shock, it is still slightly counter intuitive that current financial world stability, if not the world order, can be threatened by low oil prices.





5. The role of FinTech

Parallel to the various regulatory and other developments that we have examined, there has been the rise and increased focus on FinTech, FinTech as a solution—and as a future shaper of distribution.

It has been noted that one of the first responses to MiFID II was the appearance of robo-advisors in many different contexts—online applications designed to deliver solutions directly to clients (B-to-C) to reach out to clients without passing through distribution chains, and implicitly to draw clients to product through its capacity to deliver solutions corresponding to client requirements. The trend was with us before MiFID II or its national equivalents with many brokerage houses and fund promoters partnering with technology companies in developing offerings of different descriptions. What has been remarkable in recent months is the proliferation of such offerings, and the somewhat bewildering diversity of what robo-advice offers to deliver.

Some solutions, perhaps for the most common, offer solutions tailored to client requirements by quantifying these against a set of pre-determined criteria and matching them with a series of pre-defined solutions, both with a varying degree of dynamism and a universe and scope appropriate to the relevant offering. Others stop at offering a portfolio solution with less reference to personal experience or circumstances.

There is clearly a role for many variations on this theme, and if the amounts invested to date by these means remain modest, it is undoubtedly a trend set to develop.

The two aspects of this rise in robo-advice that are truly worthy of note and comment are the speed with which such solutions have proliferated and the regulatory context in which they are set to evolve. With regards to the speed with which these solutions are appearing it is interesting to note that in many cases they are responses to legislation that is still to be implemented. This underscores again, if there were need, the old

adage that markets will always lead legislation. Where perhaps that adage takes on a new meaning is if the legislative program of recent years has leant toward the repressive, there is a case to be made for innovation to be responsible to avoid the excesses that will inevitably attract the legislators attention should they result either in unfair outcomes for clients or put at risk the economy in which they evolve. Such solutions must be solutions in all respects and not cures for symptoms rather than causes.

This leads automatically to the second reflection and that is that these solutions will inevitably (unless arbitrarily debarred by Member States) evolve in a grey zone for the foreseeable future. The European Supervisory Authorities together under the chairmanship of the European Banking Authority have just launched a consultation on Automation in Financial Advice⁹; they are to be commended on the rapidity with which they have identified this area as one requiring rapid attention. That said, any legislation resulting from this consultation, which by definition will be broad and may present challenges similar to those encountered by PRIIPs in identifying an appropriate common ground, is at least a few years away. In the meantime, these solutions will evolve and be developed in the existing regulatory and disjointed framework.

It is ironic that we are still awaiting the implementation of the PRIIPs KID, and the final form of disclosure rules under MiFID II, and to some extent such things are partially obsolete. If FinTech solutions are to offer direct C-to-B access, but on differing terms, our need is more for a “robo-advisor” KID allowing the retail customer to accurately assess the scope, purpose, efficiency, appropriateness (and dare one add cost?) of the increasing proliferation of such offers than it is necessarily for the underlying products themselves. There is still much to be done.

⁹ https://www.eba.europa.eu/news-press/calendar?p_p_id=86_8_struts_action=%2Fcalendar%2Fview_event&_8_eventId=1299860





FinTech, however, goes well beyond the simple provision of automated advice and solution offerings.

Within the broad scope of Fintech mention must be made of both the revolutionary aspects of Blockchain and its philosophy and the possibilities this may open up when combined by other similar secure customer identification. Blockchain through secure shared registers offers transactional traceability down to client level with the client for the moment remaining the unshared cypher. It can of course be argued that the use of Blockchain is only possible by virtue of the limited take up that it has to date encountered; imagine for a moment what blockchain might look like if it were to carry a single days' Euro transactions let alone a historical record from the year dot. But for those who would see that as a reason not to consider blockchain and the undoubted adaptations, imitations, enhanced future versions as a part of the distribution landscape in the not that distant future, two reflections alone should give pause for thought. Data volume is a question of capacity. If there has been one constant since the world entered the computing age it has been the speed with which ever greater volumes of data have been accumulated, stored, and used. Blockchain meets Big Data.

And secondly the needs for secure efficient distribution are much more modest than those of a fully-fledged currency, yet another touch point in which the direct linkage of all economic activity to a banking system may not always be the optimal solution. One might quite easily envisage a Bitcoin like "cleared investment funds" where the initial traceable investment unit is created on adequate customer identification and that could evolve within the investment universe with full convertibility until pushed back into the mainstream currency network by market facing investment or dispersion. The key to these questions however is not simple plausibility – one may imagine all sorts of applications and uses, some almost within reach some as remote as manned space travel three centuries ago.



The key is recognising that it will not take three centuries for technology to advance to generate usable applications and more importantly that it will be up to the market, to producers and distributors to make judgement calls as to how innovation should be articulated around existing legislation. That legislation, almost by definition, will lag innovation. The paradox of paradoxes from the debate of rules based versus principles based legislation is that we have moved firmly into a rule based environment and yet we may yet prove dependent on principles based interpretations to stop short of innovative anarchy.

One example may be found within the somewhat starchy named "Savings and Investments Policy (TSIP) Project" in the UK. One of the initiatives within this project has seen Microsoft partnering with 40 city institutions in an initiative that has for objective the creation of a "digital" passport. The starting point for this reflection is the stark contrast between where retail banking and retail financial services are already, and where the savings and asset manager industry still loiters. It is possible in the UK (and in a number of other countries—the UK is used here as an example of a well advanced initiative but if successful it is likely to be emulated in other countries with a high take-up of self-service app usage) to apply for and obtain consumer credits entirely by modern media on the basis of electronic identification.

The same customer to open an account with an asset manager and to save via their products is faced with a marathon paper trail of documents, written applications, copies of identification documents etc.



Why—one should be no more complicated than the other?

It will be if the Digital passport takes off. It should be possible to define a digital passport sufficient to meet all the data requirements needed to allow investment—including AML/KYC data. Clearly, cyber security is high on the list of considerations in such a project, but the project is underway and the question is more when rather than if it will see the light of cyber-day. Once there, there is no reason why such a passport could not be extended to an internal market context.

The technology already exists for virtual distribution.

- Information, updated in real time in the form of a fact sheet may be delivered directly to a fact sheet
- Electronic wallets (without the application provider holding client funds) allow customers to access their bank accounts and make transfers and payments
- Digital passports are the subject of a collaboration between Microsoft and a number of UK City financial institutions—amongst other initiatives.

Very little is missing from this picture for a full virtual method of distribution, and that little something is something that even modest FinTech initiatives could reasonably be expected to provide.

It is one of the paradoxes of distribution that the increased focus on FinTech that has accompanied restrictions on the use of inducements to finance the distribution chain in financial products with a resulting negative impact on open architecture distribution models, may potentially be the catalyst for a genuine revolution towards total open architecture for investors and savers.

If we go back to some of the earlier reflections as to the potential impacts, and notably superannuation retirement schemes with auto-enrolment, it is not unrealistic to imagine that enrolment might be via the digital passport—it might even be the issuance of the digital passport and from there the process would be quasi automatic with contributions allocated via the passport to specific investment options (which could be followed, modified, topped up etc. via the relevant pension App) or the default option, through to allowing the de-accumulation phase and capital drawdowns or income payments. Far-fetched? As noted above, the technology basically exists, the aspiration via pension provision and wealth creation exists, the only reservation must be the genuine political will at national level to innovate to that extent and to break down vested bureaucracies and traditional solutions that whilst potentially less efficient, represent in the eyes of many the safeguard of the state.

If digitalization in a cyber-secure environment, can make the opening and operating of a savings account on a cross-border basis a reality, with adequate and appropriate customer identification, the industry will indeed have made a quantum leap forward.

It is a paradox that to a certain extent legislation designed to protect a small minority—the retail investor in funds, could be the catalyst to a significant expansion of genuine B to C business as a result of the solutions that the market introduces as its response, and solutions adapted to tomorrow's savers rather than today's!

If there is a conclusion to be drawn as to the role of FinTech in the future shape of distribution, it is probably that we have only just begun to scratch the surface as to the possibilities that it may potentially offer.



6. The client—the long road from caveat emptor to caveat venditor

Central to this whole debate and reflection is the “client”. We have considered the motivations, actions and intentions of the legislator and co-legislator. We have examined the aspirations of the product provider, of distribution channels, of the role and potential of technology, but at the heart of this whole reflection is the client.

How is the client served either by developments or by impending change?

It is probably true that throughout there has been a progression away from the principle of caveat emptor—to a certain extent “way back when” the client was considered as already being privileged to have access to a diversified investment whereas his or her total net worth would not normally be sufficient to construct such a portfolio individually. This has gradually changed over time to a clearer concept of shareholder rights; the advent of institutions as fund investors brought a scrutiny and focus on performance, relative and empirical that made the investing institutions de facto watch-dogs for all shareholders.

The trend has progressed to the point reached in the legislation discussed above and its direct predecessors where there is a huge focus on transparency, on providing clients with information, with indicative tools for comparative purposes (the SRRI in KIDs for example). Legislation addresses the issue not just of the cost but

in some ways of the quality of advice, determines even circumstances in which advice of some nature must be sought. Legislation only just stops short of the point where it could be accused of verging on the “nanny state” by deciding what is “good” and what is not for certain investors. It could be argued that unless it is corrected, the potential qualification of all AIF’s as complex would cross this threshold raising a whole new raft of philosophical and more importantly practical implications. While it does not draw back completely from this tendency to pre-determine what is “good” for the investor, the more recent indications of pragmatism rather than arbitrary classification as to what constitutes complexity is welcome even if it does potentially raise issues of its own. The current thinking is that the issue of complexity may be revisited along the lines that would be inherently welcomed from the considerations discussed; an AIF would not necessarily be “complex”.



This of course is to be welcomed if it makes it through the remaining re-iterations of this debate. At the same time it may cruelly expose the over-simplification of the complex— non-complex issue on UCITS as currently defined. Going further than the current differentiation would be difficult without re-opening the whole UCITS eligible assets debate which could be disastrous for the product's international profile. The pragmatic solution—doing away with that distinction and considering UCITS regulation to be sufficient, while enticing is unlikely. A compromise would seem inevitable.

To some extent that compromise, coupled with notions of suitability and appropriateness, looking back to an age of principles based regulation has its merits; implicitly it is those active in the distribution chain from manufacturer to final intermediary who would become responsible for outcomes related to the product sold. Unfortunately, as the situation stands, any compromise will be an uncomfortable half-way house between rules based regulation, itself it is to be feared sometimes inspired by misapprehension as to the nature of the product and its characteristics. And quid the direct retail investor accessing the market impersonally via a platform.

Certainly—and significantly—times have changed; in case of contention the weight of probability lies almost entirely with the client—of whatever nature, as the asset manager and distributor must be able to actively demonstrate compliance and intent to comply with the letter and spirit of investor protection measures and with the concepts of always acting in the best interests of the investor.

The promoter and distributor
must take care in what
they sell and to whom.
Caveat emptor to caveat
venditor indeed



Robot advisors, a digital passport, the ability of FinTech to design Apps and tools that can collate, gather and compare significant amounts of data can make the most impact

It would not be surprising to see an increase in class actions and the like for perceived or real shortcomings on the part of product promoters, managers and distributors alike and certainly there is a heightened consciousness amongst them of this litigation risk weighing over them. This is in addition to strengthened and increasingly harmonized sanctions regimes that tend toward the upper spectrum of the severity scales.

The promoter and distributor must take care in what they sell and to whom. Caveat emptor to caveat venditor indeed.

But is it even accurate to talk of the “client” as a concept when there is such manifest diversity in nature, geography, culture and expectations? In considering distribution we have touched upon direct retail, we have touched upon institutional on behalf of retail, a wide range of possible definitions of “client”. The case is a difficult one to make until one considers that there is in many cases an expectation that the same product—the same fund—can in one or other of its declensions meet the requirements of several or all of these categories. In reaching that conclusion, the importance of the MiFID II requirement for a target market definition takes on a new relevance, and within the overall context of examining how product will be distributed in the future, client segmentation will become more important and the client experience different per segment. The notion of “one size fits all” is probably further from what is required today than ever before even if in terms of pure product that is the baseline.

The client experience, at whatever level, is still missing something essential. Information, possibly more information than can be readily absorbed, is available and must be provided. But that information is on a case by case basis. It is about quantifying and evaluating elements that have already been selected by whatever process has been involved. Unfortunately it is not about choice. As of today, and this is something that reaches across client segments, whereas there is transparency at product level, there is little transparency as to choice.

This applies equally to straightforward product as it does to packaged products; it also applies to likely outcomes. Indeed, the impact may even be more pernicious than just an absence of assistance or—dare one use the term—advice. In the absence of advice, the transparency that is offered to the client may be misleading—the focus on costs and charges for example. While this information is essential and relevant it is not a sole criteria. The emphasis may lead the unassisted to conclude otherwise, especially in the absence of any long-term statistical comparisons of asset class returns.

One can trace a similar theme back, somewhat surprisingly, to institutional investors. The very existence, without going into the significance of the role of fund selectors is evidence in itself of a need to identify a target universe long before one can get down to the nuts and bolts of choice.



Too much information is no information and in some ways—by inundating the client in apparent disclosure—one is almost putting him back where all the onus of decision is back with him, and up to him or her to decide. The legislator has done his job by making all this information mandatory, and the promoter and distributor has provided it. That has a distinct feel of caveat emptor about it again.

It is perhaps in this area that the forces at work today can move distribution to a new and higher level. Robot advisors, a digital passport, the ability of FinTech to design Apps and tools that can collate, gather and compare significant amounts of data can make the most impact. By combining such access with digital identification, a meaningful B-to-C construct can be imagined. This would potentially have the additional advantage of shortening the distribution chain and alleviating the need to remunerate multiple intermediaries in the delivery of a single product.

Perhaps one of the solutions that is not infrequently advanced as a palliative to the various difficulties encountered around cross-border registration and delivery—the idea of central registration—could be delivered by such means and intriguingly, rather like the potential once in place for a portable pension plan to become a default option, the extra-territoriality of central registration, accessed via cyber-secure applications of the type currently being envisaged, with appropriate selection criteria could overcome those national inconsistencies that seem to spring up as soon as one aspect of the whole conundrum is harmonized.

The moral hazard in this approach is that the solutions proposed can take on a mantle of automated legitimacy that far from enhancing and facilitating investor choice can in effect impose solutions on the client. It has previously been indicated that if we take to its logical conclusion, within a mandatory retirement scheme with auto-enrolment and default choices, direct debit and automatic investment, the individual is effectively cut-out of his or her own private pension provision. The question then remains as to what entity should be the arbiter of the judgmental element of any criteria used in automated solutions, the universe included, the elected outcomes etc. It will be interesting to see where the ESA consultation on this subject finally ends up.

Regulation coming in conjunction with technology-driven solutions will potentially bring asset management and its products into greater proximity with its clients. That proximity will most probably be of greater relevance to the more recent and next generation of savers. The industry; producers, promoters, distributors, legislators and regulators alike must remain attentive that the needs and preferences of that part of the population in most need of assistance—today's aging population rather than tomorrow's—are not disenfranchised. The combination of the two forces represents the clearest opportunity to date of bringing trends that have been long defined—social media and investment—together in.

The client dynamic in successful distribution going forward will be more than ever "know your client".



7. Designing a distribution strategy for tomorrow—the do's and don'ts

Distribution is changing, that is inevitable. It will change in many different ways. Some ways may be small, such as the gradual removal of impediments with regard to marketing and reporting or certain costs.

Some of the changes will be significant and may be considered enablers to a much greater impact on financial markets and the fabric of society. It may open the door to superannuation like schemes in more European Member States or even a European wide pension scheme.

The drivers for change will be manifold—technology, legislators, unintended impacts, demographic and generation change. These will combine, sometimes in unexpected ways, to bring the citizen closer to the “financial world” and fuel present and future growth through the provision of meaningful returns for savers.

By questioning the established order—MiFID II opens the debate. In seeking growth, CMU extends the scope. In search of success, FinTech offers solutions. And in the center Asset Management, passive or active, local or global, remains the cornerstone of the edifice, with both the building blocks and the architecture needed to complete the project. Complete? Perhaps not, as the future is ever changing, but at the very least to offer those possibilities without which society will slip back instead of progressing.

At the end of the day, the acid test for any reflection such as this must be the question “so what?”

One might be forgiven for thinking that distribution is essentially about moving product today and adapting to change as and when it comes tomorrow. However, with all the dynamics that have come into play, regulatory, technological, social even, that procrastination seems an increasingly inadequate response. Tomorrow's distribution will be a very different activity to today's. Some things certainly will go on as business as usual, but others will be radically different. Other sectors will be looking to eat what today we think of as the investment funds “lunch”. Technology and regulatory change could potentially create an entirely new paradigm; this will not happen in isolation, nor without opposition and competition, and the speed of change and innovation as we have seen in the case of robo-advice, is accelerating.

All the pieces are on the chess board, and they are being moved. For the industry not to participate in shaping that change would be at best an appalling loss of an opportunity, and at worst the risk of seeing one of the most efficient investment solutions available marginalized by competition or lack of ambition.

Distribution is as ever a specialist and complex subject; understanding its mechanics as well as its dynamics in a cross-border world requires effort, intelligence, and expertise. But today distribution also has the capacity to shape the future as well as adapt to it. That surely is a goal worthy of our time and efforts.

Key highlights

Building a Distribution Strategy

- Recognize the timeline MiFID II is still two years away
 - Two years to build brand recognition
 - Two years to build track record
 - Two years to build critical mass
 - Two years to build performance

These basics have not changed: the environment has changed.

- Complexity – with a small ‘c’ will punish vague strategies
- The Real costs of inefficient and non-performing products will distract focus more than ever before
- Rationalise a fund range with a precise idea of today’s target market and tomorrows
- Look at product as a solution – and speak the client’s language

Engage with Fund selectors – Robo as well as flesh and blood

- Engage with specialists – understand fragmentation
- One product can be the building block for much but
 - How it is wrapped, sold, used can be multiple
 - There is a world outside Europe

Markets are fragmented – regulation is accentuating this

- Don’t fight regulation – understand it
- Don’t fight regulation – shape it
- Don’t fight regulation – use it
- Know your markets
- Understand the constraints
- If in doubt – don’t
- Distribution is as much about intelligent compliance as sales.
- Funds do not sell themselves nor are self-select investments without risks.
- Don’t use buzz-words – understand them
 - The same term can cover a multitude of sins – and opportunities

Above all understand your customers

- A product is sold – and next year must be sold all over again
- A solution is for life and beyond
- Asset management is part of the solution not the problem
- Innovation is change
- Technology is innovation
- The only constant is change
- For solutions change is to be found in continuity.
- And technology will bring tomorrow’s solutions for tomorrow’s generations into today’s world.
- The TER is not just cost – it should also be
- Transparency
- Efficiency
- Responsibility

List of abbreviations

AIF	Alternative Investment Funds
AIFMD	Alternative Investment Managers Directive
AML	Anti-Money Laundering
AUM	Assets Under Management
BAU	Business As Usual
B2C	Business to Customer
BRICS	Brazil, Russia, India, China, South Africa
CMU	Capital Markets Union
CRD	Credit Rate Derivatives
ELTIF	European long-term investment funds
ESMA	European Securities and Markets Authority
EMIR	European Market Infrastructure Regulation
EuSEFs	European Social Entrepreneurship Fund
EuVECA	The European Venture Capital Fund Regulation
FCA	Financial Conduct Authority
FinTech	Financial technology: is a line of business based on using software to provide financial services
Generation Y	Generation Y birth years ranging from the early 1980s to the early 2000s
IFA	Independent Financial Advisers
KIID	Key Investor Information Document
KYC	Know-Your-Customer
MIFID II	Markets in Financial Instruments Directive II
MIFIR	Markets in Financial Instruments Regulation
NPR	National Placement Regime
PE	Private Equity
PF (US)	Private Funds
PPR	Private Placement Regime
PRIIPS	Packaged Retail And Insurance-Based Investment Products
RE	Real Estate
SME	Small & Medium Enterprises
SRRI	Synthetic Risk and Reward Indicator
TSIP	Savings & Investments Policy Project
UCITS	The Undertakings for Collective Investment in Transferable Securities
UK HMRC	UK Her Majesty's Revenue and Customs

“In terms of cross-border distribution, both inside and outside the EU, investment single market but there is still room for improvement. Asset managers therefore warmly welcome Commissioner Hill’s commitment to remove unwarranted barriers in this area, as part of the CMU action plan”

Peter de Proft,
Director General of EFAMA

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